**MS 105**

# Business Environment

**Volume I**

**Block I Macro Economic Concepts and Macro Environment**

**Block II Economic Reforms and Industrial Policy**

## UTTARAKHAND OPEN UNIVERSITY

**SCHOOL OF MANAGEMENT STUDIES AND COMMERCE**

**University Road, Teenpani By pass, Behind Transport Nagar, Haldwani- 263 139**

**Phone No: (05946)-261122, 261123, 286055**

**Toll Free No.: 1800 180 4025**

**Fax No.: (05946)-264232, e-mail: info@uou.ac.in, som@uou.ac.in**

**http://www.uou.ac.in**

**www.blogsomcuou.wordpress.com**

## Board of Studies

**Professor Nageshwar Rao**
**Vice-Chacellor,**
Uttarakhand Open University
Haldwani

**Professor R.C. Mishra**
**Director**,
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani

***Professor Neeti Agarwal***
Department of Management Studies
IGNOU, New Delhi

***Dr.L.K. Singh***
Depatment of Management Studies,
Kumaun University, Bhimtal

***Dr. Abhradeep Maiti,***
Indian Institue of Management,
Kashipur

***Dr. K.K. Pandey,***
O.P. Jindal Global University,
Sonipat

***Dr. Manjari Agarwal***
Department of Management Studies
Uttarakhand Open University, Haldwani

***Dr. Gagan Singh***
Department of Commerce
Uttarakhand Open University, Haldwani

***Dr. Sumit Prasad***
**Assistant Professor,**
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani

**Programme Coordinator**

***Dr. Manjari Agarwal***
Assistant Professor, Department of Management Studies
Uttarakhand Open University, Haldwani



| **Units Written by** | **Unit No.** |
| --- | --- |

**Dr. Sunil Purohit**
M.Sc., LL.M., MBA, Ph.D., FICCE
**Adv. Sandhya Purohit**
M.A. (Economics), LL.B.

**Editor**

***Er. Sumit Prasad***
Assistant Professor,
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani



| | |
| --- | --- |
| **ISBN** | **: 978-93-85740-11-4** |
| **Copyright** | **: Uttarakhand Open University** |
| **Edition** | **: 2016 (Restricted Circulation)** |
| **Published by** | **: Uttarakhand Open University, Haldwani, Nainital – 263 139** |
| **Printed at** | **: Himalaya Publishing House Pvt. Ltd** |

# SYLLABUS

**Course Name: Business Environment**

**Course Code: MS 105**

**Course Credits: 6**

**Course Objective:**

This course aims at providing students the knowledge of basic framework and intricacies of Indian and International business environment.

## Block I Macro Economic Concepts and Macro Environment

| | |
|---|---|
| Unit I | Contemporary Global and Indian Environment |
| Unit II | Consumerism and Business |
| Unit III | Macro Economic Environment and Modern Theories of Economic Growth |
| Unit IV | Aggregate Demand and Supply |
| Unit V | Inflation |
| Unit VI | Unemployment |

## Block II Economic Reforms and Industrial Policy

| | |
|---|---|
| Unit VII | Economic Reforms in India |
| Unit VIII | Economic Planning in India and New Economic Policy |
| Unit IX | Industrial Policy and Industry Licensing |

## Block III Industrial Financial Institutions

| | |
|---|---|
| Unit X | Public Sector Enterprises and Small and Medium Enterprises |
| Unit XI | Industrial Financial Institutions: IDBI, IFCI, ICICI, IRBI, SFC |
| Unit XII | Institutions for Investments and Small Industry: UTI, LIC, GIC, SSIDC, SIDBI and Commercial Banks |

## Block IV Foreign Polices and Globalisation

| | |
|---|---|
| Unit XIII | Foreign Trade: Theories, Issues and Modern Context |
| Unit XIV | FDI and FII |
| Unit XV | Foreign Exchange Rates and Foreign Exchange Markets |
| Unit XVI | Globalisation, Liberalisation and Privatisation |
| Unit XVII | Regional Trading Blocks |
| Unit XVIII | World Trade and Emerging Environment |

# CONTENTS


| | Block I: Macro Economic Concepts and Macro Environment | |
|---|---|---|
| **1.** | **Contemporary Global and Indian Environment** | **1 – 25** |
| | 1.1 Introduction<br>1.2 Meaning and Definition<br>1.3 Business Environment<br>1.4 The General Environment i.e., External Environment<br>1.5 Scope<br>1.6 External Environment<br>1.7 External Micro Environment: Factors<br>1.8 External Macro Environment: Factors<br>1.9 Internal Environment<br>1.10 Summary of the Unit<br>1.11 Glossary<br>1.12 Key Terms<br>1.13 Check Your Progress (Multiple Choice/Objective Type Questions)<br>1.14 Key to Check Your Answer<br>1.15 Terminal and Model Questions<br>1.16 Reference Books | |
| **2.** | **Consumerism and Business** | **26 – 33** |
| | 2.1 Introduction<br>2.2 Responsibilities of Business<br>2.3 Summary of the Unit<br>2.4 Glossary<br>2.5 Key Terms<br>2.6 Check Your Progress (Multiple Choice/Objective Type Questions)<br>2.7 Key to Check Your Answer<br>2.8 Terminal and Model Questions<br>2.9 Reference Books | |
| **3.** | **Macro Economic Environment and Modern Theories of Economic Growth** | **34 – 54** |
| | 3.1 Introduction<br>3.2 Economic Growth<br>3.3 Development<br>3.4 Critical Elements<br>3.5 Money<br>3.6 Global Trade Environment<br>3.7 Host Countries<br>3.8 Meaning and Definition of Inflation<br>3.9 Features of Inflationary Economy<br>3.10 Summary of the Unit<br>3.11 Glossary<br>3.12 Key Terms<br>3.13 Check Your Progress (Multiple Choice/Objective Type Questions) | |

|  |  |  |
|---|---|---|
|  | 3.14 Key to Check Your Answer<br>3.15 Terminal and Model Questions<br>3.16 Reference Books |  |
| **4.** | **Aggregate Demand and Supply** | **55 – 74** |
|  | 4.1 Aggregate Demand<br>4.2 Aggregate Supply<br>4.3 Macroeconomic Equilibrium<br>4.4 Changes in Aggregate Demand or Aggregate Supply<br>4.5 Factors Affecting Aggregate Supply and Aggregate Demand<br>4.6 Wealth and Wealth Expectations<br>4.7 Government Demand and Taxation<br>4.8 Demand-Supply and Employment<br>4.9 Summary of the Unit<br>4.10 Glossary<br>4.11 Key Terms<br>4.12 Check Your Progress (Multiple Choice/Objective Type Questions)<br>4.13 Key to Check Your Answer<br>4.14 Terminal and Model Questions<br>4.15 Reference Books |  |
| **5.** | **Inflation** | **75 – 94** |
|  | 5.1 Introduction<br>5.2 Inflation – Index<br>5.3 Prices as Measures of Inflation<br>5.4 Inflation and Developing Economies<br>5.5 Demand-pull vs. Cost-push Inflation<br>5.6 Causes of Inflation<br>5.7 Effects of Inflation<br>5.8 Control of Inflation<br>5.9 Summary of the Unit<br>5.10 Key Terms<br>5.11 Check Your Progress (Multiple Choice/Objective Type Questions)<br>5.12 Key to Check Your Answer<br>5.13 Terminal and Model Questions<br>5.14 Reference Books |  |
| **6.** | **Unemployment and Employment in India** | **95 – 102** |
|  | 6.1 Introduction<br>6.2 Growth of Employment in India: A Case of Jobless Growth<br>6.3 Summary of the Unit<br>6.4 Glossary<br>6.5 Key Terms<br>6.6 Check Your Progress (Multiple Choice/Objective Type Questions)<br>6.7 Key to Check Your Answer<br>6.8 Terminal and Model Questions<br>6.9 Reference Books |  |

| | Block II: Economic Reforms Industrial Policy | |
|---|---|---|
| **7.** | **Economic Reforms in India** | **103 – 111** |
| | 7.1 Introduction<br>7.2 Tax Reforms<br>7.3 Summary of the Unit<br>7.4 Glossary<br>7.5 Key Terms<br>7.6 Check Your Progress (Multiple Choice/Objective Type Questions)<br>7.7 Key to Check Your Answer<br>7.8 Terminal and Model Questions<br>7.9 Reference Books | |
| **8.** | **Economic Planning in India and New Economic Policy** | **112 – 126** |
| | 8.1 Introduction<br>8.2 Domain of Public Finance<br>8.3 Basic Concepts<br>8.4 The International Monetary Fund<br>8.5 Economic Reforms and Control of Inflation<br>8.6 Economic Reforms and Their Impact on Poverty<br>8.7 Economic Reforms and Employment<br>8.8 Economic Reforms and Foreign Investment<br>8.9 Economic Reforms and India's External Debt<br>8.10 Economic Reforms and India's Foreign Trade<br>8.11 Neglect of Agriculture — The Major Sin of Economic Reforms<br>8.12 Summary of the Unit<br>8.13 Glossary<br>8.14 Key Terms<br>8.15 Check Your Progress (Multiple Choice/Objective Type Questions)<br>8.16 Key to Check Your Answer<br>8.17 Terminal and Model Questions<br>8.18 Reference Books | |
| **9.** | **Industrial Policy and Industry Licensing** | **127 – 153** |
| | 9.1 Introduction<br>9.2 Foreign Investment Promotion Board (FIPB)<br>9.3 Project implementation<br>9.4 Impact of Industrial Policy 1991<br>9.5 Government – Machinery for Indian Industrial Economy<br>9.6 Overview of new Industrial Policy of 1991 in India<br>9.7 New Industrial Policy of 1991<br>9.8 Summary of the Unit<br>9.9 Glossary<br>9.10 Key Terms<br>9.11 Check Your Progress (Multiple Choice/Objective Type Questions)<br>9.12 Key to Check Your Answer<br>9.13 Terminal and Model Questions<br>9.14 Reference Books | |

## Block I: Macro Economic Concepts and Macro Environment

# UNIT 1 CONTEMPORARY GLOBAL AND INDIAN ENVIRONMENT

### Structure:


1.1 Introduction

1.2 Meaning and Definition

1.3 Business Environment

1.4 The General Environment i.e., External Environment

1.5 Scope

1.6 External Environment

1.7 External Micro Environment: Factors

1.8 External Macro Environment: Factors

1.9 Internal Environment

1.10 Summary of the Unit

1.11 Glossary

1.12 Key Terms

1.13 Check Your Progress (Multiple Choice/Objective Type Questions)

1.14 Key to Check Your Answer

1.15 Terminal and Model Questions

1.16 Reference Books


### Objectives

After reading this Unit, you will be able to:

- Define environment.
- Classify complex structure of environment.
- Understand critical elements.

NOTES

- Analyse Indian and global perspectives.
- Explain the impact of 'influences' on business.

## *1.1 INTRODUCTION*

Every business organisation has to interact and transact with its environment. Hence, the business environment has a direct relation with the business organisation. The effectiveness of interaction of an enterprise with its environment determines the success or failure of a business.

The environment imposes several constraints on an enterprise and has a considerable impact and influence on the scope and direction of its activities. The enterprise, on the other hand, has a very little control over its environment. The basic job of the enterprise, is to identify the environment in which it operates and to formulate its policies in accordance with the forces which operate its environment. Every business organisation has to tackle its internal and external environment. For example, a committed labour force provides an internal environment of any business, whereas the ecological factors determine the external environment. While the internal environment reveals an organisation's strengths and weaknesses, the external environment reflects the opportunities available to the organisation and the threats it faces.

India has a developing economy with abundant natural resources, large population, and a low level of per capita national income. Although a substantial liberalisation has been envisaged for the country, the economic activities are still considerably controlled by the government. A low standard of living, backed by a vicious cycle of poverty, for a considerable section of population and about 250 million people under the poverty line, coupled with a considerable concentration of economic power in few hands, characterise the Indian economy.

The environmental factors varies from country to country hence, we must learn the local, regional, national and international environment of business.

## *1.2 MEANING AND DEFINITION*

"Environment" literally means the surroundings, external objects, influences, or circumstances under which someone or something exists. Keith Davis defines the environment of business as "the aggregate of all

NOTES

conditions, events, and influences that surround and affect it" (Davis and Blomstrom 1971).

## *1.3 BUSINESS ENVIRONMENT*

Thus, the term "environment" refers to the totality of all the factors which are external to and beyond the control of individual business enterprises and their managements. *Environment furnishes the macro-context*, the *business firm is* the *micro-unit*. The environmental factors are essentially the "givens" within which firms and their managements must operate. For example, the value system of society, the rules and regulations laid down by the Government, the monetary policies the institutional set up of the country, the ideological believes of the leaders, the attitude towards foreign capital and enterprise, *etc.*, all constitute the environment system within which a business firm operates. These environmental factors are many in numbers and various in form. Some of these factors are totally static, some are relatively static and some are very dynamic – they are changing every 'now and then'. Some of these factors can be conceptualised and quantified, while other can only be referred to in qualitative terms. Thus, the environment of business is an extremely complex phenomenon.

### Global

The environmental factors generally vary from country to country. The environment that is typical of India may not be found in another countries like the USA, the (former) USSR, the UK, and Japan. Similarly, the American/Soviet/British/Japanese environments may not be found in India. There may be some factors in common, but the order and intensity of the environmental factors do differ between nations. What to say of countries, the magnitude and direction of environmental factors differ over regions within a country, and over localities within a region. Thus, one may talk of local, regional, national (domestic) and international (foreign) environment of business. For example, the local custom of *"coolie"* (labour), the climate of the northern region of Assam, the policies of the State and Central Governments in India and the size of the world market: all these factors together will have an important bearing on tea industry. The production, consumption and marketing of tea will be affected by environmental factors.

NOTES

The environment differs not only over space but also over time within a country. As such, we can talk of temporal patterns of environment, i.e., past, present and future environment. Future environment is the product of past and present environments. The Indian economy of tomorrow will be influenced by what the state of the economy is at present and what it was in the past.

Sometimes, the environment may be classified into market environment and non-market environment depending upon whether a business firm's environment is influenced by market forces like demand, supply, number of other firms and the resulting price competition, or non-price competition, etc., or by non-market forces like Government laws, social traditions, etc.

Finally, we may classify the environment into economic and non-economic. Non-economic environment refers to social, political, legal, educational and cultural factors that affect business operations. Economic environment, on the other hand, is given shape and form by factors like the fiscal policy, the monetary policy, the industrial policy, physical limits on output, the price and income trends, the nature of the economic system at work.

Meaning the Environment is boundless. It is a complex question where the environment of a business starts, or where the boundaries of a business environment ends. Any meaningful organisation has certain mission, objectives and goals and a strategy to achieve them. Indeed, the mission and goals themselves should be based on an assessment of the external environment and the organisational factors. The survival and success of a firm, thus, depend on two sets of factors, *viz.*, the internal factors and external factors. However, the term business environment, often refers to the external factors.

Environment refers to all external forces which have a bearing on the functioning of the business. Business environment refers to those aspects of the surroundings of business enterprise which affect or influence its operations and determine its effectiveness.

*"The environment of a company is the pattern of all external influences that affect its life and development".*

— Andrews

The environment poses threats to a firm or offers immense opportunities for exploitation. Stressing this aspect,William F. Glueck and Lawrence R. Jauch wrote thus: *"The environment includes factors outside the firm*

NOTES

*which can lead to opportunities for or threats to the firm. Although there are many factors, the most important of the factors are socio-economic, technological, supplier, competitors and government".*

Since the business environment is always capable of producing major shocks and surprises, the success of a business enterprise depends on its alertness and adaptability to changes in the environment.

It may be difficult to develop a neat classification of environmental types because of considerable overlap from one type to the other. However, it is not difficult to appreciate that there are certain factors which affect the whole class of organisations, where they are broadly called as the *External Environment.*

Whereas, the other factors which affect a particular organisation, in this case they are called as the task specific or *Internal Environment*.

*Internal factors* are those which affect a particular firm and are generally regarded as controllable factors because the company has control over these factors; it can alter or modify such factors as its personnel, physical facilities, organisation and functional means, such as marketing mix, to suit the environment.

The external factors on the other hand, are by and large beyond the control of a company. The factors included under this category are the economic factors, socio-cultural factors, government and legal factors, demographic factors, technological factors, ecological and educational factors, geophysical factors, *etc.*, are therefore, generally regarded as uncontrollable factors.

The environmental factors may be classified into three different levels:

- Internal environment.
- Micro environment/Task environment/Operating environment. These are very close to organisation.
- Macro environment/General environment/External environment.

Some of the external factors have a direct and intimate impact on the firm such as the suppliers, customers, workforce of the firm. These factors are classified as Micro environment, also known as the Operating environment. There are other external factors which affect an industry very generally like socio-economic, technological, Government and legal factors, etc. They constitute as Macro environment/External environment.

NOTES

The important internal factors which affect the strategy and other decisions are explained.

## (a) Mission and Objectives

The business priorities, the direction for the development, its philosophy and policies, *etc.*, are guided by the Mission and Vision of the company. Where mission indicates the overall philosophy for which the company stands, objective or goal refers to the operational side of the business. The Mission statement, when translated into figures indicating yearly budgets, we have the company's goals. A series of such yearly goals, when achieved, give the statement its relevance.Vision speaks of futuristic ideology.

Ranbaxy's thrust into the foreign markets and development have been driven by its mission *"to become a research based international pharmaceutical company"*.

Company sets the objectives and mission depending on its strengths, weaknesses, opportunities and threats to its operation. For example, the environment may provide many opportunities but a company might not have the strengths to exploit all the opportunities. Here a case relating to 'Raymond' can be referred as under:

**Raymond Case**

Raymond has been a well-known fabric brand in India.The Raymond Ltd. over time had made significant investments in process oriented businesses such as cement, steel and polyester FIBRE, besides textiles.

Gautam Hari Singhania, who took over from Vijaypat Singhania as chairman and managing director in 1998, sought to put Raymond on a strong footing, restructuring its business portfolio based on a SWOT analysis. So, in early 1999, says Singhania, "we started looking at our business portfolio, and decided where we wanted to be as compared to where we are today. We decided there were three areas that the company did not want to be in, in our long-term strategy. One was filament yarn, the second was cement, and the third, steel." These businesses were either not giving adequate returns or were making losses.The company also did not have the expertise to run these units. Raymond, therefore, pulled out of these businesses and decided to focus on the core business of textiles and readymade apparel.

The divestment of these three businesses brought in about ₹ 1,100 crore. Out of this, ₹ 291 crore was used to repay outstanding debt and this helped

NOTES

to substantially reduce the interest burden. The company also spent around ₹ 158 crores for buying back shares through the open market route and this increased the Singhania's share in the Raymond from 27% to 31%. The company has been left with a large amount for investment for developing the existing core business or entering into new businesses (including acquisition).

In Singhania's vision, Raymond must turn itself into a clean and efficient company, before striking out to conquer new territory overseas. While Raymond claims to be among the top three fabric brands in the world in integrated worsted (wool-blended) fabrics, it certainly isn't a household name anywhere except South Asia. "The endeavour is to make it a truly global brand," says the chairman.

## (b) Value System

The value system and ethical standards are also among the factors evaluated by many companies in the selection of suppliers, distributors, collaborators, *etc.* It is widely acknowledged fact that the extent to which the value system is shared by all in the organisation is an important factor contributing to success.

The value system of JRD Tata and the acceptance of it by others who matter were responsible for the voluntary incorporation in the Articles of Association of TISCO its social and moral responsibilities to consumers, employees, shareholders, society and the people.

## (c) Power

Business has vast resources at its command.These resources like money, men, material, *etc.*, confer enormous economic and political power on owners and managers of business ventures.

Factors like the amount of support, the top management enjoys, from different levels of employees, shareholders and board of directors have important influence on the decision and their implementation.

Several enlightened businessmen have used their power for the betterment of the society. It is hard to imagine what would have happened to the industrial map of our country if J.N. Tata had not taken keen interest to industrialise India.

NOTES

## (d) Human Resources

Concern for employees continues to be an important aspect of Management. Caring for employee satisfaction and providing for their development has been one of the objectives of enlightened business enterprise as they could contribute to the strength and weakness of an organisation.

The organisation culture and overall environment have bearing on the characterstics of the human resources like morale, commitment, attitude, involvement *etc.* The skill and quality of personnel is considered to be one of the hallmarks of best managed and highly respected companies.

As per the new concept 'knowledge workers' are very important for selling a brand image and large market share. The talent pool and not mere quantity of employees decides.

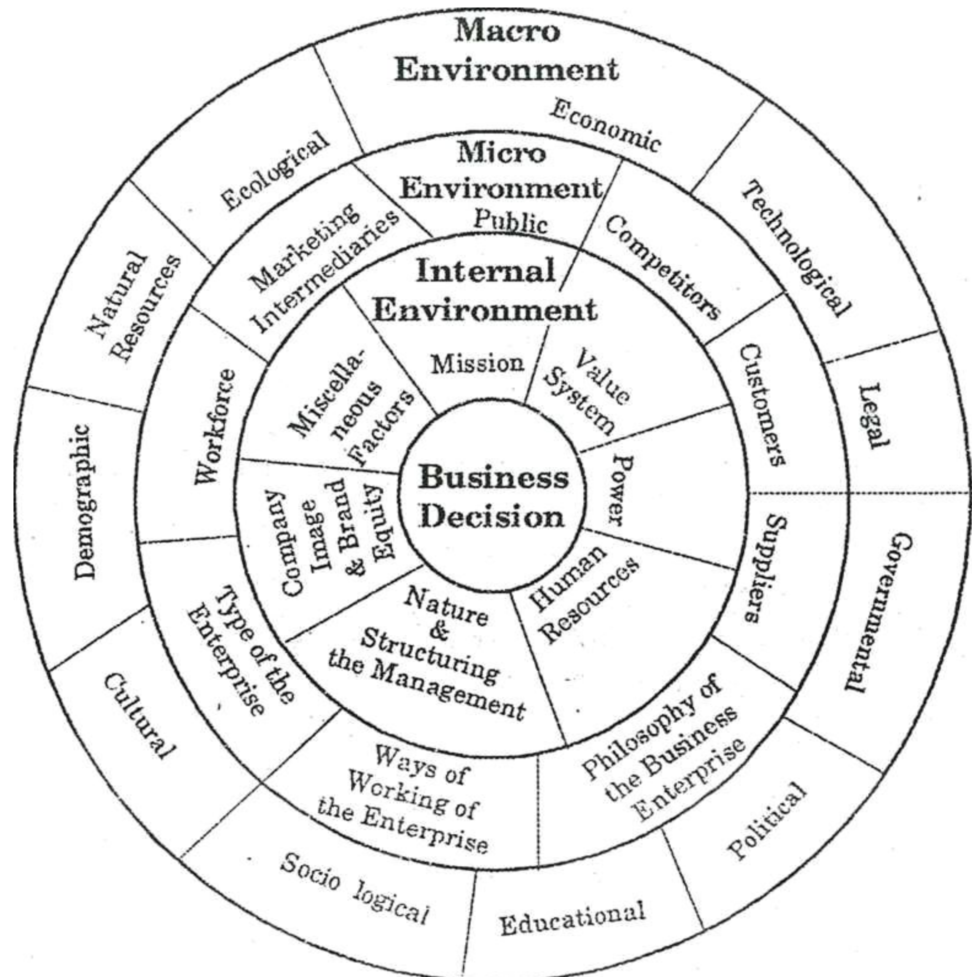



*Fig. 1.1: Environmental Constituents of Business (Environmental Scanning)*

NOTES

## *1.4 THE GENERAL ENVIRONMENT I.E. EXTERNAL ENVIRONMENT*

The General environment refers to all those factors that may have impact on an organisation. It includes factors like natural resources, economy, demography, technology, culture, government, political developments and the like which have varying degrees of influence on organisations. The effect of a particular factor on an organisation may vary, but no particular organisation is the focus of the general environment. For example, a change in the Monetary Policy of the Reserve Bank of India does not target a particular firm. It may be intended to curb credit in general.

## *1.5 SCOPE*

A business organisation does not exist in a vacuum. It is in fact dependent on external environment. For efficient and rational decision making a business organisation must understand its relationship with its environment. A business firm is an *open* system as it affects and is affected by outside events and factors which make up the external environment. Apart from external forces a business firm is affected by a number of internal factors, that is, forces inside the business organisation. While top management is generally concerned with external environment, middle level and lower level managements are more intimately concerned with internal environment. Thus, *business environment consists of all those external and internal factors that have a bearing on the business*.

A business organisation is a part of a large system such industry to which it belongs, the economy and the society. The relation of a business enterprise with its environment can be better understood from the input-output model of business system as shown in Figure. The task of the management of a business enterprise is to receive inputs from external environment, convert them into output which is then sold to the external environment. However, this simple model of business organisation needs to be further expanded into a model of operational management which shows how the transformation process is planned, organised and controlled by managers. This organisation and management of the transformation is affected both by internal and external environment, the term business environment is sometimes used in the sense of external environment. However, it also includes internal environment. Let us scan the environmental detail.

NOTES

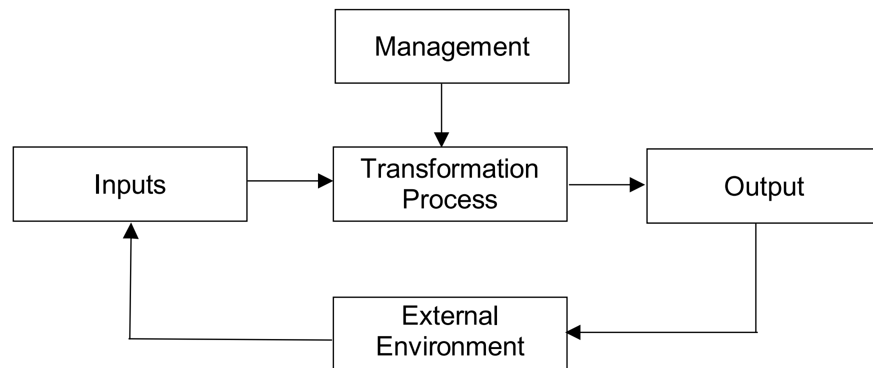



*Fig. 1.2: Business System: Input-Output Model*

# 1.6 EXTERNAL ENVIRONMENT

External environment consists of those factors that affect a business enterprise from outside. External environment includes shareholders, competitors, customers, society, government laws and regulations, public and technology. External environment is generally classified into micro environment and macro environment. *"The micro environment consists of factors in the company's immediate environment that affects the performance of the company, these include the suppliers, marketing intermediaries, competitors, customers and the publics."*

Thus, micro external environment includes all those players whose decisions and actions have a direct bearing on the activities of business firms. Since modern business firm has two aspects, namely, production and sale of goods, micro-environment of business can also be divided into two types of players. One, which affects the production of a firm such as input suppliers. Second, the factors which influence sales of the firm and includes customers, competitors and market intermediaries.

On the other hand, macro external environment includes larger social forces such as economic, demographic, technological, political, natural and cultural factors.

# 1.7 EXTERNAL MICRO ENVIRONMENT: FACTORS

Micro external forces have an important effect on business operations of a firm. However, all micro forces may not have the same effect on all firms in the industry. For example, suppliers, an important element of micro level environment, are often willing to provide the materials at relatively

NOTES

lower prices to big business firms. They do not have the same attitude towards relatively small business firms. Similarly, a competitive firm will start a price war if its rival firm in the industry is relatively small. If the rival firm is a big one which is a capable of retaliating any adverse action from its rival, a competitive firm will hesitate to start a price war. Following are important factors or forces of micro-level external environment.

**Suppliers of Inputs:** An important factor in the external environment of a firm is the suppliers of its inputs such as raw materials and components. A smooth and efficient working of a business firm requires that it should have ensured supply of inputs such as raw materials. If supply of raw materials is uncertain, then a firm will have to keep a large stock of raw materials to continue its transformation process uninterrupted. This will unnecessarily raise its cost of production and reduce its profit margin.

To ensure regular supply of inputs such as raw materials some firms adopt a strategy of *backward integration* and set up captive production plants for producing raw materials themselves. Further, energy input is an important input in the manufacturing business. Many large firms such as Reliance industries have their own power generating plants so as to ensure regular supply of electricity for their manufacturing business. However, small firms cannot adopt this strategy of vertical integration and have to depend on outside sources for supply of needed inputs.

Further, it is not a good strategy to depend on a single supplier of inputs. If there is disruption in production of the supplier firm due to labour strike or lock-out, it will adversely affect the production work of a firm. Therefore, to reduce risk and uncertainty business firms prefer to keep multiple suppliers of inputs.

**Customers:** The people who buy and use a firm’s product and services are an important part of external micro-environment. Since sales of a product or service is critical for a firm’s survival and growth, it is necessary to keep the customers satisfied. To take care of customer’s sensitivity is essential for the success of a business firm. A firm has different categories of customers. For example, a car manufacturing firm such as Maruti Udyog has individuals, companies, institutions, government as its customers. Maruti Udyog, therefore, has cater to the needs of all these types of customers by producing different varieties and models of cars.

Besides, a business firm has to compete with rival firms to attract customers and thereby increase the demand and market for its product. In

NOTES

the present day of intense competition a firm has to spend a lot on advertisements to promote the sales of its product by creating new customers and retaining the old ones. For this purpose, a business firm has also to launch new products or models. With increasing globalisation and liberalisation the customers' satisfaction is of paramount importance for which products can be imported also. For example, in the USA American firms faced a lot of competition from the Japanese firms producing electronic goods and automobiles. Similarly, the Indian firms are facing a lot of competition from Chinese products. It is important to note that for successful competition the Indian firms have to improve not only the quality of the products but also to enhance their productivity so that cost per unit can be reduced.

**Consumer:** Finally, public are an important force in external micro environment. Public, according to Philip Kotler, "is any group that has an actual or potential interest in or impact on a company's ability to achieve its objective". Environmentalists, media groups, women associations, consumer protection groups, local groups, citizens associations are some important examples of public which have an important bearing on environment of the firms. For example, a consumer protection firm in Delhi headed by Sunita Narain came out with an amazing fact that cold drinks such as Coca Cola, Pepsi Cola, Limca, Fanta had a higher contents of pesticides which posed threat to human health and life. This produced a good deal of adverse effect on the sale of these products in 2003-04. The Indian laws are being amended to ensure that these drinks must not contain pesticides beyond European safety standards. Similarly, environmentalists like Arundhati Roy have been compaigning against industries which pollute the environment and cause health hazards. Women in some villages of Haryana protested against liquor shops being situated in their localities. Many citizen groups are actively campaigning against cigarette manufactures for their advertising campaigns luring the people to indulge in smoking. Thus, the existence of various types of public, influence the working of business firms and compel them to be socially responsible.

## *1.8 EXTERNAL MACRO ENVIRONMENT: FACTORS*

Apart from micro-environment, business firms face large external environmental forces. The external macro environment determines the opportunities for a firm to exploit for promoting its business and also presents threats to it in the sense that it can put restrictions on the expansion of business activities. The macro-environment has thus both

NOTES

positive and negative aspects. An important fact about external macro-environmental forces is that they are *uncontrollable* by the management of a firm. Because of the uncontrollable nature of macro forces a firm has to adjust or adapt itself to these external forces.

External macro-environmental factors are classified into (1) economic, (2) social, (3) technological, (4) political and legal, and (5) demographic. We explain below all these factors determining external macro-environment.

## Economic Environment

Economic environment includes the type of economic system that exists in the economy, the nature and structure of the economy, the phase of the business cycle (for example, the conditions of boom or recession), the fiscal and monetary policies of the Government, foreign trade and foreign investment policies of the government. These economic policies of the government present both the opportunities as well as the threats (i.e. restrictions) for the business firms.

The type of the economic system, that is, socialist, capitalist or mixed provides institutional framework within which business firm have to work. For example, before 1991, the Indian economic system was of the type of a mixed economy with pronounced orientation towards the public sector. Prior to 1991 private sector's role in India's mixed economy was greatly restricted. Many industries were reserved exclusively for investment and production by the public sector. Private sector operations were limited mainly to the consumer goods industries. Even in these goods the private sector production and operation was controlled by industrial licensing system, Monopolistic and Restrictive Trade Practices (MRTP) Commission. The private sector was also subjected to various export and import restrictions. High tariffs were imposed to protect domestic industries and because the consumers have the option of buying imported products. Therefore, to survive and succeed, a firm has to make continuous efforts to improve the quality of its products.

**Marketing Intermediaries:** In a firm's external environment marketing intermediaries play an essential role of selling and distributing its products to the final buyers. Marketing intermediaries include agents and merchants such as distribution firms, wholesalers, retailers. Marketing intermediaries are responsible for stocking and transporting goods from their production site to their destination, that is, ultimate buyers. There are marketing service agencies such as marketing research firms, consulting firms,

NOTES

advertising agencies which assist a business firms in targeting, promoting and selling its products to the right markets.

Thus, marketing is an important link between a business firm and its ultimate buyers. A dislocation of this link will adversely affect the fortune of a company. A few years ago chemists and druggists in India declared a collective boycott of a lead-pharma company because it was providing a low retail margin. They succeeded in raising this margin. This shows that a business firm must take care of its intermediaries if it has to succeed in this age of intense competition.

**Competitors:** Business firms compete with each other not only for sale of their products but also in other areas. Absolute monopolies in case of which competition is totally absent are found only in the sphere of what are called *public utilities* such as power distribution, telephone service, gas distribution in a city *etc.* More generally, market forms of monopolistic competition and differentiated oligopolies exist in the real world. In these market forms different firms in an industry compete with each other for sale of their products. This competition may be on the basis of pricing of their products. But more frequently there is *non-price competition* under which firms engage in competition through competitive advertising, sponsoring some events such as cricket matches for sale of different varieties and models of their products, each claiming the superior nature of its products. The readers will be witnessing how intense is the competition between Coca Cola and Pepsi Cola. Sometimes there has been price war between them to capture new markets or enlarge their market share. Likewise, there is severe competition between the manufacturers of Arial and Surf washing powders, and between manufacturers of various brands of colour TV. This type of competition is generally referred to as *brand competition as it relates to producing and selling different brands of a product.*

But not only is there a competition among the producers producing different varieties or brands of a product but also among firms producing quite diverse products as all products ultimately compete for attracting spending by the consumers of their *disposable incomes.* For example, competition for a firm producing TVs does not come only from other brands of TV manufacturers but also from manufacturers of air conditioners, refrigerators, cars, washing machines etc. All these goods compete for attracting disposable incomes of the final consumers. Competition among these diverse products is generally referred to as

NOTES

desire competition as all these goods fulfil the various desires of the consumers who have limited disposable incomes.

As a consequence of liberalisation and globalisation of the Indian economy since the adoption of economic reforms there has been a significant increase in competitive environment of business firms. Indian firms have to compete not only with each other but also with the foreign firms to pursue import substitution strategy of industrial growth.

There has been significant changes in the economic policies since 1991 which have changed the macroeconomic environment for private sector firms. Far-reaching structural economic reforms were carried out by Dr. Manmohan Singh during the period 1991-96 when he was the then Finance Minister. Industrial licensing has been abolished and private sector can now invest and produce many industrial products without getting license from the government. Many industries, except only a few industries of strategic importance, which were earlier reserved for the public sector have been thrown open for the private sector. Import duties have been greatly reduced due to which domestic industries face competition from the imported products. Incentives have been given to boost exports. Rupee has been made convertible into foreign currencies on current account. It is thus evident that new economic reforms carried out since 1991 has significantly changed the business environment.

## Social and Cultural Environment

Members of a society wields important influence over business firms. People these days do not accept the activities of business firms without question. Activities of business firms may harm the physical environment and impose heavy social costs. Besides, business practices may violate cultural ethos of a society. For example, advertisement by business firms may be nasty and hurt the ethical sentiments of the people.

Businesses should consider the social implications of their decisions. This means that companies must seriously consider the impact of its actions on the society. *When a business firm in their decision making take care of social interests, it is said to be socially responsible.* Social responsibility is the felt obligation or self-enforced duty of business firms to serve or protect social interests. By doing so they promote social well being. Good corporate governance should be judged not only by the productivity and profits earned by a business firm but also by its social-welfare promoting activities.

NOTES

It is worth noting that in modern management science a new concept of *social responsiveness* has been developed. By social responsiveness we mean "the ability of a corporate firm to relate its operations and policies to social environment in way that are mutually beneficial to the company and society at large". It may be noted that social responsibility or social responsiveness is related to ethics. The discipline of ethics deals with what is good and bad, or right and wrong or with moral duty and obligation. Further, even if managers enjoy full freedom to adopt actions and policies in accordance with the conceived notion of social responsibility, they may not do so if standards applied to evaluate their performance are quite different. Every manager would like its performance to be positively appraised. Therefore, if the performance of managers of business firms are judged by the amount of profits they make for the owners of the firms, it is then not proper to expect socially responsible actions from them.

## Political and Legal Environment

Businesses are closely related to the government. The political philosophy of the government wields a great influence over business policies. For example, after independence under the leadership of Jawaharlal Nehru India adopted *'democratic socialism'* as its goal. In the economic sphere it implied that public sector was to play a vital role in India's economic development. Besides, it required that working of the private sector were to be controlled by a suitable industrial policy of the government. In this political framework private business firms worked under various types of regulatory policies which sought to influence the directions in which private business enterprises had to function. Thus, Industrial Regulation Act 1951, Industrial Policy Resolution 1956, Foreign Exchange Regulation Act (FERA), Monopolistic and Restrictive Practices (MRTP) Act were passed to control the business activities of the private sector. Besides, role of foreign direct investment was restricted to only few spheres. However, since 1991 several structural economic reforms have been undertaken following a change in political philosophy in favour of a free market economy. The collapse of socialism in Soviet Russia, China and East European Countries has brought about a change in political thinking about the roles of public and private sectors in India's industrial development.

To encourage the growth of the private sector in India, licensing has now been abolished, role of public sector greatly reduced and foreign capital, both direct and portfolio, is being encouraged to raise the rate of capital

NOTES

formation in the Indian economy. FERA has been replaced by FEMA (Foreign Exchange Management Act).

It is evident from above that with the change in the nature of political philosophy business environment for private firms has greatly changed.

## Technological Environment

The nature of technology used for production of goods and services is an important factor responsible for the success of a business firm. Technology consists of the type of machines and processes available for use by a firm and the way of doing things. The improvement in technology raises total factor productivity of a firm and reduces unit cost of output. The use of a superior technology by a firm gives it a competitive advantage over its rival firms. The use of a particular technology by a firm for its transformation process determines its competitive strength. In this age of globalisation the firms have to compete in the international markets for sales of their products. The firms which use outdated technologies cannot compete globally. Therefore, technological development plays a vital role in enhancing the competitive strength of business firms.

It has been generally observed that the competition between firms in the domestic economy and in international markets ensures that the firms will try to improve the technology they use because failure to do so would pose a threat to their survival. In the protected markets, technological improvements are slow and firms are able to survive for a long period without making technological changes. This is quite evident from the experience of automobile industry in India. Manufacturers of Ambassadors and Fiat Cars not only made no significant changes in their models, but also did not make any improvement in technology for decades because of absence of competition. The users had no choice and Ambassador and Fiat cars survived for decades in the protected environment. It is when Maruti Udyog Ltd. was started in India using superior technology and introducing more attractive models then there has been significant improvements in car manufacturing. With libersalisation of the Indian economy new car manufacturing firms have entered the industry and are producing different varities and models of cars with improved technology.

Besides, the cotton textile industry is another important example of an industry which due to protection provided to it by imposing high tariffs on imports of cotton textiles became sick. Following trade libeilisation many cotton textile firms have closed down because they could not withstand

NOTES

competition. Technological environment affects the success of firms and the need for technological advancement cannot be ignored.

## Demographic Environment

Demographic environment includes the size and growth of population, life expectancy of the people, rural-urban distribution of population, the technological skills and educational levels of labour force. All these demographic features have an important bearing on the functioning of business firms. Since new workers are recruited from outside the firm, demographic factors are considered as parts of external environment. The skills and ability of a firm's workers determine, to a large extent, how well the organisation can achieve its mission. The labour force in a country is always changing. This will cause changes in the work force of a firm. The business firms have to adjust to the requirements of their employees. They have also to adapt themselves to their child care services, labour welfare programmes etc.

The demographic environment affects both the supply and demand sides of business organisations. As mentioned above, firms obtain their working force from the outside labour force. The technical and education skills of the workers of a firm are determined mostly by human resources available in the economy which are a part of demographic environment. On the other hand, the size of population and its rural-urban distribution determine the demand for the products of industrial firms. For example, when there is good monsoon in India causing increase in incomes of rural population dependent on agriculture, demand for industrial products greatly increases.

In the wake of economic reforms initiated in the early nineties when foreign investors were allowed to make investment in India, they were prompted to invest in India by pointing out that the size of Indian market was quite large. They were told that 200 million Indian people could afford to buy the industrial products and this constituted quite a large market which could be profitably exploited.

Besides, the growth rate of population and age composition of population determine the demand pattern of goods. When the population of a country is growing at a high rate, its child population will be relatively large. This means demand for products such as baby food which cater to the needs of children will be relatively high. On the other hand, if population of a country is stable and life expectancy of the people is high, this will cause greater proportion of elderly aged people in the population of a country.

NOTES

This means different demand pattern of goods. Thus business firms have to consider all these demographic factors in their planning for production of goods and services and formulation of marketing strategies for sale of their products.

Demographic environment is also important for business firms as it determines the *choice of technology* by them. Other things being equal, if labour is abundant and relatively cheaper than capital, business firms will prefer relatively labour-intensive techniques for production of goods. However, for various reasons such as rigid labour laws and low productivity of labour, various tax concessions on investment in capital equipment and machinery, business firms in India are generally seem to be using capital-intensive technologies imported from abroad. This has resulted in the increasing in unemployment of labour, especially among the young workers. Therefore, social and government pressure is increasing on the business firms to create more employment opportunities for labour so as to render help in solving the problem of unemployment. It is quite interesting to note here that to take advantages of relatively cheap labour in India and China that foreign MNCs are setting up manufacturing plants in these countries.

It is evident from above that demographic factors play a crucial role in determining the productive activity of business firms.

## Natural Environment

Natural environment is the ultimate source of many inputs such as raw materials, energy which business firms use in their productive activity. In fact, availability of natural resources in a region or country is a basic factor in determining business activity in it. Natural environment which includes geographical and ecological factors such as minerals and oil reserves, water and forest resources, weather and climatic conditions, port facilities are all highly significant for various business activities. For example, the availability of minerals such as iron, coal etc. in a region influence the location of certain industries in that region. Thus, the industries with high material contents tend to be located near the raw material sources. For example, steel producing industrial units are set up near coal mines to save cost of transporting coal to distant locations.

Besides, certain weather and climatic conditions also affect the location of certain business units. For example, in India the firms producing cotton textiles are mostly located in Mumbai, Chennai, West Bengal, where

NOTES

weather and climatic conditions are conducive to the production of cotton textiles.

Natural environment also affects the demand for goods. For example, in regions where there is high temperature in summer there is a good deal of demand for dessert coolers, air conditioners, business firms set up industrial units producing these products. Similarly, weather and climatic conditions influence the demand pattern for clothing, building materials for housing etc. Furthermore, weather and climatic conditions require changes in design of products, the type of packaging and storage facilities.

It may, however, be noted that resource availability is not a sufficient condition for the growth of production and business activities. For instance, India though rich in natural resources remained poor and underdeveloped because available resources had not been put to use due to lack of adequate capabilities of Indian business class. Thus, it is not the availability of natural resources alone but also the technology and ability to bring them in use, that determines the growth of business and the economy.

### Ecological Effects of Business

Until recently businesses had generally overlooked the serious ecological effects of its activities. Driven purely by the motive of maximising profits, they cause irreparable damage to the exhaustible natural resources, especially minerals and forests. By their careless attitude they caused pollution to environment, especially air and water which posed health hazards for the people. By creating external detrimental diseconomies they imposed heavy costs on the society. Thanks to the efforts by environmentalists and international organisations such as World Bank, the people and the government have now became conscious of the *adverse effects of depletion of exhaustible natural resources and pollution of environment by business activity*. Accordingly, laws have been formulated for conservation of natural resources and prevention of environment pollution. These laws have imposed additional responsibilities and costs for business firms. But it is socially desirable that these costs are borne by business firms if we want sustainable economic growth and also healthy environment for human beings.

## *1.9 INTERNAL ENVIRONMENT*

Having discussed various external environmental factors let us turn to the factors which determine internal environment of a business firm. Some

NOTES

management experts confine the term business environment to external environment only. However, the recent view is to include both external and internal factors for determining business environment. *Internal environment includes such factors as value system, mission and objectives of the firm, management structure, quality of its human resources, physical assets, technological development, financial position and capital structure of the firm*. It is worth noting that internal environmental factors are to a good extent controllable factors because the firm can change or modify these factors to improve its efficiency. However, the firm may not be able to change all the internal factors. We explain below some crucial internal environmental factors.

**Value System:** The value system of an organisation means the ethical beliefs that guides the organisation in achieving its mission and objective. The value system of a business organisation also determines its behaviour towards its employees, customers and society at large. The value system of the promoters of a business firm has an important bearing on the choice of business and the adoption of business policies and practices. Due to its value system a business firm may refuse to produce or distribute liquor or it may think morally wrong to promote the consumption of liquor. The value system of a business organisation makes an important contribution to its success and its prestige in the world of business. For instance, the value system of J.R.D. Tata, the founder of Tata group of industries, was its self-imposed moral obligation to adopt morally just and fair business policies and practices which promote the interests of consumers, employees, shareholders and society at large. This value system of J.R.D. Tata was voluntarily incorporated in the articles of association of TISCO, a premier Tata company.

*Infosys Technologies* which won the first national corporate governance award in 1999 attributes its success to its high value system which guides its corporate culture. To quote one of its report, *"our corporate culture is to achieve our objectives in environment of fairness, honesty, transparency and courtsy towards our customers, employees, vendors and society at large."*

Thus value system of a business firm has an important bearing on its corporate culture and determines its behaviour towards its employees, shareholders and society as a whole.

**Mission and Objectives:** The objective of all firms is assumed to be maximisation of long-run profits. But mission is different from this narrow

NOTES

objective of profit maximisation. Mission is defined as the *overall purpose or reason for its existence* which guides and influences its business decision and economic activities. The choice of a business domain, direction of its development, choice of a business strategy and policies are all guided by the overall mission of the company. For example, "to become a world-class company and to achieve global dominance has been the mission of *'Reliance Industries of India'*. Similarly *"to become a research based international pharma company*" has been stated as mission of *Ranbaxy Laboritories* of India.

**Organisation Structure:** Organisation structure means such things as composition of board of directors, the number of independent directors, the extent of professional management and share-holding pattern. The nature of organisational structure has a significant influence over decision making process in an organisation. An efficient working of a business organisation requires that its organisation structure should be conducive to quick decision making. Delays in decision making can cost a good deal to a business firm.

The board of directors is the highest decision making body in a business organisation. It takes general policy decisions regarding direction of growth of business of the firm and supervises its overall functioning. Therefore, the managerial capability of the board of directors is of crucial importance for the functioning of a business firm and for achievement of its overall mission and objectives. For efficient and transparent working of the board of directors in India it has been suggested that the number of independent directors be increased.

Many private corporate firms in India are managed by family members of their promoters which is not conducive to the efficient working of these firms.

It is, therefore, highly desirable to increase the extent of professional' management of private corporate companies. The share holding pattern has also an important implication for business management. In some Indian companies the majority of shares is held by the promotors of the company themselves. In some others share-holding pattern is quite diversified among the public. In India financial institutions such as UTI, LIC, GIC, IDBI, IFC etc. have large share holdings in prominent Indian corporate companies and the nominees of these financial institutions play a critical role in making major business policy decisions of these corporate companies.

NOTES

Technically, shareholders elect directors who make up the board of directors. The directors then appoint company's top managers who take various business decisions. However, most of the shareholders delegate the voting rights to the management or do not attend the general body meeting. Thus, most of the shareholders regard ownership of the company as a purely financial investment. However, in recent years in developed countries like the United States the shareholders have come to wield a great influence. The bankruptcy of business giants such as Enron, World Com. in the United States have created great awareness as well as mistrust among shareholders. In the last few years there has been frequent law suits filed by shareholders against directors and managers for ignoring the interests of shareholders or in fact cheating them by not declaring dividends. That is why there is worldwide debate on proper corporate governance of business firms.

**Corporate Culture and Style of Functioning of top Management:** Corporate culture and style of functioning of top managers is important factor for determining the internal environment of a company. Corporate culture is generally considered as either closed and threatening or open and participatory. In a *closed and threatening* type of corporate culture the business decisions are taken by top-level managers, while middle level and work-level managers have no say in business decision making. There is lack of trust and confidence in subordinate officials of the company and secrecy pervades throughout in the organisation. As a result, among lower level managers and work a political parties ruling, natural calamaties and change its projects also implementation of the plans.

## *1.10 SUMMARY OF THE UNIT*

The term environment consists of many sub levels external and internal. The external environment has greater influence on business. The environment differs from one country to another. Business is an economic activity and hence it has impact on policy and planning.

Globalisation leads to new economy as there is a trade between various countries.

## *1.11 GLOSSARY*

- **Business Environment:** The aggregate of all conditions and influences that affect business.
- **External Sector:** International economy in terms of markets.

NOTES

## 1.12 KEY TERMS

- **Environment:** It means 'surrounding' with external and internal levels that influences business activity.
- **Decision:** Selecting from set of alternative course of action.
- **Economic Activity:** Activity undertaken with financial consideration.
- **W.T.O.:** World Trade Organisation.

## 1.13 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)

### (A) Fill in the Blanks

1. Cuba's Capital is ____________.
2. Cuba is an example of ____________ economy.
3. Contribution of ____________ sector to GDP is more in Poland.
4. Impact of globalisation was on ____________.
5. ____________ is the second largest employment sector after agriculture.

### (B) True or False

1. India is an example of mixed economy.
2. Poland after 1990 is an example of mixed economy.
3. Globalisation is a term used to describe restrictions on foreign trade.

## 1.14 KEY TO CHECK YOUR ANSWER

(A) 1. Havana, 2. Planned, 3. Service, 4. Economy, 5. Textile.

(B) 1. True, 2. True, 3. False.

NOTES

# 1.15 TERMINAL AND MODEL QUESTIONS

1. Give classification of business environment.
2. Explain the economic environment in India.
3. Discuss salient features of economic policy 1991.
4. What do you understand by global environment? Explain.
5. What is the importance of G.A.T.T. and WTO?

# 1.16 REFERENCE BOOKS


1. **D.H. Buchanan:** The Development of Capitalistic Enterprise in India.
2. **Ghosh Alok:** Indian Economy, Calcutta.
3. **Disrupt A:** Government and Business 'Vikas' – Delhi.
4. **Philip Kotler,** Marketing Management, Prentice Hall of India, New Delhi, 1998, p. 127.

# UNIT 2 CONSUMERISM AND BUSINESS

## Structure:

2.1 Introduction

2.2 Responsibilities of Business

2.3 Summary of the Unit

2.4 Glossary

2.5 Key Terms

2.6 Check Your Progress (Multiple Choice/Objective Type Questions)

2.7 Key to Check Your Answer

2.8 Terminal and Model Questions

2.9 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Understand the link between Business and Consumer.
- Learn enactments by the Government.
- Understand 'Business Responsibilities'.
- Know the role of professionals and woman in business.

NOTES

## *2.1 INTRODUCTION*

There are two approaches to business - (i) product oriented and (ii) consumer or customer oriented. 'Abell' recommends needs for consumer orientation. Many business mislead the consumer. The interest of the consumer must be protected. Government has more than 60 enactments for consumer safety. Management professional, have created better environment based on knowledge, skills and ethical values.

What is our business? Derek F. Abell has suggested that a company should define its business in terms of three dimensions: who is being satisfied (what customer groups), what is being satisfied (what customer needs), how are customer needs being satisfied (by what skills or distinctive competencies). Following figure illustrates these three dimensions.

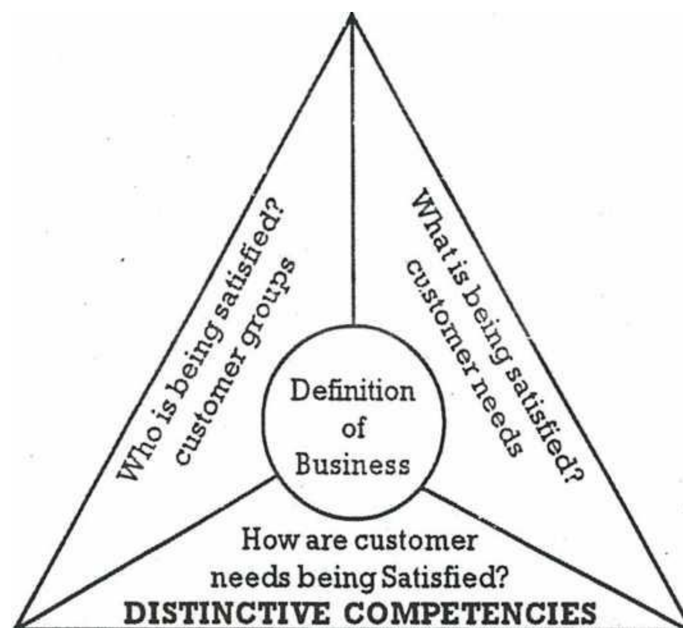



*Fig: Abell's Framework for defining the Business*

Abell's approach stresses the need for a consumer-oriented rather than a product-oriented business definition. A product oriented business definition focuses just on the products sold and the markets served. Abell maintains that such an approach obscures the company's function, which is to satisfy consumer needs. In practice, the particular need of a particular consumer group may be served in different ways. Identifying these ways through, a broad, consumer-oriented business definition can safeguard companies from being caught unawares by major shifts in demand. Indeed, by helping anticipate demand shifts, Abell's framework can assist companies in capitalising on the changes in their environment.

NOTES

Losing a customer costs more to the company, than attracting the attention of a new customer. So, in order to retain the customer, the company or the organisation should conduct its business operations more clearly in a fairway.

Consumerism is a movement to intimate and guide consumers and safeguard them from the malpractices being followed by the businessman. The focus of this movement is on the unfair business practices, inferior and dangerous merchandise, and false or misleading advertisements. The *unfair practices* being followed by the businessman may be listed as: charging unreasonably high prices and preventing competition in the production and distribution of goods, tending to lower the quality of goods supplied, limiting the capital investment or technical development for the production purposes and so on.

The examples of *Inferior and dangerous merchandise* may be considered as: Practicing unbashed adulteration; increasing improper measurements, breaking promise of delivering goods in time after accepting advance. After sales services have just become the word of mouth.

The recent *advertisements* are aiming at making huge profits by *misleading* the customers. They have been concentrated more on attracting the customers instead of retaining them for longer period. Many labels on the products supplied are false. The advertisements and labels have become half truths as per the views of the customers.

In order to protect and safeguard the interest of the customers, the consumerism has come into existence. The Government has passed many major laws and amended the legislations as per the changes in the business environment to protect the views and interest of the consumers in a competitive market. For example, we have around fifty to sixty laws which have been enacted to safeguard the consumer interest. The latest Act to be enacted by the Government is the Consumer Protection Act 1986, which mainly deals with:

1. Protecting the customers against deceptive practices, defective goods and unsatisfactory services.
2. Consumer complaints and issues by setting up of special forums exclusively at district, state and central levels.
3. Awarding and protecting the aggrieved consumer by effective compensation.
4. Each and every customer by understanding the public as a whole.

NOTES

In short, this is the effective legislation which is powerful enough to protect and safeguard the interest of the consumer and the public as a whole. This legislation makes clear the responsibility of businessmen and his commitment to provide qualitative products and render effective services.

Other than the enactment of legislations, the Government has also taken effective steps in implementing various programmes. One can remember an item of the 20 – Point programme undertaken by the government to protect the consumer from the unfair trade practices. Many agencies, including State governments, the Department of Science and Technology, the textile committee, the department of R&D have set up Consumer Advisory Councils to intimate about the false claims, hike in prices, *etc.* and safeguarding the consumer from becoming victim under the deceptive practices. The different media like Television, All India Radio are also playing significant role in protecting the consumer interest by organising competitive programmes. The Government can just intimate and protect the interest of the consumers but it always lies with the consumer to safeguard himself from unfair trade practices by exercising his own rights. The basic theme of the consumerism is to protect the interest of the consumers, as of reason many consumer movements have come up to provide information about the false advertisements and labels *etc.,* and protect them from the deceptive trade practices.

Today's consumer has become intelligent enough to find the false claims and is aware of asserting his rights to protect himself from unabashed practices and so on. As he is becoming more competitive in exercising his rights and understanding his responsibilities we can expect more effective movements under consumerism in the coming era.

## *2.2 RESPONSIBILITIES OF BUSINESS*

Following are the responsibilities of business in addition for fulfilling the needs of the consumer by producing goods and rendering services as per their tastes and preferences.

**1. Advertising:** Advertising has become a vast apparatus of persuations and inducements by which the eyes and ears of the public are constantly asserted to do this or to buy that. In creating a demand for the product many sellers are going for the false advertisements. The seller can retain the consumer only when he is true in his performance and loyal in his commitments. But unfortunately, the producer is just aiming at skimming

NOTES

the cream before the entry of the competitor for his product, by immoral and false advertisements.

The main purpose of advertising is to give information about the product and the Brand and so on. It persuades the buyer to purchase the product. So here exists the duty of the advertisement to be true enough. It should not misguide the consumer just to increase the sales. Unfortunately there is no such legislation passed by the government to check the misleading advertisements. So an individual himself has to exercise an exact purchase decision. But even then it is the role of the advertisement that the producer has to exercise to bring in "increased awareness."

The role of the advertisement should not be misused by the seller in reaching new areas of new segments of population within existing areas. Instead he should utilise the main purpose of advertisement in developing overseas market.

**2. Products and Services:** Consumer can always expect the product he wants as many competitors exist in the market. Earlier, the product produced by the manufacturer was simple to operate and easy to use. But now the very important feature of the product is "complexity." As the product becoming more complex leading to difficulties in its operation and usage, the role of businessmen has to be exercised in providing proper information about the operation and performance of the 'complex' product. The complexity of product has increased because of more adoption to the technological advancements. Responsibility for performance and safety throughout the life of the product should be assumed by the producer.

Today's consumer is enjoying the right in selecting the products as there exists many substitutes in the competitive market. He also expects the services to be offered by the sellers, together with the product that he purchases. The consumers' expectations are increasing making the producer to spend more in manufacturing quality products. This process is leading to hike in the following costs:

- Economic costs
- Social costs
- Opportunity costs and
- Total costs which is inclusive of R&D costs.

**3. Women and Business:** Women have been playing a crucial role in the development process since the early stages of civilised life. It is said that it was women who not only discovered fire, but also the use of fire the basic

**NOTES**

cooking techniques like boiling, roasting, baking, steaming *etc.* The Constitution has granted them equality of status and opportunity. The Directive Principles of State Policy empowered the state to make special provisions for the progress of women.

Women play a significant role as mothers, wives, sisters at home. In the same way in recent years she has started showing her better performance even at the corporate level as owners, managers, employers and employees. It is the responsibility of Business to offer a helping hand to women by contributing to their education and nourishing in depth capabilities in them.

### Professional

Professionalisation has achieved importance because of growing demand for management education and training. The growth of professionalisation has affected positively to the growth of social orientation of business. Professionalisation brings in to existence the dignity to management. It also makes business more effective and efficient, dynamic and flexible to adjust to the changing business environment.

The growth of management education in the country and the facilities abroad to obtain management education have contributed to professionalisation in the business field. A professional has innumerable responsibilities. He has to support the society by following ethical values in the operations of the business. Professionalisation imparts certain social responsibilities. A professional shall not use his power, knowledge and skill in a wrong route. He should not harm the feelings and emotions of the customers knowingly. He shall not utilise his knowledge and skill to maximise his own profits or the earnings. He is responsible to the management as well as to the society. He shall do his work in such a way that both shall be benefited to the maximum extent leading to 'win-win' situation.

Now, it is clear that a professional is one who possesses systematic knowledge and skill to perform certain responsible functions with authority.

## *2.3 SUMMARY OF THE UNIT*

The economic activity now has more emphasis on efficiency, quality and interest of consumers. The consumers have also become conscious of their rights *e.g.,* consumers Movement. The Government has also enacted laws to protect the interest of consumers.

NOTES

## *2.4 GLOSSARY*

- **Economy:** System in which productive units use resources to provide products.
- **C.P.I:** Consumer price index (Cost of buying goods).
- **Exchange Rate:** Price of one unit of currency in terms of other currencies.

## *2.5 KEY TERMS*

- **Social Environment:** This level includes social structure and its truncation formation.
- **Social Responsibility:** Awareness of impact of business on society.
- **Consumer:** Beneficiary of business activity.

## *2.6 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (a) Fill in the Blanks

1. Rise in prices reduces the __________of wage earners.
2. Excess supply results in __________ demand for goods.
3. High rise in prices raises the cost of living and workers ask for __________ wages.

### (B) True or False

1. Consumerism is related to modern consumer movement.
2. Excise tax is imposed on export.
3. Import means to bring goods from another state.

## *2.7 KEY TO CHECK YOUR ANSWER*

(a) 1. Consumption, 2. Increased, 3. Higher.

(b) 1. True, 2. False, 3. False.

NOTES

## 2.8 TERMINAL AND MODEL QUESTIONS

1. What do you understand by social responsibility of business?
2. Explain social and cultural environment.
3. Explain the following:
   (a) Consumer awareness
   (b) Consumer protection
   (c) Consumer movement

## 2.9 REFERENCE BOOKS

1. Economic Survey of India (2007-08).
2. Das, ‘Trade and Development’, New Delhi, Deep Publications.

# UNIT 3 MACRO ECONOMIC ENVIRONMENT AND MODERN THEORIES OF ECONOMIC GROWTH

## Structure:

3.1 Introduction
3.2 Economic Growth
3.3 Development
3.4 Critical Elements
3.5 Money
3.6 Global Trade Environment
3.7 Host Countries
3.8 Meaning and Definition of Inflation
3.9 Features of Inflationary Economy
3.10 Summary of the Unit
3.11 Glossary
3.12 Key Terms
3.13 Check Your Progress (Multiple Choice/Objective Type Questions)
3.14 Key to Check Your Answer
3.15 Terminal and Model Questions
3.16 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Know major economic issues which are considered by business firms.
- Understand economic growth and development.

NOTES

- Understand the critical elements of 'economy'.
- Explain money and planning for business.
- Know about MNC's GATT, and WTO.

## 3.1 INTRODUCTION

The important Macro economic issues are – rate of economic growth, magnitude of employment generation and extent of unemployment. The economic growth and development, though go together, must be treated separately.

Having discussed the nature and scope of business environment, we will now discuss the major macroeconomic issues which are considered by business firms while taking business decisions. The important macroeconomic issues are the economic growth rate of the country, the magnitude of employment generation in the economy and the extent of unemployment prevailing in the economy, the rate of inflation in the economy, foreign exchange rate of the national currency and balance of payments situation of the country. All these macroeconomic issues have an important bearing on the business decision-making by the firms.

## 3.2 ECONOMIC GROWTH

### Meaning

Economic growth has been defined in two ways. In the first place, *economic growth is defined as increase in an economy's real national income or gross national product* (GNP) *over a period of time*. In other words, economic growth means rising trend of national product at constant prices. This definition has been criticised by some economists as inadequate and unsatisfactory. They argue that total national income may be increasing and yet the standard of living of the people may be falling. This can happen when the population is increasing at a faster rate than total national income. For instance, if national income is rising by 1.5 per year and population is increasing at 2% per year, the standard of living of the people will tend to fall. This is so because when population is increasing more rapidly than national income, per capita income will go on falling.

Therefore, the second and better way of defining economic growth is to do so in terms of per capita income. Thus, *economic growth means the annual*

NOTES

*increase in real per capita income of a country*. Professor Arthur Lewis writes that *"economic growth means the growth of output per head of population"* Since the main aim of economic growth is to raise the standard of living of the people, the second way of defining economic growth which runs in terms of per capita income is considered to be better. However, the concept of economic growth is generally used in both these senses, that is, in the sense, of increase in GNP or in per capita real income over a period. Economic growth of a country is a major measure of macro economic performance of a country.

Another point which is worth mentioning in regard to the definition of economic growth is that the increase in national income or increase in per capita income must be a *'sustained increase'* if it is to be called economic growth. Sustained increase in per capita income is meant the *upward or rising trend in per capita income over a long period of time*. A mere short-period rise in per capita income, such as that occurs within a business cycle, cannot be validly called economic growth.

Now, almost universally, rates of economic growth are measured both in terms of increase in overall Gross National Product (GNP) or Net National Product (NNP) and increase in per capita income. While Gross National Product (GNP) measures the value of total output of goods and services which an economy is capable of producing, per capita income measures how much of the total value of goods and services which an average person of the community will have for consumption and investment, that is, average level of living of a citizen of a country.

Thus, world organisation such as World Bank, and IMF have been employing both these measures of economic growth in their annual *World Development Reports* for comparing growth and levels of living of the developed and the developing countries. In India also our Planning Commission, Central Statistical Organization (CSO), and Reserve Bank of India have been measuring economic growth on the basis of both overall GNP or GDP or NNP and per capita income. The recent estimates of annual growth in GNP and per capita income are given in Table. This table reveals an interesting feature that economic growth achieved in recent years is higher in the developing countries than in the developed countries. However, it should be noted that in the past several decades the present-day developed countries recorded much higher growth rates than the developing countries which remained static for a long period. As a result, per capita income and levels of living of the people of the developed countries are now much higher as compared to those of the developing

NOTES

countries. The problem of the developing countries is to catch up with the developed countries through attaining rapid economic growth so as to enjoy higher levels of living.

*Table 3.1: GNP Per Capita, Growth Rate and Population in Some Developed and Developing Countries*

| Country | Populat-ion (millions) 2004 | GNP Per Capita in 2004 (US Dollars) | Growth Rate of GNP 1980-90, 1990-2000, 2000-04 | | |
|---|---|---|---|---|---|
| Developed Countries U.S.A. | 293.7 | 41,440 | 3.0 | 3.5 | 2.5 |
| Australia | 20.1 | 27.070 | 3.5 | 3.9 | 3.5 |
| U.K. | 59.9 | 33,630 | 3.2 | 2.7 | 2.3 |
| Canada | 32. | 28,310 | 3.4 | 3.1 | 2.6 |
| Japan | 127.8 | 37,050 | 4.1 | 1.3 | 0.9 |
| Developing Countries India | 1080.0 | 620 | 5.8 | 6.0 | 6.2 |
| China | 1296.2 | 1500 | 10.2 | 10.6 | 9.4 |
| Pakistan | 152.1 | 600 | 6.3 | 3.8 | 4.1 |
| Bangladesh | 139.2 | 440 | 4.3 | 4.8 | 5.2 |
| Sri Lanka | 19.4 | 1010 | 4.2 | 5.3 | 3.7 |

**Source:** World Bank, World Development Report, 2006.

## *3.3 DEVELOPMENT*

No distinction was drawn between economic growth and development in the beginning of the evolution of economics of development. However, since the seventies it has been thought necessary to distinguish between economic growth and economic development. There are two views even about the concept of economic development. The traditional view has been to interpret it in terms of changes in the structure of national product and the occupational pattern of labour force and the institutional and technological changes that bring about such changes or accompany such changes. In this view share of agriculture in both national product and employment of labour force declines and that of industries and services increases.

NOTES

## 3.4 CRITICAL ELEMENTS

These critical elements may not always be mutually exclusive. But one may treat them separately for analytical purposes.

### List of the Critical Elements of Macro-Economic Environments

- economic system
- nature of the economy
- anatomy of the economy
- functioning of the economy
- economic planning and programmes
- economic policy statements and proposals
- economic controls and regulations
- economic legislations
- economic trends and structure, and
- economic problems and prospects

## 3.5 MONEY

Money is the life and blood of business activity and of the economic system. The flows of consumption, investment, saving, income, employment and output are all affected by transactions of money. Monetary transactions affect the price level, thereby influencing the real value of all macro-economic variables. Significant developments have taken place in macro-economics to define the role of money. The essential question is: Does money matter?

There are different answers to this question: (1) Money does not matter at all (Classical); (2) Money matters least (Keynesian); and (3) Money matters most (monetarist). The theoretical debate is quite interesting. But you have to examine its empirical relevance in the economic environment of a country like India. This will provide you with a further insight into the role of centralised planning in the present context, administered price system as well as free market pricing, and central banking.

Economic planning is supposed to give a direction to the changes in the economic environment. Most countries function today on the basis of

NOTES

planning. Either it is planning by direction – typical of a socialist economy, or it is planning by incentives, i.e., democratic planning typical of a mixed economy, or it is indicative planning typical of the French economy. It is through the system of a perspective planning, five-year planning and annual planning that the economies try to overcome their environmental constraints and optimise their achievements over a period of time.

## India Consumer Protection

There are a wide range of enactments to protect the consumer. Some are of general application covering particular aspects of a wide range of products; Other apply only to specific products. The first category consists of the Standard of Weight and Measures Act, 1956, the Sale of Goods Act, 1930, the Trade and Merchandise Marks Act, 1958, the Display of Prices Order, 1973, the Packaged commodities (Regulation) Order, 1979, the Standard Institutions Certificate Marks Act, 1952, *etc.* Some of the important legislations relating to particular goods and transactions are the Essential Commodities Act, 1955, the Prevention of Food Adulteration Act, 1959, the Drugs and Magic remedies (Objectionable Advertisement) Act, 1954, and the Cigarettes (Regulation of Production, Supply and Distribution) Act, 1975. Lately, our Government has brought in the Consumer Protection Act 1986. Through this Act, an attempt is being made to strengthen the institutional framework to protect the consumer at the local; state and central levels. There are various institutional factors which account for growing concern about consumer protection in India.

## Planning

Planning is a programme of action, it is not a guarantee in itself. The formulation of plans and programmes must, therefore, be flowed by proper implementation. This calls for economic policy statements and legislations. Apart from having general policy statements affecting industry and agriculture, the Government often formulates and executes fiscal-cum-budgetary policies. The Resere Bank will work through the instruments of money and credit policies, exchange rate policies, *etc.* Some sort of physical policies of controls and regulations may also be needed. Price control, trade control and exchange control are all moves in the same direction. Sometimes legislations and enactments become necessary for effective implementation of all these policy statements and proposals. The national economic environment of business is determined by the existing macro-economic policy framework.

NOTES

### Summary of Variables

These policies, planning and pricing together make the economy function effectively. The functioning of a economy is reflected in short-period fluctuations and long-term trends in macro-economic variables like income, money supply, prices, production, employment, balance of trade and payments, foreign exchange earnings, *etc.* These trends decide the course of the prevailing economic environment. Some of these economic trends may define the nature and dimension of various macro-economic problems like inflation, unemployment, recession and the like.

## *3.6 GLOBAL TRADE ENVIRONMENT*

Trade is the voluntary exchange of goods, services, assets or money between one person or organisation and another. Because it is voluntary, both parties to the transaction must believe they will gain from the exchange or else they would not complete it. International trade is trade between residents of two countries. The residents may be individuals, firms, non-profit organisations or other forms of associations. Such international trade has important direct and indirect effects on national economies. On the other hand, imports can pressure domestic suppliers to cut their prices and improve their competitiveness. Failures to respond to foreign competition may lead to shutdown of factories and unemployed workers. Because of international trades obvious significance to businesses, consumers, workers, scholars have attempted to develop theories to explain and predict the forces that motivate such trade. Governments use these theories when they design policies they hope will benefit their countries, industries and citizens. Business use them to identify promising markets and profitable internationalisation strategies.

The global business environment is significantly influenced by the principles and agreements of World Trade Organisation (WTO). Thanks to Economic Reforms which have opened up opportunities to the Indian businesses to compete with international business.

### IMPACT

The concept of Multinationality has several dimensions, there is no single universally accepted definition of multinational corporations. According to an ILO report, “the essential nature of the multinational corporations lies in the fact that its managerial headquarters are located in one country (which can be referred to as home country) while the corporate carries out

operations in a number of other countries as well (which can be referred to as Host Countries)."

NOTES

The multinational corporations account for a significant share of the world's industrial investment, production, employment and trade as they play an important role by operating in many host countries. Although the MNCs took birth in the early 1860s, it was after the Second World War that they grew rapidly. United States was the home of most of the MNCs in the early days. Now there are a large number of Japanese and European Multinationals.

MNCs of the US are more focused, wherein they confine their business to one industry or product category. Whereas European companies concentrate more on broader product line. Japanese companies, generally have product lines that are much too broad.

MNCs can locate their different operations in different countries on the basis of availability of raw materials, consumer markets, low cost labour and host country government regulations.

The case explains the operations of Canara Bank branches being set up in countries.

## International Operations

Canara Bank started its International Operations in the year 1953 and established its International Division in 1976, to supervise the functioning of its various foreign departments and giving required thrust to foreign exchange business, particularly exports and to meet the requirements of NRIs. Though small in size, the Bank's presence abroad has brought in considerable foreign business, especially in the form of NRI deposits. The Bank has its presence abroad, as follows:

1. Canara Bank, London, UK (branch)
2. Indo Hong Kong International Finance Ltd., Hong Kong (Subsidiary) Canara Bank, Moscow (Representative Office). A Joint Venture Bank is being established on 40/60 basis with SBI in Moscow shortly.
3. AI Razouki Intl. Exchange Company, Dubai, UAE (Secondment agreement and DD drawing facility on Canara Bank).

   Eastern Exchange Establishment, Doha, Qatar (Management Agreement and DD drawing facility on Canara Bank).

   Ruwi Exchange Co. LLC, Muscat (Under our Management and Supervision and DD drawing facility on Canara Bank.

NOTES

In addition, following Exchange Companies have DD drawing arrangements with Canara Bank:

**UAE:** 1. Al Razouki International Exchange Company LLC, Dubai. 2. UAE Exchange Centre, Abu Dhabi. 3. AI Fardan Exchange Company, Abu Dhabi. 4. Leela Megh Exchange Company LLC, Dubai. 5. Thomas Cook AI Rostamani Exchange Co., Dubai. 6. Habib and AI Mansoor Exchange Co., Abu Dhabi. 7. AI Ahalia Money Exchange Bureau, Abu Dhabi. 8. AI Ansari, Abu Dhabi.

**OMAN:** l. Laxmidas Tharia Ved Exchange Co., Ruwi, Muscat. 2. Musandam Exchange, Ruwi, Muscat.

**KUWAIT:** 1. Kuwait Bahrain International Exchange Co., Safat. 2. Bahrain Exchange Co., Safat, Kuwait. 3. Dollarco Exchange Co. Ltd., Safat.

**BAHRAIN:** 1. Zenj Exchange Co., WLL, Bahrain. 2. Bahrain Financing Co., Bahrain.

***Source:*** Economic Times, 12th August, 2002.

Multinational Corporations may also be called as international corporations, transnational corporations and global corporations, which are used synonymously in practice. However, the interpretation of these terms given by different authors are different. These corporations are differentiated on the basis of salient characteristics as pointed out by Bartlett and Ghosal. The features considered for the differentiation are resources and responsibilities configuration, relationship between parent and subsidiary and the mentality towards the overseas operations.

## *3.7 HOST COUNTRIES*

Firms establishing operations beyond the borders of their home country affect and are affected by the political, economic, social and cultural environments of the host countries in which they operate to compete effectively in these markets and maintain productive relationships with the host country governments. Managers of MNCs must recognise this and their firms should interact with the national and local environments.

### Economic and Political Impacts

MNCs affect every local economy in which they compete and operate. Many of their effects are positive. They may make direct investments in

NOTES

new plants and factories, thereby creating local jobs. Such investments also provide work for local contractors, builders, and suppliers. MNCs also pay taxes, which benefit the local economy, helping to improve educational, transportation and other municipal services. Technology transfer can also have positive local effects.

However, MNCs may also have negative effects on the local economy. To the extent MNCs compete directly with local firms, they may make those firms to lose both jobs and profits. Also the local economy becomes more dependent on the economic health of an MNC, the financial fortunes of that firm takes an increasing significance when retrenchment by the MNC is accompanied by layoffs, cutbacks, or a total shutdown of local operations. The effects can be devastating to the local economy.

MNCs also may have a significant political impact, either locally or internationally. Their sheer size, for example, often threat the country in which they operate. There exists the possibility that this power may be misused. They simply threaten to shift production and jobs to other locations. For example when Spain passed new laws in the early 1990s that raised labour costs, MNCs such as Colgate Palmolive, S.C Johnson and Son, Kubota and Volkswagen closed some of their Spanish factories and/or slashed pay rolls. The result was soaring unemployment that reached 24.5% in the Mid 1990s.

## Cultural Impacts

MNCs can also exert a major influence on the cultures in which they operate. They raise local standards of living and introduce new products and services previously unavailable locally. People in the host culture develop new norms, standards and behaviours. Some of these changes are positive. Such as the introduction of safer equipment and machinery, better health care and pharmaceuticals and pure and more sanitary food products. An important example is Nestle’s heavy promotion of infant formula in the world’s developing countries.

It is to be emphasised that MNCs are considered as change agents and they should be encouraged by the developing Nations where improving standard of living is a top priority. However, MNCs must operate in host countries in such a way that, their existence will encourage the interest of economic sovereignty without affecting the long term development plans of the country.

NOTES

## GATT

The predecessor of WTO (World Trade Organisation), is the General Agreement on Tariffs and Trade (GATT) was born in 1948 as a result of the international desire to liberalise trade.

The collapse of the international economy between the two world wars has been blamed in part on countries imposing prohibitive tariffs, quotas, and other protectionist mechanisms on imported goods. Trading and investment opportunities for international businesses dried up as country after country adopted such "beggar-by-neighbour" policies. By raising tariff and quota barriers, each nation believed that it could help its own industries and citizens.

### How the GATT Works?

Many MNCs strongly support GATT objectives, for its goal is to promote a free and competitive international trading environment that benefits efficient producers. The GATT accomplishes this by sponsoring international negotiations to reduce tariffs, quotas and other non-tariff barriers (NTBs), as tariffs were initially the most serious impediments towards trade. The GATT seeks to ensure that international trade is conducted on a non-discriminatory basis by helping international businesses to compete in world market. This is accomplished through the use of Most Favoured Nation (MFN) principle. Under GATT rules, all members must utilise the MFN principle in dealing with other members. Because of MFN principle, Multilateral, rather than bilateral trade negotiations have been encouraged, thereby strengthening GATT rule.

Ever since the GATT was established after the Second World War, it has been striving hard to achieve international economic operations. Towards this objective, GATT has been conducting several trade rounds, the latest being the Uruguay Round which is the most expensive.

### The Uruguay Round

The eighth and most recent, round of GATT negotiations began in Uruguay in September 1986. UR agreement took effect in 1995. Like its seven predecessors, the UR had cut tariffs on imported goods. Most countries viewed Non Tariff Barriers (NTBs) as the major obstacles to trade. So the UR addressed the more difficult task of reducing their use.

NOTES

It is called as Uruguay Round as it was launched in 'Puntadel Este' in Uruguay, a developing country. The basic concepts involved for discussion in the Uruguay Round were:

- Improving and developing market access by reducing specific trade barriers.
- Strengthening GATT disciplines
- Problems cf liberation of trade in services, trade related aspects of intellectual property rights (TRIPs) and trade related investment measures (TRIMs).

The traditional concerns of the GATT were limited to international trade in goods whereas the UR went much beyond the coverage of goods to services technology, investment and information.

Salient Features of UR Agreement

- Achieving liberalisation of trade in manufacturer by reducing tariff and phasing out non-tariff barriers.
- Protecting agricultural sector by liberalisation of agricultural trade.
- Encouraging the exports of non-agricultural goods by providing subsidies.

## Objectives of GATT

Expansion of international trade by liberalisation of trade was the primary objective of GATT, in order to increase all-round economic prosperity. Following were considered as its important objectives in the preamble to the GATT:

- To increase standard of living.
- To maintain constant growth in real income and steady increase in demand.
- To encourage and ensure full employment.
- To utilise minimum resources of the world to the maximum extent.
- To encourage and expand the production activities and international trade.

NOTES

## Rules or Conventions of GATT

The rules of GATT applicable to the international trade among countries are:

Any change in the proposed tariff, or type of commercial policy of a member country should be undertaken with the consultation of other parties to the agreement.

The member country to GATT should work towards removal of barriers to international trade and reducing tariffs by negotiating within the limits of GATT.

## Principles of GATT

General principles governing international trade embodied by GATT for the realisation of its objectives are as follows:

1. **Non-discrimination:** This principle says that no member country shall discriminate the conduct of international trade between the members of GATT. The Principle of Most Favoured Nation (MFN) to be applicable to all imports and export duties to ensure non-discrimination, which in turn means that "each nation shall be treated as Most Favoured Nation."

   There are certain exceptions to this principle. For instance, GATT encourages economic integration like free trade areas or customs union, which facilitate the trade without creating barriers to the trade of other parties. The member countries are allowed to adopt measures to counter dumping and export subsidies under the principle of GATT. The application of such measures are, however, limited to the offending Nations.

2. **Discouraging Quantitative Restrictions:** GATT principle seeks to discourage and even to prohibit quantitative restrictions. This principle ensures limiting restrictions on trade to the less rigid tariffs. However, few developing countries and countries confronted with balance of payment difficulties are allowed with the exceptions to this prohibition. Again agricultural and fishery products were granted with the application of import restrictions, where restrictive production and marketing controls were present with the domestic production of these articles.

3. **Continuing Consultation:** GATT sought to resolve disagreements to the trade through consultation and negotiations.

NOTES

GATT had gone through eight bigger rounds of trade negotiations so far. Each round took several years for the completion. The Uruguay Round, the eighth and the latest Round of the multilateral trade negotiations (MTNs) took very long time to conclude. The lengthy process of completion shows the complex issues involved in negotiating international trade.

## WTO

The principles and agreements of World Trade Organisation (WTO) influence the global business and affect the domestic environment significantly. The GATT was transformed into a World Trade Organisation (WTO) with effect from January, 1995. Thus, after about five decades, the original proposal of an International Trade Organisation took shape as the WTO. The WTO, which is a more powerful body than the GATT, has an enlarged role than the GATT.

The WTO is the Constituent of the Uruguay Round results and the improvement to the General Agreement on Tariffs and Trade. The WTO has a broader scope which enjoys larger membership than GATT. India is one of the founder members of the IMF, World Bank, GATT and WTO.

International standards and quality have played an important role in both protection of health and safety of consumers and facilitation of international trade. However, with the establishment of the WTO and the signing of the non-tariff agreements, the international scenario has rapidly changed and opportunities are available to all countries to benefit from greater access to world markets. In the given scenario, the role of standards and conformity assessment procedures by member countries, it is necessary that certain rules and disciplines are followed so that the standards/regulations do not act as unreasonable barriers to trade. This aspect has been taken care through the non-tariff agreements, which basically lay down the rules and disciplines with regard to standards and conformity assessment procedures for international trade.

## Creation of the WTO

Another important facet of the UR was the creation of WTO, which is changed with the implementation of the UR. In 1995 the WTO scheduled to subsume the activities of the GATT and serve as the world’s advocate and monitor more open and free international trade in goods, services, and technology. The establishment of WTO is not without controversy. However, some politicians are concerned that national government will

NOTES

have less control over their trade policies. Environmental and human rights advocates are worried that in the interest of promoting trade, the WTO will override national laws.

## WTO Agreements

The aspects relating to standardisation and certification of quality are addressed in the following three agreements under WTO trade regime to serve its overriding purpose of helping trade flow as freely as possible.

1. Agreement on Technical Barrier to Trade (TBT).
2. Agreement on Sanitary and Phytosanitary Measures (SPM).
3. Agreement on Pre-shipment Inspection (PSI).

These agreement basically aim at as free flow of trade as possible, by adherence to international standards in respect of quality, safety management systems, laboratory testing and conformity assessment (inspection and certification) systems and mutual recognition by member countries of each others systems. Such mutual recognition is further based on establishment of accreditation mechanisms in each country for inspection, certification or laboratory testing activities based on widely-accepted international criteria (ISO 17020, ISO 17025, ISO/IEC Guide 62 for ISO 9000, ISO/IEC Guide 66 for ISO 14C00).

Both SPM and TBT agreement require countries to participate in international standardisation work.

## The Future of WTO

The GATT is generally given high praise for its success in lowering tariffs on a wide range of goods over the past 50 years. In the Uruguay Round GATT negotiators made significant progress in addressing subsidies, trade in services, and protection of international property rights. Experts recognise, however, that much work remains to be done in eliminating Non Tariff Barriers (NTBs). Other analysts argue that GATTs multilateral philosophy is disintegrating as individual countries bargain bilaterally to resolve their conflicts. The US in particular has borne the brunt of sharp criticism that its Super 301 actions are undermining the GATTs multilateral framework. Finally, many international trade experts are concerned that the strengthening of regional trading blocks, such as the EU and NAFTA, may promote international trade among their members but diminish trade among the regions of the world.

NOTES

## Role of WTO

Following points explain the role or the function of WTO:

1. To provide effective framework for implementing, administering and operating plurilateral trade agreements.
2. To make an easy process of implementing, administering and operating the multilateral trade agreements.
3. To observe and evaluate the rules and procedures governing the settlement of disputes among the member countries involved in the trade agreements,
4. To make availability of details regarding negotiations concerning agreements among member countries undertaking multilateral trade.
5. To administer the "Trade Review Mechanism."
6. To meet greater coherence in global economic policy by enhancing better cooperation with the IMF, IBRD and its affiliated agencies.

The WTO is a powerful body having vast branch of functions as compared to the GATT. To become a member of the WTO, a country has to accept completely the results of the Uruguay Round. The WTO plays an important role in the world economic affairs. In short, the WTO is GATT plus a lot more.

## Gains and Losses from the WTO

One factor where India gained considerably was the issue of TRIPS (Trade Related Intellectual Property Rights). Originally conceived as a proposal to fight counterfeit products, the law had threatened to become a Frankenstein where India and other developing countries were concerned. It was trying to be used by the developed world to strangulate indigenous products like basmati rice and at the same time to prevent development of cheap medicines for which the internal pharmaceutical industry has the infrastructure and know how, all in the interests of Western patent rights in an earlier age and where the products are priced exorbitantly by Indian and Third World Standards.

NOTES

*Differences between GATT and WTO*

| Nature | GATT | WTO |
|---|---|---|
| 1. Institution | GATT was associated in a small secretariat without institutional foundation. | WTO is a permanent institution with its own secretariat. |
| 2. Agreements | GATT agreements were provisional. | WTO agreements are permanent. |
| 3. Commitments | GATT was applied on a "Provisional basis," even if, after more than 40 years, government choose to treat it as a permanent commitment. | WTO commitments are full and permanent. |
| 4. Coverage | GATT rules were applied to trade in merchandise goods only. | WTO is a wide aspect which covers not only trade in goods but also in services and intellectual property. |
| 5. Instrument | GATT was based on selective nature as it included both Multilateral and Plurilateral instruments/ agreements. | Agreements under WTO are almost multilateral, leading to full commitments for the entire membership. |
| 6.Dispute Settlement System | Disputes under GATT were not settled fast. | WTO is based on more automatic system which shall settle disputes very fast. |
| 7. Parties/ Members | GATT had contracting parties. | WTO has members. |
| 8. Power | GATT was less powerful and narrow scope which concentrated only on trade in goods. | WTO is more powerful and broader in scope as it consists of services and intellectual property in addition to goods. |

The developing countries would be granted the right to break any monopoly, which will almost inevitably mean a Western one, over patented drugs in case of health emergencies like the outbreak of epidemics.

Indian companies have over the years developed cheap and effective drugs for AIDS which can be used both domestically and exported to regions in Africa where the problem is far more endemic. Indian drug companies now need to co-ordinate with other similar companies in Africa to ensure

NOTES

that there is no needless competition and that life-saving drugs are available to the poor and needy at affordable prices.

Another vital sector where India gained was in agriculture — while the developed world, especially the combined might of the European Union (EU), wanted the Indian market to be opened up for its high-tech products, it still insisted on providing massive subsidies for its own farmers to develop those products.

## *3.8 MEANING AND DEFINITION OF INFLATION*

"Inflation" is commonly understood as a situation of substantial and rapid general increase the level of prices and consequent deterioration in the value of money over a period of time. The behaviour of general prices is measured through price indices. The trend of price indices reveals the course of inflation or deflation in the economy. As Lerner says, "a price rise which is unforeseen and uncorrected is inflationary".

Thus, inflation is statistically measured in terms of percentage increase in the price index, as a rate percent per unit of time—usually a year or a month. Generally, the wholesale price index (WPI) numbers are used to measure inflation. Alternatively, the Consumer Price Index (CPI) or file cost of living index number can be adopted in measuring the rate of inflation.

Inflation is like an elephant to the blind men. Different economists have defined inflation differently. We may, thus, enlist a few important definitions of inflation as follows, which would give us a comprehensive idea about this intricate problem.

Harry Johnson defines inflation as a "sustained rise in prices". Crowther, similarly, defines inflation as "a state in which the value of money is falling, that is, prices are rising". The common feature of inflation is a price rise, the degree of which may be measured by price indices. Edward Shapiro puts it thus: "Recognising the ambiguities our words contain, we will define inflation simply as a persistent and appreciable rise in the general level of prices".

Prof. Samuelson puts it thus: "Inflation occurs when the general level of prices and costs is rising". Authors like Thorp and Quandt, however, opine that it is of great help to define inflation in terms of observable phenomenon and, for this reason, the process of rising prices should be considered as inflation. There are, at least, two distinct views on the

NOTES

concept of inflation. To some economists, inflation is a pure monetary phenomenon, while to others it is a post-full-employment phenomenon.

## *3.9 FEATURES OF INFLATIONARY ECONOMY*

The following are the strategic features of an inflationary economy:

1. There is a continuously rising price trend, whether it is measured through WPI or CPI.
2. The money supply is in excess of the requisite production and exchange needs of the economy. There is an undeserving excess of monetary liquidity adding fuel to the fire.
3. A good part of the flow of credit is supplied to unproductive channels, speculative a ties, and sick and non-viable units of production. In many cases, there is no direct relation between the bank loans and the physical capacities of the enterprises.
4. There is a lack of financial discipline on the part of the government. The budget is large with huge deficits on the revenue and capital account.
5. A large number of commodities are in short supply paving ways for the sectoral price disequilibrium.
6. Artificial scarcity is commonly caused by hoarding activities and has become conspicuous for traders, producers, and consumers.
7. The rate of return of speculative hoarding of commodities, precious metals like gold, silver, and investments in immovable properties—land, buildings, flats, and so on, much high and fascinating than the rate of returns on the shares and bonds in an inflationary economy.
8. Interest rates in the unaccounted and unorganised sectors tend to be higher than organised sectors of the money market.
9. Labour unrest, strikes, lock-outs, and so on, are common. Organised labour force successful resists any reduction in the real wages and pushes up the money-wages, they are accelerating the process of cost-push inflation.
10. In an inflationary economy, the government is trapped in the cobweb of an ever increasing public expenditure, larger budgets, higher taxes, larger public debts, huge deficit financing, and a

NOTES

large number of controls, which, in turn, encourage black money a dual accounting system, black marketing, smuggling, and other antisocial activities account of the deterioration of the community's morals, in general, caused by the inflationary impact.

In short, an economy is inflationary because it is inflationary. There tends to be a vicious circle of inflation when it is curbed immediately. In the long period, the state of unchecked inflation becomes a built-in feature of the economy and people expect the rate of inflation to accelerate further.

## *3.10 SUMMARY OF THE UNIT*

The environmental levels interact with one another. The external level has forces which are difficult to control by business activity. At the micro level, the policies, laws, competition *etc.*, provide threats and challenges. This interacts with external macro environment.

## *3.11 GLOSSARY*

- **LDC:** Least Developed Countries
- **G.D.P. (Gross Domestic Product):** Total market value of goods and services produced by a nation (in one year).

## *3.12 KEY TERMS*

- **Cultural Environment:** It refers to customs, traditions and beliefs in the society.
- **Political Environment:** Laws, Executive action and Judiciary contribute in shaping business.
- **Customers:** Refers to buyers and ultimate consumers.

## *3.13 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (a) Fill in the Blanks

1. _______ introduced Human Development Index.
2. GNP minus net factor income from abroad is equal to _______.

NOTES

3. The extent of poverty in a community with respect to quality of life is measured using ______index.

### (B) True or False

1. Growth rate of economy refers to rate at which the GDP is increasing.
2. Economic growth is uni-dimensional and development is multidimensional.
3. Gender development index of UNDP adjusts HDI for gender equality.

## *3.14 KEY TO CHECK YOUR ANSWER*

(a) 1. UNDP, 2. GDP, 3. Human Poverty Index.

(b) 1. True, 2. True, 3. True.

## *3.15 TERMINAL AND MODEL QUESTIONS*

1. What do you understand by economic growth and development? Discuss.
2. How is the human development index helps as an indicator of development? Explain.
3. Explain the indices – GDI and HDI.

## *3.16 REFERENCE BOOKS*

1. Bedi: Business Environment 'Excel', Delhi
2. Cherunilam F.: Elements of business environment. HPH – Mumbai.

# UNIT 4 AGGREGATE DEMAND AND SUPPLY

## Structure:

4.1 Aggregate Demand
4.2 Aggregate Supply
4.3 Macroeconomic Equilibrium
4.4 Changes in Aggregate Demand or Aggregate Supply
4.5 Factors Affecting Aggregate Supply and Aggregate Demand
4.6 Wealth and Wealth Expectations
4.7 Government Demand and Taxation
4.8 Demand-Supply and Employment
4.9 Summary of the Unit
4.10 Glossary
4.11 Key Terms
4.12 Check Your Progress (Multiple Choice/Objective Type Questions)
4.13 Key to Check Your Answer
4.14 Terminal and Model Questions
4.15 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Explain what is meant by aggregate demand.
- Explain what is meant by aggregate supply.
- Define demand inflation.
- Explain what is supply shock.

NOTES

When we analyse the demand for and the supply of an individual good, we graph the quantity of the good and the price of that good. Now, we are considering all goods and services. So, instead of the quantity of a particular good, we show the quantity of all goods and services produced in states. Macroeconomics is about aggregates.

The term 'aggregates' refers to large group of goods and services or of people.

Here, we begin the analysis of aggregate demand and aggregate supply. The concept must be clear 'aggregate demand' refers to total demand and 'aggregate supply' refers to total supply.

While plotting for individual good we considered the 'price' of the some. Now, we show quantity of goods and services, produced in states. This quantity is measured by Real GDP (Gross Domestic Product). Here, the prices are measured by price index called GDP deflector.

## *4.1 AGGREGATE DEMAND*

Aggregate demand is the demand for all goods and services produced in the states. The graph below shows the aggregate demand curve. The graph tells us that, as ***the prices of all goods and services (the GDP Deflator) rise (fall), the demand for all goods and services (aggregate demand) will fall (rise).***

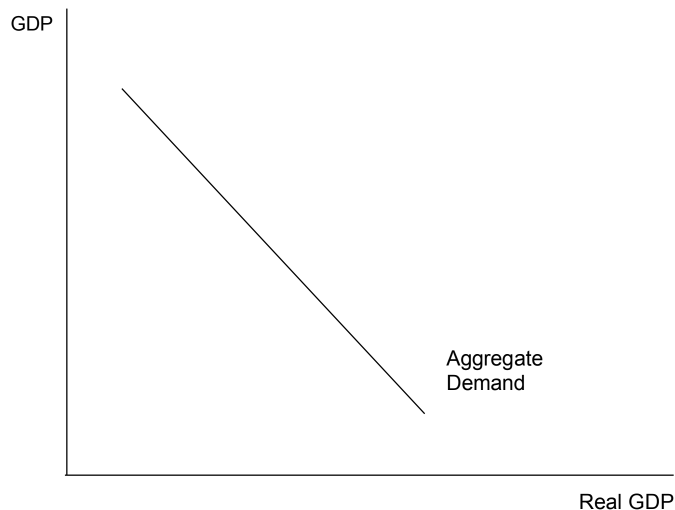



*Fig. 4.1*

Notice that the aggregate demand curve looks just like the demand curve for an individual product. This is convenient. But one does not follow from the other. There are several reasons for the downward slope of the

NOTES

aggregate demand curve (that is, for the fact that people will buy fewer goods and services if the prices of all goods and services rise). Some of these reasons we will encounter later. But two of the reasons have already been explained.

If prices rise local will buy more imported products and foreigners will buy fewer export products. These will reduce aggregate demand.

***As prices of all goods and services rise (this is inflation), people whose wealth is in financial form are losers.*** That is, those with checking accounts, savings accounts, FDs, bonds, bills, stocks, and so forth will see their assets go down in value. ***If people become less wealthy, they are likely to spend less, causing aggregate demand to fall.*** There are other reasons for the downward slope of the aggregate demand curve.

The graph operates in the same manner as the graphs we have used earlier in economics. What will cause a movement along the aggregate demand curve? The answer is a change in the prices of all goods and services produced in the States (that is, in the GDP Deflator). What will cause a shift in the aggregate demand curve? The answer is a change in anything other than the prices of all goods and services produced in the States. ***Remember that aggregate demand is divided into – net exports.*** So, anything that affects any of these categories (other than prices) will cause the aggregate demand curve to shift. If aggregate demand increases, the shift is to the right and if aggregate demand decreases, the shift is to the left.

Later we will consider many factors that will affect consumer spending. We already know about considered exchange rates. All of these factors will cause the aggregate demand curve to shift. But most of our focus in the course will be on fiscal policy and monetary policy. Fiscal (government) policy involves changes in government spending and in the tax system.

Government spending can involve either ***government purchases or government transfers,*** such as Social Security. So, if the government purchases increase, perhaps for an increase in defense spending, aggregate demand increases. The aggregate demand curve would shift right, and if the government transfers increase, perhaps for an increase in social security payments, aggregate demand increases. Again, the aggregate demand curve would shift right. And if the government increases taxes, aggregate demand decreases. If the government takes the income from you, you cannot spend it. The aggregate demand cure would shift left. Also,

NOTES

***monetary policy changes in the money supply (the number of dollars in existence).*** If the money supply increases, there are more dollars. Someone with those dollars would spend them. Aggregate demand would increase. The aggregate demand curve would shift to the right. If the money supply decreases, the aggregate demand curve shifts left. The agency responsible for changes in the money supply is called the ***Federal Reserve System*** (Fed). i.e., Government.

Test your understanding

For each of the following, state whether there is a movement along or a shift in the aggregate demand curve. If there is a shift, is it to the right or left?

1. The Federal Reserve Decreases the Money Supply
2. Workers Receive Higher Wages
3. The American Dollar Depreciates
4. Taxes on Personal Incomes are Decreased
5. Taxes on Businesses are Increased
6. Government Purchases Decrease
7. Foreign Incomes Increase
8. The GDP Deflator Rises

## *4.2 AGGREGATE SUPPLY*

Aggregate supply refers to the supply of all goods and services produced in the states. The graph below shows the aggregate supply curve. The graph tells us that, ***as the prices of all goods and services (the GDP Deflator) rise (fall), the supply of all goods and services (aggregate supply) will rise (fall).***

NOTES

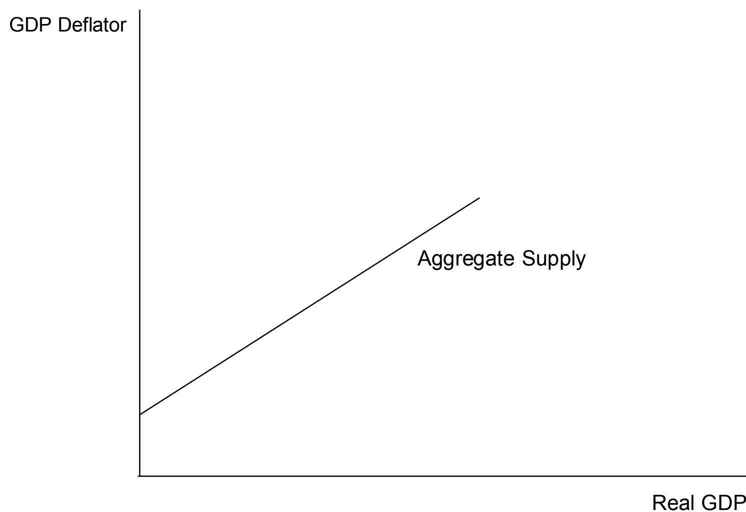



*Fig. 4.2*

Notice that this aggregate supply curve looks just like the supply curve for an individual product. Again, this is convenient. But, again, one does not follow from the other. ***The reasons for the upward slope of the aggregate supply curve (that is, for the fact that companies will sell more of all goods and services if the prices of all goods and services rise) requires logic.***

There is some disagreement about the shape of this aggregate supply curve. Some people believe that the aggregate supply curve is actually vertical, as shown below.

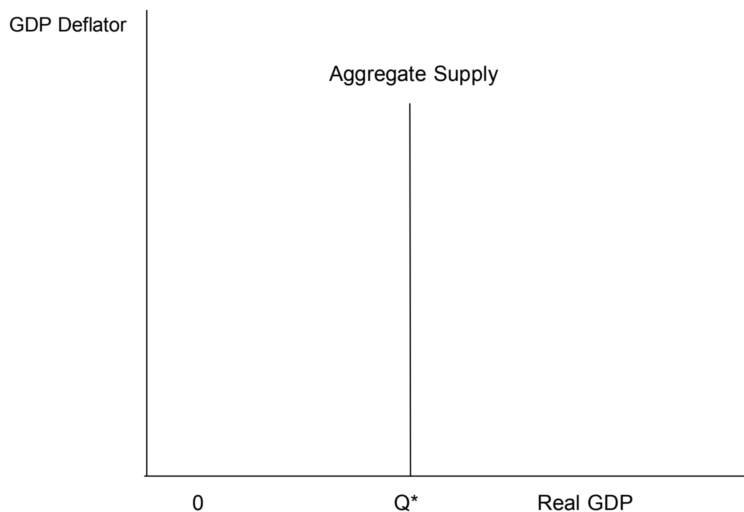



*Fig. 4.3*

According to this graph, the quantity of all goods produced in the states will be the same whether the prices of these goods rise or fall. The quantity that will remain unchanged (Q*) is the Potential Real GDP.

NOTES

***The Potential Real GDP is the amount of production necessary to have unemployment equal full-employment (the natural rate of unemployment).*** Today, we think this means the amount of production to generate enough jobs so that the unemployment rate is only 4%. Those who argue that the aggregate supply curve is vertical believe that the economy will always be able to maintain the Potential Real GDP (the economy will never experience a recessionary or inflationary gap).

The aggregate supply graph operates in the same manner as the other graphs. What will cause a **movement along** the aggregate supply curve? The answer is a change in the **prices** of all goods and services produced in the states (that is, in **the GDP Deflator**). What will cause a **shift** in the aggregate supply curve? The answer is a change in **anything other than the prices** of all goods and services produced in the states. Let us focus on only one factor that will shift the aggregate supply curve – a change in the costs of production. Any change that increases costs of production will decrease aggregate supply, shifting the aggregate supply curve to the left. Any change that decreases costs of production will increase aggregate supply, shifting the aggregate supply curve to the right.

Test your understanding

For each of the following, state whether there is a movement along or a shift in the aggregate supply curve. If there is a shift, is it to the right or left?

1. The Productivity of Workers Increases at a more Rapid Rate
2. Workers Receive Higher Wages (Consider this now as a Cost of Production)
3. An Increase in the Price of Oil, Which is used in the Production of Most Products
4. A Government Subsidy to Business to Buy More Capital Goods
5. Government Regulations which Raise Costs of Production to Businesses
6. A Depreciation of the Dollar (Which Affects the Prices of Imported Parts and Materials used in Production)
7. Increase in the GDP Deflator

NOTES

## 4.3 MACROECONOMIC EQUILIBRIUM

Putting the aggregate demand and the aggregate supply curves together provides us with equilibrium, as it did for individual products. This is shown in the graph below. GDP Deflator.

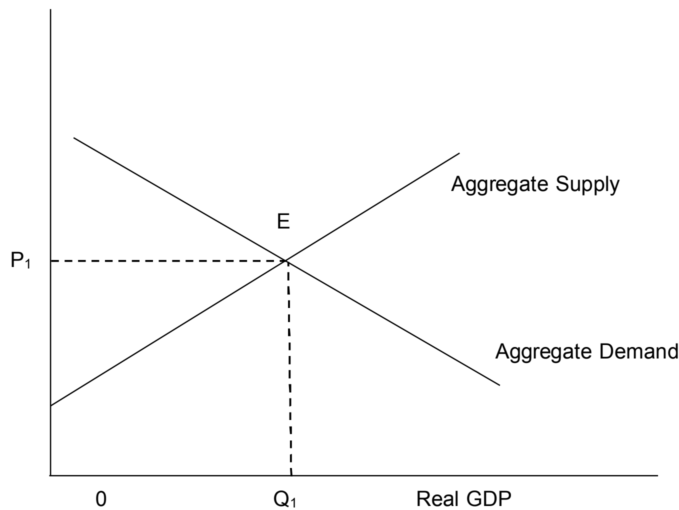



*Fig. 4.4*

The behaviors of all buyers (aggregate demand) and the behaviors of all sellers (aggregate supply) have determined that the quantity (Real Gross Domestic Product) will be $Q_1$ and that the price index (GDP Deflator) will be $P_1$. In 2003, $Q_1$ would equal $10,493 billion and $P_1$ would equal 105.88. We know that both aggregate demand and aggregate supply can change. Each can increase and each can decrease. There are four possibilities. Let us examine each in turn and then some recent development.

## 4.4 CHANGES IN AGGREGATE DEMAND OR AGGREGATE SUPPLY

### Case 1: Aggregate Demand Increases

Let us assume that something occurs to cause aggregate demand to shift to the right (increase). This is shown in the graph below.

NOTES

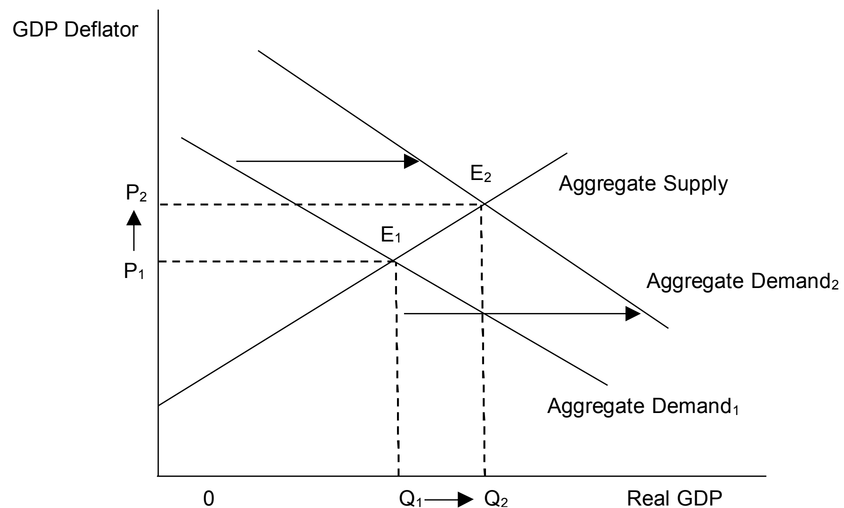



*Fig. 4.5*

First, what happens to Real GDP if aggregate demand rises? As you can see, Real GDP rises. Called ***an expansion***. And during an expansion, unemployment falls. The increase in goods and services being produced and the reduction in unemployment are both good things. Second, what happens to prices (the GDP Deflator) if aggregate demand rises. As you can see, they rise. A rise in prices is, of course, called inflation. But since the cause was an increase in aggregate demand, we call this ***"demand inflation"***. So there is **a trade-off** involved; we gain the benefits of greater production and lower unemployment but bear the costs of higher inflation.

This situation is relevant to understanding several periods in recent American economic history. First, there is the period from 1964 to 1969. The increase in aggregate demand began with a tax decrease known as the **Kennedy Tax Cut of 1964**. Then, there was a large increase in government purchases.

This began with a series of government spending programmes known as the **War on Poverty** in 1964. Then, there was a large increase in government spending on health care as **Medicare** was passed in 1965. Medicare provides health insurance coverage for people over age 65. Most significantly, there was a large increase in government spending as the **Vietnam War** spending rose significantly throughout the decade. As our graph shows, there was an expansion in this period. The expansion lasted $8\frac{1}{2}$ years, which was the longest expansion in American history until the 1990s. Unemployment fell to a low of 3.2%, a rate that has not been achieved since. But as the graph also shows, the result was inflation. The period of steady inflation began in the decade of the 1960s.

NOTES

The period from 1982 to 1990 also illustrates the effects of an increase in aggregate demand. In this period, there was an increase in aggregate demand caused by the large increase in defense spending, by a major tax cut passed in 1981 and by and increase in the money supply by the Federal Reserve. The increase in aggregate demand caused an expansion. Real GDP rose. Unemployment fell from over 10% in the fall of 1982 to a low of 5% in March of 1989. The Consumer Price Index (CPI) rose from 94.3 in January or 1982 to 127.4 eight years later.

Finally, the ten-year period from 1991 to 2001 illustrates the effect of an increase in aggregate demand. Here, the major cause was an increase in the money supply and resulting low interest rates. The low interest rates caused business investment spending to greatly increase creating an expansion – the longest in American history.

Unemployment fell to a low of 3.9% in 2000. But again, there was inflation. The Consumer Price Index (CPI) rose again from 134.6 in January of 1991 to 172.2 at the end of 2000.

### Case 2: Decrease in Aggregate Demand

Now, let us assume that something occurs to cause aggregate demand to shift to the left (decrease). This is shown in the graph below.

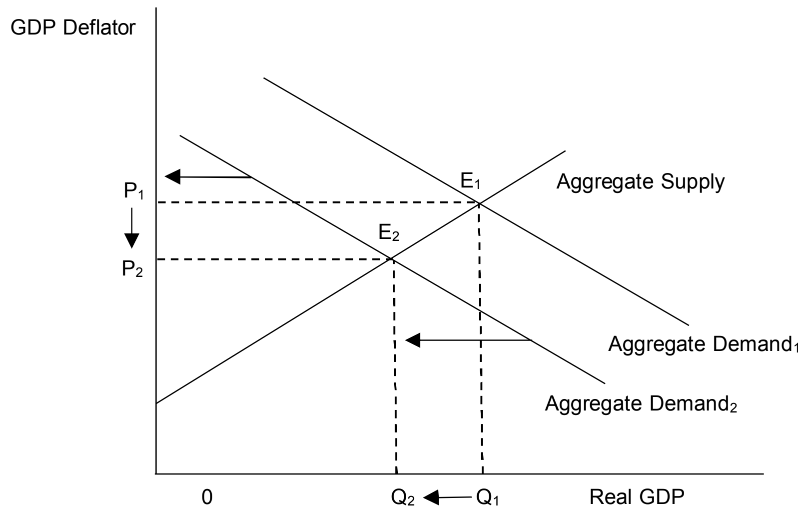



*Fig. 4.6*

First, what happens to Real GDP if aggregate demand decreases? As you can see, Real GDP falls. This period in which Real GDP is falling is called ***a recession***. And during a recession, unemployment rises. The decrease in goods and services being produced and the increase in unemployment are both bad things. Second, what happens to prices (the GDP Deflator) if aggregate demand decreases. As you can see, they fall. A fall in prices is

NOTES

called ***deflation***. You know that the United States has not experienced deflation since 1950s. In reality, in this situation, we would see ***disinflation*** (not shown on the graph). ***Disinflation means that prices are still rising, hut they are rising at a slower rate than previously.*** If prices rise 4% one year and then rise 3% more the next year, we have disinflation. We will consider later why the country experiences disinflation and not deflation, when aggregate demand falls. Both deflation and disinflation can be considered good. So once again, there is a trade-off. We gain the benefits of deflation or disinflation. But we must bear the burden of falling production and rising unemployment.

The graph illustrates several periods in recent American history. From 1969 to 1971, from 1974 to 1976, and again from 1979 to 1982, aggregate demand fell due to a decrease in the money supply by the Federal Reserve. In all three periods, the Federal Reserve decreased the money supply in order to try to slow inflation. In all three periods, the Federal Reserve succeeded. The United States experienced disinflation each time. However, the United States also experience recession each time, with falling production and rising unemployment. Unemployment reached its postwar peak of over 10% in 1982. The graph also illustrates the period from 1990 to 1991. In this case, the decrease in aggregate demand was not caused by a decrease in the money supply.

Instead, the causes were a decrease in consumer spending, as consumers found themselves heavily in debt, and a decrease in government spending on the military, as the Cold War came to an end. The decrease in spending on military equipment, bases, and personnel caused the 1990 recession to be particularly severe in southern California. Finally, the graph illustrates the period from 2000 to 2001. In this case, aggregate demand fell because of a decline in business investment spending. We will consider this near the end of the course.

### Case 3: Decrease in Aggregate Supply

Now let us assume there is a shift of aggregate supply to the left (a decrease). This is shown in the graph.

NOTES

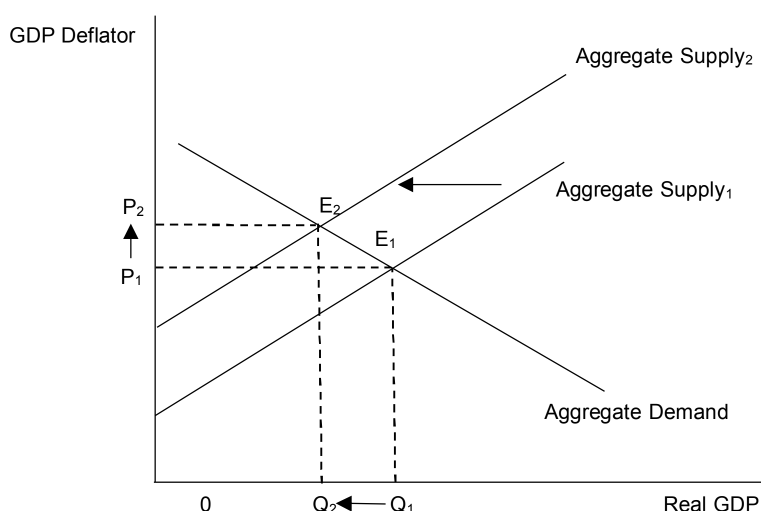



*Fig. 4.7*

What happens to Real GDP if aggregate supply decreases? As you can see, Real GDP falls. A period in which Real GDP is falling is called ***a recession***. During a recession, unemployment rises. The decrease in goods and services being produced and the increase in unemployment are both bad. What happens to prices (the GDP Deflator) if aggregate supply decreases, they rise. A rise in prices, is ***inflation***. Why would aggregate supply decrease? Aggregate supply decreases when something occurs to increase the costs of production. Because this is so, the resulting inflation is called ***"cost-inflation"***, to differentiate it from demand-inflation. Notice that there is no trade-off now. The decline in production is a bad thing. The rise in unemployment is a bad thing. The rise in prices is a bad thing. This is a "Murphy's Law" situation: everything that could go wrong did go wrong. A period with both recession and cost-inflation together is called ***stagflation*** (a combination of the words stagnation and inflation).

There were two important periods in recent American economic history that illustrate this graph. One began in 1973. The other began in 1979. In both cases, aggregate supply shifted to the left because of a large increase in costs of production caused by increases in the price of oil. In the 1973 period, oil prices rose from about $4 per barrel to about $14.50 per barrel in a little over one year. (A barrel of oil is 42 gallons.) In the 1979 period, oil prices rose from the $14.50 per barrel to almost $40 per barrel, before settling in at around $28 per barrel. This meant that oil prices in 1980 were seven times what they had been at the beginning of 1973. As oil is involved in the costs of so many products, these costs rose greatly. (Oil is used in power generation, in all transportation, in the development of plastic materials, and so forth.) Because the costs of production rose

NOTES

greatly, consumer prices also rose greatly (as high as $13\frac{1}{2}$ % per year by 1980). Since the price rises were shocking, and since it was a decrease in aggregate supply that caused them, they came to be called ***supply shocks.*** In both periods, the supply shocks United States caused stagflation. This went through both a severe recession and a severe Inflation. Both the periods led up to Election in each period in which the incumbent President was defeated (Ford in 1976 and Carter in 1980). Oil prices rose dramatically again in 2000 and 2003.

## Case 4: An Increase in Aggregate Supply

Finally, let us assume there is a shift of aggregate supply to the right (an increase). This is shown in the graph below.

What happens to Real GDP if aggregate supply increases? As you can see, Real GDP increases. A period in which Real GDP is increasing is called an ***expansion.*** During an expansion, unemployment falls. The increase in goods and services being produced and the decrease in unemployment are both good things. What happens to prices (the GDP Deflator) if aggregate supply increases — they decrease. A decrease in prices is ***deflation*** (in reality, we would most likely see ***disinflation***). This is a "win-win" situation. The rise in production, the fall in unemployment, and the decline in inflation rates are all good things.

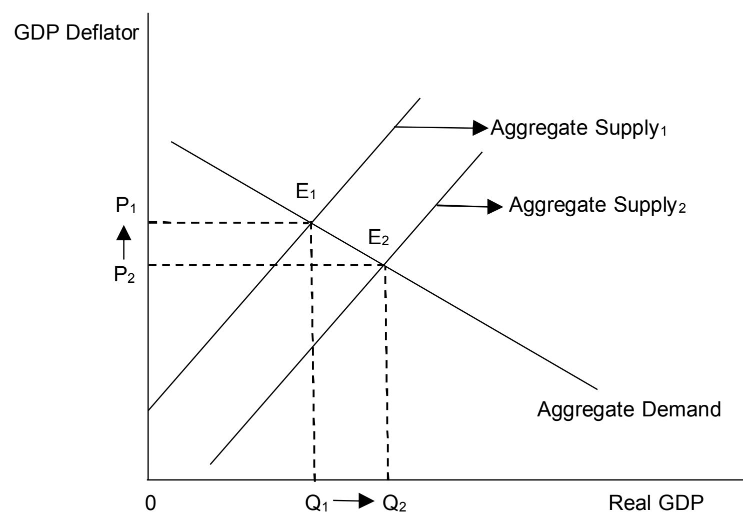



*Fig. 4.8*

What would make aggregate supply increase? We would like to know, as the results of an increase in aggregate supply are all good. ***The answer is that aggregate supply increases if something happens to make the costs of production decrease.*** This graph likely characterises the period from 1995 to 2000 and again from late 2001 to the present. In this period,

NOTES

aggregate supply has been rising because of a large increase in the productivity of workers.

Generally, we do not know how to use public policy to make costs of production decrease more than little. However, various groups have had proposals that they believe would make aggregate supply increase significantly. One group, known as ***supply side economics,*** focused on effects of reducing tax rates on increasing aggregate supply.

## *4.5 FACTORS AFFECTING AGGREGATE SUPPLY AND AGGREGATE DEMAND*

Like the micro economic supply-and-demand model, changes in equilibria in the **AS/AD** model are caused by changes in the variables that affect supply and demand. Table below. Again, the variables that are likely to affect supply or demand are listed. The presumed direction of influence is shown with a (+) or (–) sign as was done with the microeconomics model.

The relationship between **AS, AD** and price are represented by the slope of the **AS** and **AD** curves; changes in all other variables cause the curves to shift right or left.

*Factors that Affect Aggregate Supply and Aggregate Demand*

| Aggregate Demand | | Aggregate Supply | |
|---|---|---|---|
| 1. Income | (+) | 1. Costs | (–) |
| 2. Wealth | (+) | (a) Labour (wages) | |
| 3. Population | (+) | (b) Resource | |
| 4. Interest rate | (–) | 2. Investment (prior) | (+) |
| 5. Credit availability | (+) | 3. Productivity | (+) |
| 6. Government demand | (+) | 4. Interest rates | (–) |
| 7. Taxation | (–) | 5. Credit availability | (+) |
| 8. Foreign demand | (+) | 6. Foreign supply | (–) |
| 9. Investment | (⁺) | 7. Expectations | |
| 10. Expectations | | (a) Profits | (+) |
| (a) Inflationary | (+) | 8.Taxation | (–) |
| (b) Income | (+) | | |
| (c) Wealth | (+) | | |
| (d) Interest rate | (+) | | |

(+): An increase in this factor causes the curve to shift **right**.

(–): An increase in this factor causes the curve to shift **left**.

NOTES

A review of the list shows some overlap or redundancy. For example, both interest rates and credit availability are related of course, and one might be used to the exclusion of the other. Despite the fact that these are related, there is a difference between them. For example, credit extended by credit cards became more readily available to consumers in the late 1970s and throughout the 1980s because computerisation lowered transaction costs. This is an institutional reason for credit availability and would be reflected in a model concerned with showing the effects of this institutional change.

## *4.6 WEALTH AND WEALTH EXPECTATIONS*

It should be obvious that income would be strongly correlated with aggregate demand since that is primarily how demand is financed, but the effect of wealth and expectations of future wealth (and for that matter income expectations) is perhaps not so obvious. The argument here is that consumer perceptions of their own wealth, which is linked to income but not the same thing, and expectations of future wealth will effect their consumption behaviour. A reasonable measure of wealth would certainly include consumer savings (including bank deposits and ownership of liquid financial assets, such as stocks and mutual funds) but would also include more abstract and less liquid categories of wealth, such as home equity, consumers, in other words, with considerable equity (the difference between the market value and what is owed on the loan balance) in their homes have more latitude for spending than consumers who do not. This is especially true if they expect that equity to grow.

One might ask how consumers can increase their spending if the source of wealth is illiquid (not easily converted to cash) or is based upon expected rather than realised income and wealth. One source of potential demand is obvious; savings. The general availability of consumer credit is another. Consumers expecting an increase in income can finance purchases immediately with credit cards or instalment credit (such as that used to purchase automobiles) and make payments from future income. Likewise, consumers living in states like New York and California, having experienced substantial increases in home equity (at least up until 1989) perceived that their wealth had grown and could raise their standard-of-living with the popular home equity loans.

In summary, when savings are ample or credit is readily available, spending is not directly restricted by immediate, realised income, and

NOTES

aggregate demand can respond to consumer perceptions of wealth, expected income, or expected wealth.

## *4.7 GOVERNMENT DEMAND AND TAXATION*

Government demand in this context is the equivalent of Government Purchases of Goods and Services in the national income account. The treatment of *transfer payments* like Social Security, which merely pass income from one private party, the taxpayer, to another, the recipient, must depend on how, taxation, is treated. If transfer payments are excluded from government demand, then the proportion of taxation used to finance transfer payments.

Taxation has a negative sign for aggregate demand for two reasons: (1) it reduces disposable income for consumers and, (2) because it lowers business profits, it lowers any investment that might have been financed by those profits. Because from the perspective of business, taxation is yet another cost of doing business, at least to some degree, it has the same effect upon aggregate supply as other cost categories. An increase in taxation tends to reduce aggregate supply.

On net then, government spending tends to stimulate demand whereas taxes tend to retard demand. Therefore, a government running a balanced budget would have a roughly neutral effect on aggregate demand and a government running a budget deficit (where expenditures exceed revenues) would have a stimulating effect. There are considerable tax advantages of using home equity loans to encourage this activity as well. Interest paid on home equity loans are deductible from taxable income, reducing the consumer's income tax burden.

Unfortunately, nothing is ever quite so simple as this. Some theories claim, for example, that even a balanced budget stimulates the economy.

## *4.8 DEMAND-SUPPLY AND EMPLOYMENT*

Another important macroeconomic issue is what determines the level of employment in the economy and what causes involuntary unemployment. *Involuntary unemployment is defined as the situation when in the country there are a large number of workers who are willing to work at the current wage rates but are unable to get employment*. In times of depression, the level of employment declines very low with the result that a large number of persons become involuntarily unemployed.

NOTES

## Say's Law and Employment

Classical economists were of the view that there was always full employment in a free-market economy. According to them, if there are lapses from the full employment level, then some forces would work automatically to restore full employment. Their view was based upon their faith in Say's *Law of Markets*. According to Say's law, there is always enough expenditure or aggregate demand to purchase the total output produced with full-employment of resources. In other words, in their theory, the classical economists neglected the problem of deficiency of demand for purchasing goods produced at full employment level of resources. Even when deficiency of aggregate demand arises, according to them, prices and wages would change in such a way that real production, employment and income will not decline.

J.B. Say was the famous French economist of the 19th century. Say's law is based on the fact that every production of goods also creates income for the factors of production equal to the value of goods produced by them. Income earned by the factors are spent on purchasing goods produced. In other words, production of goods creates purchasing power for itself. Therefore, Say's law is expressed as *'supply creates its own demand'*, that is, the supply of goods produced creates demand for it equal to its own value. As a result, the problem of general overproduction and unemployment of resources do not arise. In this way, according to Say's law, the possibility of lack of aggregate demand had been ignored.

We thus see that according to Say's law, aggregate demand for goods will always be adequate so as to ensure that all resources are fully employed. The factors which participate in productive activity and earn incomes from it, spend a good part of their incomes on consumer goods and save some part of them. But, according to classical economists, savings by the individuals are automatic, *industry would not significantly affect the demand for the product of that industry because most of the demand for the product of that industry comes from the workers and persons employed in other industries*. However, to assume that demand curve for output of *all industries* will remain unchanged when a *simultaneous cut in wages in all industries together* made is not valid. In other words, to apply the result of micro analysis of the determination of price, output and employment in an individual industry to the economy as a whole is quite misleading and invalid. This is because *wages are not only costs for the individual industries, they also constitute incomes of the workers and these incomes determine the demand for the products of various industries*. When all-

NOTES

round cut in wages is made in all industries, it will reduce aggregate demand for the products because workers would have now less incomes and therefore, would spend less on goods and services. With reduced demand for the products of industries smaller output will be produced. As a result, smaller amount of labour will be demanded and employed.

Keynes explained that level employment was determined by aggregate demand and aggregate supply. He further showed that equilibrium level of income and employment could well be established at less than full-employment level of national income. Thus, according to him, lack of aggregate demand can cause involuntary unemployment of labour and unutilised productive capacity.

## 4.9 SUMMARY OF THE UNIT

Macro economics is about aggregates. It refers to total supply of all goods and services. This quantity is measured by real G.D.P. *i.e.,* Gross Domestic Product. This is linked to G.D.P deflator. Rise in prices is called inflation. If the cause is increase in aggregate demand it is called demand inflation.

## 4.10 GLOSSARY

- **Export:** Sale of goods and services to another country.
- **Nationalisation:** Is the process of transforming private assets into public assets by bringing them under the public ownership of government.
- **MFN:** Most Favoured Nation

## 4.11 KEY TERMS

- **GDP:** Gross Domestic Product.
- **Productivity:** The effectiveness of productive effort as measured in terms of output per unit of input.
- **GDP deflator:** A ratio of nominal GDP to real GDP expressed as a percentage. Used to measure the inflation rate.

NOTES

## *4.12 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the blanks

1. Effect of increase in money supply depends on ________.
2. Inflation means sustained rise in ________.

### (B) True or False

1. Black money encourages more spending and causes economic growth.
2. Artificial scarcity in prices is caused by hoarding.

### (C) Multiple Choice Questions

1. The aggregate demand curve slopes:
   (a) Horizontally (b) Vertically
   (c) Down and Right (d) Up and Right
2. Which of the following would cause movement along the aggregate demand curve?
   (a) an increase in government spending
   (b) an increase in the money supply
   (c) depreciation of the American dollar
   (d) an increase in the GDP Deflator
3. Which of the following would cause the aggregate demand curve to shift to the right?
   (a) an increase in government spending
   (b) an increase in the money supply
   (c) depreciation of the American dollar
   (d) all of the above
4. The aggregate supply curve is:
   (a) horizontal (b) vertical
   (c) upward-sloping (d) downward-sloping

NOTES

5. Which of the following would cause the aggregate supply curve to shift to the right?
   (a) an increase in wages paid to workers
   (b) productivity increases which lower costs of production
   (c) depreciation of the American dollar which increases the costs of imported materials
   (d) all of the above
6. Assume that something occurs to cause aggregate demand to increase. Which of the following should result?
   (a) expansion and inflation (b) recession and deflation
   (c) recession and inflation (d) expansion and deflation
7. Assume that something occurs to cause aggregate demand to decrease. Which of the following should result?
   (a) expansion and inflation (b) recession and deflation
   (c) recession and inflation (d) expansion and deflation
8. Assume that something occurs to cause aggregate supply to decrease. Which of the following should result?
   (a) expansion and inflation (b) recession and deflation
   (c) recession and inflation (d) expansion and deflation
9. Assume that something occurs to cause aggregate supply to increase. Which of the following should result?
   (a) expansion and inflation (b) recession and deflation
   (c) recession and inflation (d) expansion and deflation
10. Stagflation is a combination of:
   (a) expansion and inflation (b) recession and deflation
   (c) recession and inflation (d) expansion and deflation

## *4.13 KEY TO CHECK YOUR ANSWER*

**(A)** 1. Liquidity, 2. prices.

**(B)** 1. False, 2. True.

**(C)** 1. (c), 2. (d), 3. (d), 4. (c), 5. (b), 6. (a), 7. (b), 8. (c), 9. (d), 10. (c).

NOTES

## 4.14 TERMINAL AND MODEL QUESTIONS

1. What do you understand by demand and supply?
2. What do you understand by supply shock? Explain.
3. What steps can be taken to counter inflation?

## 4.15 REFERENCE BOOKS

1. Avadhani V.A.: 'Global Business', HPH, Mumbai.
2. Misra S.K. & V.K. Puri: Indian Economy, HPH, Mumbai.

# UNIT 5 INFLATION

## Structure:

5.1 Introduction
5.2 Inflation – Index
5.3 Prices as Measures of Inflation
5.4 Inflation and Developing Economies
5.5 Demand-pull vs. Cost-push Inflation
5.6 Causes of Inflation
5.7 Effects of Inflation
5.8 Control of Inflation
5.9 Summary of the Unit
5.10 Key Terms
5.11 Check Your Progress (Multiple Choice/Objective Type Questions)
5.12 Key to Check Your Answer
5.13 Terminal and Model Questions
5.14 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Know the causes and effects of inflation.
- Understand how population and poverty effect welfare economy.
- Measures to fight inflation.

NOTES

## *5.1 INTRODUCTION*

It means steep increase in prices, resulting in decrease in the value of money over a period of time. To understand one has to study, the impediments in 'growth process.' There are theories called – Demand pull and cost push – inflation. There are causes such as – money supply, berk credit, hoarding *etc.* that has effect on economic activity.

## *5.2 INFLATION – INDEX*

Whereas economic growth is a major yardstick of macroeconomic performance of a country, low rate of inflation is generally regarded as the indicator of macroeconomic stability. By inflation we mean a general rise in prices. To be more correct, inflation is a *persistent rise in general price level* rather than a once-for-all rise in it. Rate of inflation is either measured by the percentage change in Wholesale Price Index number (WPI) over a period or by percentage change in Consumer Price Index number (CPI). Opinion surveys conducted in India and the United States reveal that inflation is the most important concern of the people as it affects their standard of living adversely. A high rate of inflation erodes the real incomes of the people. A high rate of inflation makes either on grounds of a prior rise in productivity or cost of living. The employers in a situation of high demand and employment are more agreegable to concede to these wage claims because they hope to pass on these rises in costs to the consumers in the form of rise in prices. Therefore, when inflation is caused by rise in wages or hike in other input costs such as rise in prices of raw materials, rise in prices of petroleum products, it is called *cost-push inflation*. If this happens we have another inflationary factor at work, of other inputs, there is another factor responsible for cost-push inflation. This is the increase in the *profit margins* by the firms working under monopolistic or oligopolistic conditions and as a result charging higher prices from the consumers. In the former case when the cause of cost-push inflation is the rise in wages it is called *wage-push* inflation and in the latter case when the cause of cost-push inflation is the rise in profit margins, it is called *profit-push inflation*.

In addition to the rise in wage rate of labour and increase in profit margin, in the seventies the other cost-push factors (also called *supply shocks*) causing increase in marginal cost of production became more prominent in bringing about rise in prices. During the seventies, rise in prices of raw

NOTES

materials, especially energy inputs such a hike in crude oil prices made by OPEC resulted in rise in prices of petroleum products. For example, sharp rise in world oil prices during 1973-75 and again in 1979-80 produced significant cost-push factor which caused inflation not only in India but all over the world. Now, in June-August 2004 again the world oil prices have greatly risen. As a result, in India prices of petrol, diesel, cooking gas were raised by petroleum companies; pushing inflation.

## 5.3 PRICES AS MEASURES OF INFLATION

Prices as measures of inflation – It is well recognised that inflation is a structural as well as monetary Phenomenon. The trend in price indices reveal the course of inflation. In long therm the movement of monetary aggregates such as money supply have influenced aggregate demand. Thus there are changes in price level in the economy.

The short term localised demand—supply imbalances in wage goods, often due to season variations in production—coupled with market rigidities and regulatory failures have supported inflationary expectations. That has resulted in a more widespread impact, than the initial inflationary impulse, on the consumers. In the medium to long term, the movement and outcome of monetary aggregates, such as the money supply and reference interest rates of the financial systems, have influenced aggregate demand and consequently, changes in the price levels in the economy. The latter considerations and the influence of global commodity prices on the domestic, prices have become more important with the opening and growing integration of the Indian economy with the rest of the world. Indeed, the fiscal year (FY) 2007-08 has demonstrated this facet of the economy more than ever before. With a huge surge in capital inflows, the liquidity management with its underlying implications for inflation has been a major challenge for the policymakers.

*Housing Price Index*

| | | | |
|---|---|---|---|
| Delhi city | 129 | 150 | 201 |
| Mumbai metropolitan region | 132 | 149 | 178 |
| GMCC | 136 | 159 | 198 |
| CM | 130 | 141 | 163 |
| Kolkata metropolitan region | 129 | 148 | 172 |
| Kolkata MC | 136 | 159 | 192 |

NOTES

*Housing Price Inflation*

| City | 2002 | 2003 | 2004 | 2005 | Annual Average |
|---|---|---|---|---|---|
| Delhi city | 6.0 | 21.7 | 16.3 | 34.0 | 19.1 |
| Mumbai metropolitan region | 16.0 | 13.8 | 12.9 | 19.5 | 15.5 |
| GMCC | 19.0 | 14.3 | 16.9 | 24.5 | 18.6 |
| CM | 14.0 | 14.0 | 8.5 | 15.6 | 13.0 |
| Kolkata metropolitan region | 15.0 | 12.2 | 14.7 | 16.2 | 14.5 |
| Kolkata MC | 20.0 | 13.3 | 16.9 | 20.8 | 17.7 |
| KMA | 11.0 | 12.6 | 11.2 | 13.7 | 12.1 |
| Bengaluru city | 33.0 | 27.8 | 31.8 | 22.8 | 28.8 |
| Bhopal city | 20.0 | 13.3 | 13.2 | 16.2 | 15.7 |

**Source:** Economic Survey 2007-08, Government of India.

## *5.4 INFLATION AND DEVELOPING ECONOMIES*

Inflation in the developed countries may be regarded as a full-employment phenomenon and it may be well-linked with a full-employment policies. But what about the underdeveloped or newly developing economies? To explain the phenomenon of inflation in developing economies, champions of Development Economics like Myrdal say that underdeveloped countries like India are structurally backward with a lop-sided development, characterised by sectoral imbalances due to market imperfections and stagnancy, as may be caused by a dual nature of the economy with a high fragmentation. As such, scarcity in some sectors may cause underutilisation of the productive capacity of the economy and create the problem of sectoral inflation, more serious than a general price rise. Hence, the general aggregate demand-and-supply analyses are not suitable to such types of situation. It should be replaced by the analyses of sectoral demand-and-supply balances and the bottlenecks involved to study the true nature of inflation in these economies.

In short, to understand the true nature of inflation in an underdeveloped country, one has to examine the bottlenecks and gaps of various types, which obstruct the normal growth process, causing prices to rise with the generation of money income, without an appropriate rise in the real income. These gaps and bottlenecks may be enlisted as follows:

NOTES

## Market Imperfections

Market imperfections like factor immobility, price rigidity, ignorance of market conditions, rigid social and institutional structures and lack of specialisation and training in underdeveloped economies do not allow an optimum allocation and utilisation of resources. Hence, an increase in only income remain unaccompanied by an increased supply of output, causing a net price rise of inflationary nature. In these economies there are following obstacles.

## Entrepreneurial Block

Entrepreneurs in the underdeveloped countries lack skill, the spirit of boldness and adventure. They prefer trading or safer traditional investments rather than attempting risky innovations. Absence of adequate industrial capital, prevalence of merchant capital and a colossal amount of private investments in such unproductive fields like land, jewellery, gold, and so on, which is a gross socio-economic waste, starve the developing economy of its much-needed capital resources. Thus, the increased money supply of savings in terms of money makes a little impact on the real output, and monetary equilibrium is just obtained through a galloping price rise in various sectors of the economy.

## Food Obstacle

Due to the slow growth of agriculture, over pressure on land due to the growing population, primitive methods of cultivation, defective land tenure system, lack of adequate irrigation facilities, and many other reasons, agricultural output—especially, food supply that constitutes a large part of wage goods, has failed to keep in pace with the growing demand for it, from the growing population, but has increased rural employment in the rural industrialisation process in these countries. This food bottleneck has created the problem of price rise of food grains, and it has become the cornerstone in the whole of price structure in the developing economies.

## Infrastructural Bottleneck

This bottleneck refers to power shortages and inadequacies of transport facilities in the underdeveloped economies. It obviously restricts the growth process in industrial, agricultural, and commercial sectors and causes underutilised capacity in the economy as a whole. The

NOTES

underutilisation of resources does not absorb the full increase in money supply but reflects upon the rising prices.

### Foreign Exchange

The developing economies suffer from a fundamental, structural disequilibrium in the balance of payments due to high imports and low exports on unfavourable terms of trade; hence, they usually suffer from foreign-exchange scarcity problem. In recent years, day by day, the rising import bills due to high oil prices have aggravated the problem further. This foreign exchange bottleneck comes in the way of necessary imports to check domestic inflation. Again, the need to boost exports to meet the growing deficits in the balance of payments, puts an extra pressure on the marketable surplus that is meant for domestic requirements. This eventually leads to a heavy price rise of exportable commodity in the domestic market.

### Resources Gap

When the public sector is widely expanded for industrial development in the underdeveloped countries, the government aggravates the problem of "resources gap". Owing to the backward, socio-economic-political structure of the less-developed country (LDC), the government always finds it difficult to raise sufficient resources through taxation, public borrowings, and profit of enterprises, to meet the ever increasing public expenditure in intensive and extensive dimension. As such, under the pressure of the resources gap, the government has to resort to a heavy dose deficit financing, despite knowing its dangers. This makes the economy inflation prone. Similarly, the resource gap in the private sector, caused by low voluntary savings and high cost economy presses for an over-expansion of money supply through bank credit which, by and large, results an acceleration of inflationary spiral in the economy.

## *5.5 DEMAND-PULL VS. COST-PUSH INFLATION*

There are two schools of thought regarding the possible causes of inflation. One school views the demand-pull element as an important cause of inflation, while the other group of economists holds that inflation is mainly caused by the cost-push element.

NOTES

## Demand-pull Inflation

According to the demand-pull theory, prices rise in response to an excess of aggregate demand over the existing supply of goods and services. The demand-pull theorists point out that inflation (demand-pull) might be caused, in the first place, by an increase in the quantity of money, when the economy is operating at the full-employment level. As the quantity of money increases, the rate of interest will fall and, consequently, the investment will increase. This increased investment expenditure will soon increase the income of the various factors of production. As a result, the aggregate consumption expenditure will increase leading to an effective increase in the effective demand. With the economy already operating at the level of full employment, this will immediately raise prices, and inflationary forces may emerge. Thus, when the general monetary demand rises faster than the general supply, it pulls up prices (commodity prices as well as factor prices, in general). Demand-pull inflation, therefore, manifests itself when there is an active cooperation, of passive collusion, or a failure to take counteracting measures by monetary authorities.

However, the demand-pull inflation can also occur without an increase in the money supply. This can happen when either the marginal efficiency of capital increases or the marginal propensity to consume (MPC) rises, so that investment expenditures may rise, thereby leading to a rise in the aggregate demand, which will exert its influence in the raising prices beyond the level of employment that was already attained in the economy.

According to the demand-pull theorists, during the process of demand inflation, the rise in wages accompanies or follows price rise as a natural consequence. Under the condition of rising prices, when the rate of profit is increasing, producers are inclined, in general, to increase investment and employment, in that they bid against each other for labour, so that labour prices (i.e., wages) may rise. In short, the inflationary process, described by the demand-inflation theory, implies the following sequences: increasing demand, increasing prices, increasing costs, increasing income, and so on.

## Causes of Demand-pull Inflation

It should be noted that the concept of demand-pull inflation is associated with a situation of full employment where an increase in the aggregate demand cannot be met by a corresponding expansion in the supply of real output. There can be many reasons for such excess monetary demand as follows.

NOTES

## Increase in Public Expenditure

There may be an increase in the public expenditure (G) in excess of public revenue. This might have been made possible (or rendered necessary) through public borrowings from banks or; through deficit financing, which implies an increase in the money supply.

## Increase in Investment

There may be an increase in the autonomous investment (I) in firms, which is in excess of the rent savings in the economy. Hence, the flow of total expenditure tends to rise, causing a less monetary demand, leading to an upward pressure on prices.

## Increase in MPC

There maybe an increase in the MPC, causing an excess monetary demand. This could be due to the operation of demonstration effect and such other reasons.

## Increasing Exports and Surplus Balance of Payments

In an open economy, an increasing surplus in the balance of payments also leads to an excess demand. The increasing exports also have an inflationary impact because there is a generation of money income in the home economy due to export earnings but, simultaneously, there is a reduction in the domestic supply of goods because products are exported. If an export surplus is not balanced by increased savings, or through taxation, the domestic spending will be in excess of the value of domestic output, marketed at current prices.

## Diversification of Goods

A diversion of resources from consumption goods sector to either to the capital-good sector or the military sector (for producing war goods) will lead to an inflationary pressure because while the generation of income and expenditure continues, the current flow of the real output decreases on account of high gestation period involved in these sectors. Again, the opportunity cost of war goods is quite high in terms of consumption goods meant for the civilian sector. This leads to an excessive monetary demand for the goods and services against their real supply, causing the prices to move up. In short, it is said that the demand-pull inflation could be averted through deflationary measures adopted by the monetary and fiscal

authorities. Thus, passive policies are responsible for the demand-pull inflation.

NOTES

## Cost-push Inflation

A group of economists hold the opposite view that the process of inflation is initiated not by an excess of general demand but by an increase in costs, as factors of production try to increase their share of the total product by raising their prices. Thus, it has been viewed that a rise in prices is initiated by growing factor costs. Therefore, such a price rise is termed as "cost-push" inflation as prices are being pushed up by the rising factor costs.

Cost-push inflation, or cost inflation, as it is sometimes called, is induced by the wage-inflation process. It is believed that wages constitute nearly 70% of the total cost of production. This is especially true for a country like India, where intensive techniques are commonly used. Thus, a rise in wages leads to a rise in the total cost of production and a consequent rise in the price level, because fundamentally, the prices are based on costs. It has been said that a rise in wages causing a rise in prices may, in turn, generate an inflationary spiral because an increase would motivate the workers to demand higher wages. Indeed, any autonomous increase in costs, such as a rise in the prices of imported components or an increase in the indirect cost-push inflation may occur either due to wage-push or profit-push. Cost-push analysis assumes monopoly elements either in the labour market or in the product market. When there are monopolistic labour organisations, prices may rise due to wage-push. And, when there are monopolies in the product market, the monopolists maybe induced to raise the prices in order to fetch high profits. Then, there is profit-push in raising the prices.

However, the cost-push hypothesis rarely considers autonomous attempts to increase profits, as an important inflationary element. Firstly, because profits are generally a small fraction of the total price, a rise in profits would have only a slight impact on the prices. Secondly, there hesitation to raise price monopolists generally hesitate to raise prices in the absence of obvious demand-pull elements. Finally, the motivation for profit-push is weak since, at least in corporations, those who make the decision to raise the prices are not the direct beneficiaries of the price increase.

Hence, cost-push is generally conceived as a synonymous one with wage push. When wage are pushed up, the cost of production increases to a considerable extent so that the prices may rise. Since wages are pushed up

NOTES

by the demand for high wages by the labour unions, wage-push may be equated with union-push.

## 5.6 CAUSES OF INFLATION

Inflation is a complex phenomenon which cannot be attributed to a single factor. We may summarise the major causes of inflation as follows:

### Over-expansion of Money Supply

Many a times, a remarkable degree of correlation between the increase in money supply and the rise in the price level may be observed.

### Expansion of Bank Credit

Rapid expansion of bank credit is also responsible for the inflationary trend in a country.

### Deficit Financing

The high doses of deficit financing, which may cause reckless spending, may also contribute to the growth of the inflationary spiral in a country.

### Ordinary Monetary Factors

Among other monetary factors, influencing the price trend in an economy, the major ones are listed as follows:

1. **High Non-development Expenditure:** The continuous increase in public expenditure and especially, the growth of defense and non-development expenditure.
2. **Huge Plan Investment:** The huge plan investment and its high rate of growth in every plan may lead to an excess demand in the capital goods sector, so that the industrial prices may raise.
3. **Black Money:** Some economists have condemned black money, which is in the hands of tax evaders and black marketeers, as an important source of inflation in a country. Black money encourages lavish spending, which causes excess demand and a rise in prices.
4. **High Indirect Taxes:** Incidence of high commodity taxation. The prices tend to raise on account of high excise duties imposed by the government on raw materials and essential goods.

NOTES

## Non-monetary Factors

There are various non-monetary and structural factors that may cause a rising-price trend in a country. They are as follows:

1. **High Population Growth:** Undoubtedly, the rising pressure of demand, resulting from growing population and money income, will cause a high price rise in an over-populated country
2. **Natural Calamities and Bad Weather Conditions:** Vagaries of monsoon, bad weather conditions, droughts, and failure of agricultural crops have been responsible for the price spurts from time to time, in many underdeveloped countries. Agricultural prices are most sensitive to inflationary forces in India. Natural calamities also contribute occasionally to the inflationary boost in a country. Events such as cyclones and floods, which destroy village economies also aggravate the inflationary pressure.
3. **Speculation and Hoarding**: Hoarding and speculative activities, that is, corruption at every level in both private and public sectors and so on, are also responsible to some extent for aggravating inflation in a country.
4. **High Prices of Imports:** Inflation has also been inflicted on some countries through the import content used by their industries. The prices of petroleum products have been increased in many countries due to price hikes by the oil-producing countries.
5. **Monopolies:** Monopoly profits and unfair trade practices by big industrial houses are also responsible for the price rise in countries like India.
6. **Underutilisation of Resources:** Non-utilisation of installed capacities in large industries is also a contributory factor to inflation.

Ration in a country may be regarded as a symptom of a deep-seated malady, born of structural **deficiencies** involved in the functioning of its economic system, which is characterised by inherent weaknesses, wastages, and imbalances.

## Gaps and Bottlenecks

To understand the true nature of inflation in an underdeveloped country, one has to examine the bottlenecks and gaps of various types, which

NOTES

obstruct the normal growth process, causing prices to raise with the generation of money income, without an appropriate rise in the real income. These gaps and bottlenecks may be enlisted as follows: market imperfections, capital bottleneck, entrepreneurial bottleneck, food bottleneck, infrastructural bottleneck, foreign exchange bottleneck, and resources gap.

## *5.7 EFFECTS OF INFLATION*

Inflation has direct socio-economic consequences. As such, inflation has been taken to be a serious social and economic problem. The US Presidents Ford and Carter have considered inflation as "public enemy number one".

### Economic Effects of Inflation

The effects of inflation on the economic system may be classified into three kinds as follows: (1) effects on production, that is, changes in the tempo of economic activity, (2) effects on income distribution, that is, re-distribution of income and wealth, and (3) effects on consumption and welfare.

### Effects on Production

Keynes argues that a moderate rise in prices, that is, a mild inflation, or creeping inflation, as it may be called, has a favourable effect on production when there are unutilised or underemployed resources in existence in an economy. The rising prices breed optimistic expectations within the business community in view of increasing profit margins, because the price level moves up at a faster rate than the cost of production. Businessmen are induced to invest more, and as a result, employment, output, and income increase.

The tempo of economic activity starts raising. But, there is a limit to it—this limit is set by the employment ceiling. Once the full-employment stage is reached in an economy, a further rise in prices will not stimulate production, employment, and real income, due to physical limitations. Thus, when the inflation has reached an advanced stage, its brighter aspects disappear and the evil aspects manifest themselves. The disastrous consequences of inflation on the economic system may be stated briefly as follows:

NOTES

1. **Maladjustments:** Inflation leads to maladjustments in production and disrupts the working of the price system, which is ruinous to the entire system.
2. **Hindrance to Capital Accumulation:** Capital accumulation is hindered by uncontrolled inflation, and the savings potentiality of the community also declines due to the diminish purchasing power of money.
3. **Speculation:** Since excessive inflation disturbs all economic relationships and leads to uncertainty, the skills and energies of the business community are concentrated on speculate and on making quick profits rather than on genuine productive activity, as a result. In short speculation takes the place of production in the economy.
4. **Hoarding and Black Marketing:** During inflation, when prices are rapidly rising, the holding of larger stocks of goods becomes very profitable. Hoarding is encouraged, which further decreases the available supply of goods in relation to increasing monetary demand. Eventually, the phenomena of black marketing and spiralling inflation develop.
5. **Distortion of Production Pattern:** Inflation not only adversely affects the volume of production but also changes its pattern. Generally, resources are diverted from the production of essential goods to those of non-essential because the rich people, whose incomes increase mid rapidly, make their demand for luxury goods felt in the market. Production of undesirable lines is, therefore, stimulated and finally, results in the breakdown of the economic system.
6. **Creation of a Sellers Market:** Inflation tends to create a sellers market. As a result, sellers have a command on prices because of the excessive demand in the market. Anything can be sold in such a market. The sellers do not care for quality as their interest is in high profits only.
7. **Distortions in Resource Allocation:** Inflation will turn away resource allocation from longer term productive investments and towards unproductive assets like housing, real estate inventories, gold, and so on. Such a diversification of savings tends to inhibit the full capacity to grow.

NOTES

8. **Disincentive Effect due to Income-tax Bracket Creep:** During inflation, with the rise money income in of the individuals under progressive income tax system, the effective tax rate will raise (called "Income-tax Bracket Creep"). This may cause a disincentive effect on willingness to work, save, and invest, thus, discouraging the productive activity.

## Distributional Effects

Inflation redistributes income because prices of all factors do not rise in the same proportion. Since the effect of inflation on the income of different classes of earners varies, there are serious social consequences. During inflation, the distributive share accruing to the profiteers increase more than that of wage earners or fixed-income earners, such as the rentier class. All product traders, and speculators gain during an inflation because of the windfall profits which has arisen price rise at a faster and a higher rate than the cost of production; wages, interest, and rent not increase rapidly, and are more or less fixed. Moreover, profits increase because there is a log between the rise in the prices and the rise in the cost of production. Businessmen always find the money value of their inventories going up because the general price level raises. Usually, inflation enlarges the money income in the hands of the flexible groups, and adversely affects the people in the fixed-income groups, such as pensioners, government employees, and salaried classes, such as teachers, clerks, and, to some extent, labourers or wage earners. Among the wage earners or labour class, those who are well organised are effected less than others.

The changes in the value of money also cause redistribution of wealth, partly because during inflation, there is no uniform price rise as prices of some types of goods alone change more than others and (b) debts are expressed in terms of money. Inflation is a sort of hidden tax, steeply regressive in effect. The redistribution of wealth due to inflation is a burden on these groups of people who are least able to bear it. Let us study the concrete effects of inflation on various economic groups as follows:

## Effect on Groups

**Debtors and Creditors:** Generally, debtors gain and creditors lose during an inflation. Gain accrues to a debtor because he repays loan at a time when the purchasing power of money is slower than when it was borrowed. The creditor, on the other hand, is a loser during inflation, since he receives, in effect, less in goods and services than he would have received

NOTES

in times of low prices. Thus, the borrowers who borrowed funds prior to inflation stand to gain by inflation, and creditors who lent funds lose. However, this does not mean that debtors always welcome inflation because, usually, they are members of one another group of people who are adversely affected by inflation.

**Business Community:** Inflation is welcomed by entrepreneurs and businessmen as they stand to profit by raising prices. They find that the value of the then inventories and stock of goods is rising in money terms. They also find that prices are rising faster than the costs of production, so that their profit margin is greatly enhanced. The business community, therefore, gets super normal profits during the period of inflation, and those profits continue to increase as long as the prices raise. However, the producers of conventionally priced goods and services, such as electricity and transport services, gain very little or not at all during inflation, because the prices of their goods are fixed by convention or by law. When the prices in general raise, the cost of production of these commodities or services also raises but their price remains constant, giving the producer a continuously decreasing margin of profit.

**Fixed Income Groups:** Inflation hits wage earners and salaried people very hard. Although wage earners, by the grace of trade unions, can chase the galloping prices, they seldom win the race. Since the wages do not raise at the same rate and at the same time as the general price level, the cost of living index raises, and the real income of the wage earner decreases. Moreover, in trying to push up wages to sustain their real income, wage earners bring about a cost-push inflation and, in the process, worsen their position. Those who depend exclusively on fixed salaries for a living are severely affected by inflation. Among these people are teachers, clerks, government servants, pensioners, and persons living on past savings. The salaried groups are further handicapped by the fact that they are less organised than the labour class, to press for higher pay in order to compensate for a fall in the real income.

**Investors:** Those who invest in debentures and fixed-interest bearing securities, bonds, and so on, lose during inflation. However, the investors in equities benefit because more dividend is yielded on account of high profits made by the joint-stock companies during inflation.

**Farmers:** Farmers usually gain during an inflation, because they can get better prices for their harvest during inflation.

NOTES

We may conclude that inflation redistributes income and wealth in favour of businessmen, debtors, and farmers but hits consumers, creditors, small investors, labour class, middle class, and fixed-income groups very hard. Inflation favours one group at the expense of another. Besides, it is always regressive in effect, that is, it hits hard all those who cannot protect themselves.

## Effects on Consumption and Welfare

Inflation implies an erosion of the consumers value of money. It is a form of taxation. Due to deteriorating purchasing power, the real consumption of the common people declines. The rising cost of living during inflation implies falling standard of living and lowering of general economic welfare of the community at large. A galloping inflation is, therefore, described as the "cruelest tax of all". In short, inflation is unfair on the distribution side of economic activity.

Inflation other effects may lead to many adverse consequences as follows:

**Deterioration in Savings:** A continuous inflation reduces the real worth of savings in the long run. Savers are also adversely affected when the annual rate of inflation is exceeding the current rate of interest. During an inflation, the real rates of interest tend to decline capacity to save, due to the rising cost of living and the consequent money expenditure caused by the rising prices. Persistent inflation also discourages individual savings.

**Distortion of the Budget and Vicious Circle:** The budgetary provision for public spending proves to be inadequate, due to the rising costs caused by inflation. A vicious circle is developed. When deficit financing leads to inflation, more deficit financing may be needed to fill the resource gap occurring in public spending, which further pushes up the prices, causing further deficit financing and further inflation and so on, and thus, a vicious circle is developed.

**Disturbance in the Planning:** Plan programmes and allocation of resources may be get disturbed due to resource constraints caused by a continuous inflation and rising factor. The investment allocation based on the current price level at the beginning of a particular, obviously proves to be inadequate in the later years of the plan. Thus, a severe resource constraint may be experienced in the fulfilment of the plan targets.

**Lowering of International Competitiveness:** If the rate of inflation in a country is more than in other countries, its international competitiveness in foreign market is weakened.

NOTES

**Distortion of the Exchange Rate:** A high rate of inflation in a country, when compared to the inflation rates in other countries, it would ultimately lead to a decrease in the external value of; its currency, that is, lowering of its exchange rate in terms of foreign currencies or key currencies such as Dollar. Even a key currency like the Dollar has lost its real worth and reputation due to the high inflation rate in the US economy.

**Irrationality of Consumption:** Inflation enhances money incomes of many. This fosters "consumerism" resulting in distorted consumption patterns. Consumerism spurts the trend to consider all goods as non-durable. Due to expensive labour, repair gives way to replacement of parts/products. Modern society is, thus, becoming a "junk" society in which nothing is durable. People fanatically crave for new models and new things, which is by the consumer credit given by the banks. Today's inflation-oriented prosperity is based on credit-induced consumption in many countries. Thus, to stop, credit involves a great unemployment and recession.

## *5.8 CONTROL OF INFLATION*

### Data Management

The price policy since 1973-74 has relied predominantly on fiscal and monetary measures view to check the demand of the general public for goods and services.

### Fiscal Measures

Since 1990-91, the government of India has woken up to the importance of reducing fiscal deficit. The budget of July 1991-92 took the first decisive action to limit the fiscal deficit by bringing it down from 8.4% of GDP in 1990-91 to 6.2% in 1991-92 and 4.9% in 93. Since then, the government has failed to reduce the fiscal deficit which has remained 7% of GDP till date.

### Monetary Measures

In general, the RBI uses its monetary policy to achieve a judicious balance between the growth of production and control of the general price level. RBI uses Bank Rate, CRR (Cash Reserve Ratio) SLR (Statutory Liquidity Ratio), and Open-market Operations to increase bank credit and expenditure of business activity (in times of business recession), or to contract bank credit and business and speculative activity (in periods of inflation).

NOTES

However, some economists, especially Alwyn Young have found that there are no 'special tricks' used by these countries to achieve remarkably high rates of growth in Per Capita Income. Instead, they have relied on well-known factors determining growth, namely, using more labour input, saving and investing more, and expanding education of work force and thereby building more human capital. An important fact about determinants of growth which is noteworthy is that the growth in Total Factor Productivity (TFP) (by which technical progress is generally measured) has been high but not remarkably high. It will be seen that all these countries have remarkably high growth rates in GDP per capita but their growth is explained by increased inputs (that is, by use of more labour input, more human capital, i.e. increase in education and correspondingly more physical capital) and not by much higher increase in total factor productivity (TFP). It may be noted that change in total factor productivity measures the change in output per unit increase in inputs and represents technological progress. Although the change in total factor productivity in these countries (except Singapore) is high but not remarkably high and therefore, cannot explain remarkably high growth rate in per capita GDP achieved by them. Total factor productivity growth rate in Singapore is very small but still its growth in per capita GDP has been very high (6.8% per annum).

It will be seen that in all these countries there has been a very large increase labour force participation rate indicating use of more labour input in the production of goods and services. It is noteworthy that much of this increase in labour force participation rate has been due to more women joining the labour force. Each of these countries substantially increased its human capital. In fact education level of these countries reached close to those of rich industrialised countries.

Another important feature of these East Asian countries is that they have pursued *outward-looking economic strategy* i.e. promoting exports to generate growth and followed laissez-faire free market policies with emphasis on competition as driving force of growth with the exception of Singapore where Government played a significant role in regulating and controlling private enterprise and direction of investment. Moreover, Singapore relied on foreign direct investment to bring in new technologies.

To sum up, in the history of economic development these Asian Tigers countries have achieved extraordinary high growth rates, and that too with the well-known way through using more labour input, more investment in capital, both physical and human, and fostering competition. It is

NOTES

reassuring to note that these former poor countries will soon catch up with the developed industrialised countries in Per Capita Income level. Singapore has already achieved Per Capita Income level of the rich industrialised nations of the world. It is important to note that *since 1991, China and India too have registered a higher growth rate and have become the two fastest growing economies of the world*. India achieved 6.2% growth in GDP during 1992-2006 and further its annual growth rate during three-year period, 2004-2007 rose to over 9% per annum. In 2009-10 and 2010-11, India's growth of GDP has been 8% and 8.6% respectively. In fact India is now the second fastest growing country of the world, next only to China.

## *5.9 SUMMARY OF THE UNIT*

There are obstacles that curtail normal growth process. Inflation at best can be defined as sustained rise in prices. To some it is a monetary phenomena and to others it is an employment problem. Inflation in India can be examined by studying poverty and unemployment.

## *5.10 KEY TERMS*

- **Demand Pull:** Rise in prices in response to over all demand over the existing supply.
- **Cost Push:** Rise in prices is initiated by growing factor cost.
- **Deficit Financing:** High amount of deficit financing causes more spending that leads to increased inflation.
- **Hoarding:** During inflation hoarding large stocks leads to profit.

## *5.11 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. Inflation occurs when level of prices ____________.
2. Scarcity in products is created by ____________.

NOTES

### (B) True or False

1. Rapid expansion of Bank credit is responsible for inflation.
2. High population growth will cause high price rise.
3. Economic growth is because of black money.

## *5.12 KEY TO CHECK YOUR ANSWER*

**(A)** 1. Prices, 2. Increase, 3. Hoarding.

**(B)** 1. True, 2. True, 3. False.

## *5.13 TERMINAL AND MODEL QUESTIONS*

1. Explain the causes of inflation.
2. Explain the measures to control inflation.

## *5.14 REFERENCE BOOKS*

1. Misra S.K. & V.K. Puri - 'Indian Economy' Mumbai
2. Avadhani VA : 'Global Business' HPH Mumbai

# UNIT 6 UNEMPLOYMENT AND EMPLOYMENT IN INDIA

**Structure:**

6.1 Introduction

6.2 Growth of Employment in India: A Case of Jobless Growth

6.3 Summary of the Unit

6.4 Glossary

6.5 Key Terms

6.6 Check Your Progress (Multiple Choice/Objective Type Questions)

6.7 Key to Check Your Answer

6.8 Terminal and Model Questions

6.9 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Know about the growth of employment in India.
- Different theories and laws such as 'Supply creates its own demand'.
- You will understand about employment in organised private sector.
- Learn about labour intensive technology.

## *6.1 INTRODUCTION*

The unemployment in countries like India is quite different. The main cause of unemployment is deficiency of stock of physical capital with which to employ large number of people. Other reasons like, lack of infrastructure, i.e. telecommunications, roadways and power. This works as obstacle for productive employment.

NOTES

The unemployment in developing countries like India is of quite different nature. The main cause of unemployment and underemployment prevailing in the developing countries such as India is *deficiency of the stock of physical capital* with which to employ the growing labour force. Due to the lack of physical capital, it has not been possible to absorb the growing labour force in productive employment. The result has been the emergence of *long-term or chronic unemployment*.

Apart from the relative low rate of capital formation as compared to the growth in labour force, the use of *capital-intensive techniques* in the industries mostly imported from the Western developed countries is another important factor causing unemployment in developing countries like India. Besides, in agriculture, despite the existence of surplus labour *reckless mechanisation of various* agricultural operations has reduced the employment opportunities in agriculture. Another important reason of rural unemployment prevailing in the developing countries like India is extremely unequal distribution of land so that many agricultural households have no *adequate access to land* for production and self-employment in agriculture.

Lack of infrastructure such as roads, power, telecommunications, highways, irrigation facilities in agriculture is also responsible for the existence of huge unemployment in India. Inadequate availability of infrastructure is a great obstacle for the generation of opportunities for productive employment.

## *6.2 GROWTH OF EMPLOYMENT IN INDIA: A CASE OF JOBLESS GROWTH*

An important objective of planning in India has been to generate enough employment opportunities not only to provide jobs to the backlog of unemployed but also to the new annual additions to the labour force. The new economic reforms initiated in India in 1991 visualised that acceleration of economic growth would also lead to rapid growth of employment opportunities. The total growth rate of employment (*on usual principal status*) which was 2 per cent per annum in the period 1983-94, fell to about 1.57 per cent annum during the post-reform period, 1993-94 to 1999-2000. However, it recorded a higher growth rate of 2.48 per cent per annum in 1999-2000 to 2004-05. The organised sector employment which grew 1.2 per cent per annum during 1983-94 recorded less than half of that growth (0.44 per cent) during (1994-2000).

NOTES

**Inflation Index:** Rate of inflation decides the environment low rate indicates stability, rate is measured as Wholesale Price Index or Consumer Price Index. A high rate is considered anti-poor. Inflation redistributes income and wealth in favour of the rich. Thus, it makes the rich richer and the poor poorer. Above all, a high rate inflation adversely effects output and encourages investment in unproductive channels such as purchase of gold, silver, jewellery and real estate. Therefore, it adversely affects long-run economic growth, especially in developing countries like India. Inflation has therefore, been described *'as enemy number one'*.

## Measurement of Rate of Inflation

Inflation has been one of the important problems facing the economies of the world. Precisely stated, inflation is the rate of change of general price level during a period of time. And the general price level in a period is the result of inflation in the past. Through rate of inflation economists measures the *cost of living* in an economy. Let us explain how rate of inflation is measured. Suppose $P_{t-1}$ represents price level on 31st March 2006 and $P_t$ represents the price level on 31 st March 2007. The the rate of inflation in year 2006-07 will be equal to: $\pi = \frac{P_t - P_{t-1}}{P_{t-1}}$

$P_t = 275$

$P_{t-1} = 250$

Substituting

$$\pi = \frac{P_t - P_{t-1}}{P_{t-1}} = \frac{275 - 250}{250} \times 100 = \frac{25}{250} \times 100 = 10\% .$$

$\therefore$ Rate of inflation will be 10%. This is called point to point inflation rate

But excess of aggregate demand over aggregate supply does not explain persistent rise in prices, year after year. An important factor which feeds inflation is wage-price spiral. *Wage-price spiral* operates as follows: A rise in prices reduces the real consumption of the wage earners. They will, therefore, press for higher money wages to compensate them for the higher cost of living. Now, an increase in wages, if granted, will raise the prime cost of production and, therefore, entrepreneurs will raise the prices of their products to recover the increment in cost. This will add fuel to the inflationary fire. A further rise in prices raises the cost of living still further and the workers ask for still higher wages. In this way, wages and prices chase each other and the process of inflationary rise in prices gathers momentum. If unchecked, this

NOTES

may lead to *hyper-inflation* which signifies a state of affairs where wages and prices chase each other at a very quick speed.

**Cause of Inflation:** *Monetarist View*. We have followed the Keynesian explanation of demand-pull inflation. It is important to note that both the original quantity theorists and the modern monetarists, prominent among whom is Milton Friedman, explain inflation in terms of excess demand for goods and services. But there is an important difference between the monetarist view of demand-pull inflation and the Keynesian view of it. Keynes explained inflation as arising out of real sector forces. In his model of inflation excess demand comes into being as a result of *autonomous* increase in expenditure on investment and consumption or increase in government expenditure. That is, the increase in aggregate expenditure or demand occurs independent of any increase in the supply of money. On the other hand, monetarists explain the emergence of excess demand and the resultant rise in prices on account of the increase in money supply in the economy. To quote Milton Friedman, a Nobel Laureate in economics. *"Inflation is always and everywhere a monetary phenomenon and can be produced only by a more rapid increase in the quantity of money than in output."*

Friedman holds that when money supply is increased in the economy, then there emerges an excess supply of real money balances with the public over their demand for money. This disturbs the monetary equilibrium. In order to restore the equilibrium the public will reduce the money balances by increasing expenditure on goods and services. Thus, according to Friedman and other modern quantity theorists, the excess supply of real monetary balances results in the increase in aggregate demand for goods and services. If there is no proportionate increase in output, then extra money supply leads to excess demand for goods and services. This causes inflation or rise in prices. Thus, according to monetarists Prof. Milton Friedman, excess creation of money supply is the main factor responsible for inflation.

**Cost-Push Factors.** Even when there is no increase in aggregate demand, prices may still rise. This may happen if the costs, particularly the wage costs, increase. Now, as the level of employment increases, the demand for workers rises progressively so that the bargaining position of the workers is enhanced. To exploit this situation, they may ask for an increase in wage rates which are not justifiable.

**The Organised Sector:** In the organised private sector, the growth in employment was not sufficient to make up for the loss of jobs in the public

NOTES

sector till 1999. As a result, there was a decline in employment in the organised sector in 1999-2000 to 2004-05 despite a quite high growth of output in it. The much lower growth of employment opportunities is due to the fact that the *employment elasticity of output growth* in the organised private sector has sharply declined in the recent years as a result of *increase in capital intensity*. It means fewer people have been able to participate in and benefit from the growth process in the private organised sector in the post-reform period.

The Tenth Five Year Plan (2002-07) estimated that there was *backlog of 35 million persons unemployed in the beginning of the 10th Plan in April 2002 and additional about 35 million persons were estimated to enter the labour force during 2002-07*. The Tenth Plan aimed at creating employment for *50 million persons during the Five Year Plan period*, 30 million jobs from the normal process of economic growth and additional 20 million from special employment schemes during the five years period (2002-2007). The results of the 61st NSSO round shows that about 47 million persons were employed during 2000 to 2005. Note that since, as mentioned above, there was no any growth in employment in the organised sector, all 47 million new employment opportunities were created in the *unorganised sector*.

It may, however, be noted that despite higher growth in employment in the 10th plan period (*though in the unorganised sector*), unemployment rate on *Usual Principal Status* (UPS) basis was higher at 3.06 per cent of the labour force in 2004-05 compared to 2.78 in 1999-2000. Besides, average *daily status unemployment rate* also increased from 7.3% in 1999-2000 to 8.3 per cent in 1999-2000. According to Approach to the 11th plan, worsening of unemployment situation is due to *faster growth in labour force*. However, the fact that there was decline in increase in employment in the organised sector despite of higher growth in GDP shows the utter failure of the strategy of employment generation. Employment growth in the organised sector (both public and private combined) increased during the post-reform period 1994-2008 at the rate of only 0.05 per cent per annum as against 1.20 per cent during 1983-94 (see Table).

*Table: Rate of Growth of Employment in the Organised Sector*

(per cent per annum)

| | **1983-94** | **1994-2008** |
|---|---|---|
| Public Sector | 1.53 | -0.65 |
| Private Sector | 0.44 | 1.75 |

NOTES

| Total Organised Sector | 1.20 | 0.05 |
|---|---|---|

**Source:** Planning Commission and Directorate General of Employment and Training (DGET).

This lower rate of growth of employment in the organised sector has been there even in the post-reform period despite the fact that there has been very high rate of growth of output, both in the organised industrial and services sector. Obviously, this is bound to increase the problem of unemployment in the country.

## Employment Strategy to Reduce Unemployment

The following measures should be adopted if unemployment problem is to be solved *Use of Labour-Intensive Technology*. Both the organised and unorganised sectors must adopt *labour-intensive technology* if sufficient employment opportunities are to be generated in both the rural and urban sectors of the economy. The decline in employment elasticity of output growth is primarily due to the *increasing trend in capital intensity* in the organised industrial sector as well as in agriculture. Increasing mechanisation of agriculture in various states has lowered the employment elasticity of growth of agricultural output. Therefore, for raising labour intensity, suitable monetary and fiscal measures need to be adopted to discourage the use of capital-intensive techniques. Of course, the use of labour-intensive techniques with lower productivity of workers in the industry and agriculture may lower the growth of output. Thus, there might the same *trade off between employment and growth of output*. In general due to the seriousness of unemployment problem some output growth should be sacrificed for the sake of more employment.

*Accelerating Investment in Agriculture.* Second, and important reason for slow growth of employment in agriculture and rural sector has also been a *shortfall in investment or capital formation in agriculture*. Both the public and private sector investment in agriculture has declined since the early nineties. Of special importance from the viewpoint of employment generation investment in irrigation, rural roads, flood control projects, power generation and other infrastructure. It is worth noting that investment not only generates employment directly but also has a multiplier effect which operates through backward and forward linkages. Therefore, UPA government's Common Minimum Programme (CMP) which provides for stepping up of investment in agriculture and rural infrastructures is a greatly welcome step for employment generation. The announcement by the government to *furnish more credit to farmers at*

NOTES

*lower than market rates of interest* from commercial banks will also ensure that the small and medium farmers will be able to buy fertilizers, and other high-yielding inputs, arrange for their irrigation. This will raise their productivity and tend to reduce under-employment and disguised unemployment. Despite more than five decades of planned industrial development, agriculture continues to be principal source of employment in the Indian economy. Though the share of GDP from agriculture has come down to around 22 per cent, still about: 58 per cent of labour force continues to be employed in agriculture. In fact, agriculture continues to be parking lot of the unemployed in the country. But a good number of persons engaged in agriculture and related activities are not productively employment. In fact there is widespread under-employment and disguised unemployed. Economic reforms initiated in 1991 have by and large neglected agriculture which even now does not get enough credit from commercial banks.

No wonder that there has been a fall in investment or capital formation in agriculture both by the private and public sectors. This is an important reason why employment opportunities in agriculture have not risen much causing increase in rural unemployment.

## 6.3 SUMMARY OF THE UNIT

In growing economy it is important to provide work opportunities to people. It helps them to earn income and create purpose in life. Efficient job opportunities can lead to development and reduce poverty.

## 6.4 GLOSSARY

- **Inflation:** A process in which the general price index (GPI) records a sustained and appreciable increase over a period of time.
- **Recession:** It is a period when there is significant reduction in employment and production, trade and investment.

## 6.5 KEY TERMS

- **Unemployment:** One is not gainfully employed in productive activity.
- **White collar unemployment:** Due to lack of facilities there are educated unemployed.

NOTES

## 6.6 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)

### (A) Fill in the Blanks

1. Involuntary unemployment means people are ready to accept work but do not get ____________.
2. White collar job hunting leads to scramble for ____________ jobs.
3. Poor person cannot make any gainful use of existing ____________.
4. Unless population problem is ____________ unemployment will remain.

### (B) True or False

1. Economic planning alone cannot solve the problem of unemployment.
2. Unemployment in India is structural unemployment.
3. Unemployment is a chronic problem and hence cannot be solved.

## 6.7 KEY TO CHECK YOUR ANSWER

(a) 1. salary, 2. clerical, 3. resources, 4. controlled.

(b) 1. True, 2. True, 3. False

## 6.8 TERMINAL AND MODEL QUESTIONS

1. Explain the nature of unemployment in India?
2. How can economic reforms solve unemployment problems? Discuss.
3. Explain the causes of unemployment.

## 6.9 REFERENCE BOOKS

1. World Development Report of World Bank. 2003-04.
2. Jalan Bimal: ‘Indian Economy’ – ‘Penguin’, Delhi.
3. Bhattacharya B.: ‘Indian Economic Crisis’ – B.R. Publication, Delhi.

# UNIT 7 ECONOMIC REFORMS IN INDIA

**Structure:**


7.1 Introduction

7.2 Tax Reforms

7.3 Summary of the Unit

7.4 Glossary

7.5 Key Terms

7.6 Check Your Progress (Multiple Choice/Objective Type Questions)

7.7 Key to Check Your Answer

7.8 Terminal and Model Questions

7.9 Reference Books


## Objectives

After reading this Unit, you will be able to:

- Understand the term 'Fiscal reforms' which implies correction in government's budgetary policy toward better system.
- Understand cutting of unproductive expenditure.
- Know about the fiscal reforms in India.
- Understand the primary objective of industrial policy to achieve international competitiveness.

## *7.1 INTRODUCTION*

The need for comprehensive fiscal reforms in India was apparent during the late 1980s, as there was rapid deterioration in Government finances. During this period, the expenditure of the Central Government rose much faster than its revenue leading to a steep rise in the Centre's fiscal deficit to GDP ratio. For the States, given the restrictions on their capacity to borrow,

NOTES

the increase in expenditure was relatively aligned to the corresponding rise in revenue. Consequently, the rise in the fiscal deficit of States was relatively less steep. The sharp increase in revenue deficit of the Central Government and the emergence of such deficits in State finances were the most worrisome developments in the fiscal scenario during the 1980s.

Reflecting these developments, there was a sharp increase in the outstanding liabilities of both Central and State Governments as ratio to GDP from 41.6 per cent and 16.7 per cent, respectively, in 1980-81 to 55.3 per cent and 19.4 per cent, respectively, in 1990-91. The growing size of liabilities eventually generated a considerable debt-service burden.

During 1980, there was rapid deterioration in Government finances. This required comprehensive fiscal reforms, as there were outstanding financial liabilities both at centre and state. Various economic measures were introduced.

## Fiscal Reforms in India

While the move towards fiscal adjustment was discernible in the pronouncements made as a part of long-term fiscal policy announced in the mid – 1980s a comprehensive fiscal reform programme at the Central Government level was initiated only at the beginning of the 1990s as part of the economic adjustment programme initiated in 1991-92. On the other hand, in the case of States, efforts towards fiscal adjustment began only in the late 1990s. Fiscal reforms in the States were necessitated by:

- Growing fiscal imbalances
- Sluggishness in Central transfers resulting from falling tax to GDP ratio.
- Introduction of reform-linked assistance as a part of Medium-Term Fiscal Reform Programme on the basis of the recommendation of the Eleventh Finance Commission and
- Adjustment programme undertaken in some of the States, which was linked to borrowings from multilateral agencies.

Fiscal reforms at the Centre covered tax reforms, expenditure pruning, restructuring of PSUs and better coordination between monetary and fiscal policies.

## Reforms in 2001-02

NOTES

- Various economy measures introduced including downsizing some of the departments.
- Excise duty structure was rationalised to a single rate of 16 per cent CENVAT (Central Value Added Tax) in 2000-01. The Budget for 2001-02 replaced earlier three special rates of 8 per cent, 16 per cent and 24 per cent by a single rate of 16 per cent.
- Peak level of customs duty reduced from 38.5 per cent to 35 per cent with abolition of surcharge on customs duty. Customs duty reduced on specified textile machines, information technology, telecommunications and entertainment industry.
- Goods imported by 100 per cent EOUs and units in FTZs and SEZs exempted from antidumping and safeguard duties.
- All surcharges abolished on personal and corporate income tax rates except the Gujarat earthquake surcharge of 2 per cent leviable on all non-corporate and corporate assesses except foreign companies.
- Weighted deduction of 150 per cent of expenditure on in-house R&D extended to biotechnology.
- Five-year Tax holiday and 30 per cent deduction of profits for the next five years extended to enterprises engaged in integrated handling, transportation and storage of foodgrains.
- Incentive Fund created for incentivising fiscal reforms in states.

## Expenditure Reform

We have noted that the impact of Government expenditure on aggregate demand and supply varies with each type of expenditure. Table shows the long-term trend in the financing of Government expenditure in India.

*Table Financing of Government Expenditure (As per cent of GDP)*

| Year | Total Expend-iture | Tax Revenue | | | Borrowings | | | Other Sources |
|---|---|---|---|---|---|---|---|---|
| | | Tax | Non-tax | Total | Domestic | Abr-oad | Total | |
| 1990-91 | 17.3 | 7.6 | 2.1 | 9.7 | 4.1 | 0.7 | 4.8 | 2.0 |
| 1996-97 | 13.9 | 6.8 | 2.4 | 9.2 | 3.1 | 0.3 | 3.4 | 1.0 |
| 1997-98 | 14.2 | 6.3 | 2.5 | 00 | 5.1 | 0.1 | 5.6 | -0.1 |

NOTES

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 1998-99 | 14.7 | 6.0 | 2.6 | 8.6 | 5.6 | 0.2 | 5.8 | 0.0 |
| 1999-00 | 15.4 | 6.6 | 2.8 | 9.4 | 5.7 | 0.1 | 5.8 | 0.0 |
| 2000-01 | 15.3 | 6.5 | 2.7 | 9.1 | 5.7 | 0.1 | 5.8 | 0.1 |
| 2001-02 | 16.4 | 7.1 | 3.0 | 10.1 | 5.7 | 0.1 | 5.8 | 0.0 |

***Source:*** Economic Survey 2001-02.

Government action is needed in reducing expenditure under four major heads of current spending. With respect to internal public debt, there is one important mechanism that could substantially ameliorate the fiscal situation. Privatisation of public enterprises could raise significant funds as a per cent of GDP, which could be used to buy down the public debt. Not only would the stock of debt itself be reduced, but also the interest costs of servicing the debt would surely decline as the debt stock itself was brought under control. Interest payments account for as high as 4.9 per cent of GDP in 2001-02. The cash value of these enterprises vastly exceeds the present value of profit flows that the state now collects on these assets. Public sector profits are dissipated in poor productivity, over manning, excessive public sector salaries, soft budget constraints, and generally poor public-sector management. For this reason, sales of the enterprises to private sector buyers, if used to buy down the public debt, would yield annual saving in interest costs that far exceed the government revenues that are claimed by virtue of state ownership of the assets.

### Income Tax Policy

The share of income tax general as well as agricultural has not increased rapidly over the years. In the early eighties about 2 million people paid income tax. By 1990-91 it increased to only 6 million. The number of tax payers has remained very low partly because of large-scale tax evasion and partly because of a continuous hike in the tax exemption limit. There are two criticisms against personal income tax: first, it acts as a disincentive to earn income and produce output, and, second, high rates of taxation induce evasion and generate black income. Both the criticisms are valid in view of the marginal tax rates which have been very high.

## *7.2 TAX REFORMS*

In formulating its recommendations the Tax Reforms Committee (1994) headed by R.J. Chellaiah enunciated the following goals which formed the blueprint for tax reforms:

NOTES

(i) reduction of rates of all major taxes *viz.*, customs, income tax, and central excise;

(ii) widening of the bases of all taxes by removing or curtailing exemptions and concessions, drastic simplifications of the laws and procedures;

(iii) replacement of the existing taxes on domestic production and trade by a Value Added Tax (VAT);

(iv) a thorough revamping and modernisation of the administration.

*Progress of Financial Sector Reforms (till March 2000)*

| | |
|---|---|
| **1. Banking Market** | Banking industry in India in 1990 consisted of just 70 players, 27 of these were in the public sector, 24 in private and 21 are the foreign banks. Ten years later, banking industry is vastly expanded with the number of foreign banks nearly doubling and ten more new banks in the private sector. Banking industry today is intensively competitive. |
| **2. Banking Products** | At the time of reforms, most of the products offered by banks are plain vanilla. Massive expansion of products and services took place in the last few years driven by rapid advances in technology that has dramatic impact on the delivery systems and ability to service a greater number of products. |
| **3. Regulation** | Regulation is much more refined now. While banks are given greater operational freedom, the quality of regulation has heightened with stringent norms prescribed in respect of capital adequacy, classification of assets, provisioning, valuation of investments etc. Regulation is evolved broadly on the emerging international developments which while promotes deregulation and liberation at the same time prescribes stringent rules governing business operations and market developments. |
| **4. Supervision** | Increase in the quality of on-site and off site surveillance and supervision. A new Board for Supervision came into being which undertakes comprehensive banking supervision on the lines of international better practices. |
| **5. Ownership** | While public sector continues to account for a major part of the banking, greater inroads are made by the private sector in the form of new banks allowed in the private sector, entry of a large number of foreign banks, partial divestment of the government equity in the public sector banks, allowing the public sector to dilute government |

NOTES

| | |
|---|---|
| | equity up to 33 per cent, allowing foreign direct investment in banking etc. |
| **6. Prudential Norms** | International better practices covering a wide range of banking operations and practices prescribed in the post reforms and are being introduced gradually in a number of areas. |
| **7. Disclosure Standards** | The balance sheet of banks today is vastly different from what was in the beginning of reforms. Every year additional disclosures are being made in the bank balance sheets providing greater amount of information to market players and participants. |
| **8. Governance** | A code of governance in banking is yet to be evolved but the implementation of prudential norms and adoption of banking standards particularly in respect of transparency and disclosure has significant impact on the quality of governance in Indian banking. |
| **9. Market Share** | There are sizeable shifts in the market share of domestic banking institutions; but there is no perceptible increase in the share of foreign banks. For instance in the total assets, the share of the public sector banks has declined from 90 per cent in 1990-91 to 80 per cent in 1999-2000, whereas that of the private sector shot up from 3.62 per cent to 12.56 per cent during this period. The share, of foreign banks in assets which was 6.05 per cent in 1990-91 increased to 8.08 per cent in 1992-93 but later softened to 7.30 per cent in 1990-2000. |
| **10. Capital** | The equity of banks made a massive jump from ₹ 3,071 crores in 1990-91 to ₹ 18,448 crores in 1999-2000. All the bank segments such as the public sector, private sector and foreign banks showed impressive rise in the equity levels. Reserves also showed rapid rise in the post reform period. |
| **11.Deposits** | Total Deposits of banks showed a massive jump from ₹ 2,31,975 crores in 1990-91 to ₹ 9,00,307 crores in 1999-2000. |
| **12. Credit** | Bank advances shot up from ₹ 1,43,961 crores in 1990-91 to ₹ 4,43,661 crores in 1999-2000. |
| **13. Income** | Income increased manifold from ₹ 27,448 crores in 1990-91 to ₹ 1,15,855 crores in 1999-2000. |
| **14. Profit** | Net Profit of the banking sector showed an impressive jump from ₹ 640 crores in 1990-91 in 1999-2000. |

NOTES

| | |
|---|---|
| **15. Profitability** | Net Profits as a per cent of Working Funds showed a sharp rise from 0.22 in 1990-91 to 0.66 in 1999-2000. |
| **16. Productivity** | Business per employee registered a robust growth from ₹ 40.38 lakhs in 1990-91 to ₹ 140.93 lakhs in 1999-2000. |
| **17. Non-Interest Income** | Non-Interest Income as a per cent to total income increased from 9.85 percent in 1990-91 to about 13.70 per cent in 1999-2000 |
| **18. New Business** | Post reforms period in Indian banking unleased a wide range of new products and services. Driven by technology a number of new generation products such as electronic fund transfers, debit cards, smart cards, electronic clearing service, farm and consumer credit cards etc., are introduced. Retail banking received greatest thrust in the post reform period. Deregulation of the insurance sector is envisaged to lead to further proliferation of the products. |
| **19. Competition** | Competition intensified with a larger base of players and non-banking financial institutions emerging stronger in a liberalised and deregulated environment. |
| **20. Consolidation** | Evidence of consolidation is found in the private sector with the merger of HDFC Bank and Times Banks, ICICI Bank and Bank of Madura, UTI Bank and Global Trust Bank (yet to be finalised) *etc.* The only exercise of consolidation of the public sector banks was at the beginning of the reforms with merger of New Bank of India with the Punjab National Bank. The pace of consolidation is expected to intensify in the process of second generation reforms. |
| **21. Globalisation** | Indian banking is gearing up for absorbing the challenges of global finance. Starting with harmonisation of the operational norms and procedures, endeavours are being made to enhance the quality and content of the efficiency parameters, which is essential to withstand the impact of global competition. The ushering in of the second-generation reforms is envisaged to strengthen the role and performance of Indian banking in this regard. |

## *7.3 SUMMARY OF THE UNIT*

During early days Indian economy faced the problems of poverty and lack of job opportunities. Even after 50 years we were in a position of

NOTES

disadvantage in world economy Economic reforms were therefore required. This was done in order to achieve international competitiveness.

## 7.4 GLOSSARY

- **Import:** It means to bring goods into the country from abroad.
- **CENVAT:** Central Value Added Tax

## 7.5 KEY TERMS

- **Money supply:** Total volume of money circulating in the economy.
- **Monetary policy:** It regulates the supply of money and cost.
- **C.R.R:** Cash reserve ratio. It is the amount of cash that Banks have to maintain with the Reserve Bank of India.

## 7.6 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)

### (A) Fill in the Blanks

1. Economic planning helped development of _________ in India.
2. Development of industries lead to development of _________.
3. Setting of new industrial units created _________ opportunistic.

### (B) True or False

1. Salient features of Indian Economy is low per capita GDP.
2. Increasing trade deficit was neutralised by surplus created due to service exports.
3. The main objectives of Export Import Policy is to earn money.

## 7.7 KEY TO CHECK YOUR ANSWER

(a) 1. Industries, 2. Markets, 3. Job.

(b) 1. True, 2. True, 3. False.

NOTES

## 7.8 TERMINAL AND MODEL QUESTIONS

1. Discuss the policy of Fiscal reforms in India.
2. What are the main functions of the policy?
3. Explain the importance of reforms on growth.

## 7.9 REFERENCE BOOKS

1. Pates I.G.: Economic Reforms – 'Macmillan', Delhi.
2. Misra and Puri: Economic Environment of Business, HPH, Mumbai.

# UNIT 8 ECONOMIC PLANNING IN INDIA AND NEW ECONOMIC POLICY

**Structure:**


8.1 Introduction

8.2 Domain of Public Finance

8.3 Basic Concepts

8.4 The International Monetary Fund

8.5 Economic Reforms and Control of Inflation

8.6 Economic Reforms and Their Impact on Poverty

8.7 Economic Reforms and Employment

8.8 Economic Reforms and Foreign Investment

8.9 Economic Reforms and India's External Debt

8.10 Economic Reforms and India's Foreign Trade

8.11 Neglect of Agriculture — The Major Sin of Economic Reforms

8.12 Summary of the Unit

8.13 Glossary

8.14 Key Terms

8.15 Check Your Progress (Multiple Choice/Objective Type Questions)

8.16 Key to Check Your Answer

8.17 Terminal and Model Questions

8.18 Reference Books

**NOTES**

## Objectives

After reading this chapter, you will be able to:

- Understand the basic issues related to fiscal reforms.
- Review India's fiscal system.
- Discuss basic concepts of public finance.

## *8.1 INTRODUCTION*

The term Fiscal reforms means corrections in government policies for betterment. There are public finance theories that help making reforms. These are terms to grasp such as fiscal deficit, GDP, Revenue Deficit, Public debt etc. The term fiscal reform implies corrections in the Government's budgetary policies towards a more efficient fiscal system. In most cases it begins with cutting unproductive expenditure so taxes and Government borrowing may be reduced to a tolerable limit. It may also require rationalisation of the tax structure.

## *8.2 DOMAIN OF PUBLIC FINANCE*

C. Pigou began his classic volume, Public Finance with the following passage:

"In every developed society there is some form of Government organisation which may or may not represent the members of society collectively but certainly has coercive authority over them individually.

Public finance is the study of the financial activities of governments and public authorities. It is a part of the study of economics and is, therefore, concerned with the allocation of scarce resources. Also, it is not merely a matter of public economics, since both the public and the private sectors operate in an integrated fashion. Public finance is specifically concerned with the effect of the activities of the Government (and also of public enterprises) on the allocation of resources.

Some basic propositions about public finance are as follows;

- Public finance is that branch of economics, which deals with the expenditures and revenues of the public sector.
- The basic norms of public finance are universal.

NOTES

- Fiscal deficit measures the difference between Government revenue and expenditure.
- Excessive fiscal deficit is harmful for the economy.
- Fiscal reform is needed to improve the efficiency of governmental budgetary allocation of both revenue and expenditure.

## *8.3 BASIC CONCEPTS*

This section deals with some of the basic tools, which help us in understanding the fiscal system of an economy better.

### Fiscal Policy

To quote the Seventh Five Year Plan (1985-90), "through it (i.e. fiscal policy) the Government creates, sustains the public economy consisting of the provision of public services and public investment; at the same time it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability"

### Major Functions of Fiscal Policy

There are three major functions of a fiscal policy:

(i) The allocation function of budget policy, that is, the provision for social goods. It is a process by which the total resources are divided between private and social goods and by which the mix of social goods is chosen.

(ii) The distribution function of budget policy, that is distribution of income and wealth in accordance with what society considers at 'fair' or 'just' distribution.

(iii) The stabilisation function of budget policy, that is maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth, with due consideration of its effects on trade and the Balance of Payments.

### Theory of Social Goods

Social goods are goods which are required for the welfare of society as a whole, but for which the market fails to provide a value. People are generally ignorant of the value or utility of social goods. An individual knows that once one piece of social goods say a road, is constructed, he

NOTES

cannot be denied its use whether he paid for its construction or not. Everyone assumes that others would pay for it. It is these failures of the market (i.e. provision of social goods), which bring the role of the government in focus for providing social goods for the welfare of the public in general.

*Table 8.1: Major and Subsidiary Objectives of Economic Policy*

| Policy Objectives | | |
|---|---|---|
| **A.** | **Static Efficiency (Short run)** | |
| | 1. | Satisfaction of private consumption wants |
| | 2. | Satisfaction of public wants* |
| | 3. | Balance of payments equilibrium. |
| | 4. | Price stability. |
| | 5. | Removal of market imperfections. |
| **B.** | **Social Justice** | |
| | 6. | Increased employment* |
| | 7. | Reduced inter-personal income inequalities* |
| | 8. | Reduced inter-regional income inequalities |
| **C** | **National Cohesion** | |
| | 9. | Economic independence |
| | 10. | Provisions of economic symbols of nationhood |
| **D.** | **Economic Development** | |
| | 11. | High savings |
| | 12. | Maximum capital inflows from the rest of the world |
| | 13. | Structural change (modernisation) |
| | 14. | Reduced population growth* |

* denotes a subsidiary objective that tends to promote more than one major objective.

## Categories of Revenue for the Government

To finance any proposed expenditure and purchases or pay off public debt, governments need revenues. These revenues may be derived from taxes, charges for the use of public goods and services, or borrowings. Taxes and charges are raised from the private sector without any obligation to pay them back.

A good tax structure has the following requirements:

1. Tax burden must be equitably distributed among citizens. Each should pay his or her fair share.

NOTES

2. Excessive tax burden (which may interfere with the economic decisions in otherwise efficient markets) should be avoided.
3. The cost of administration and compliance should be kept at the lowest possible level.
4. The tax structure should facilitate the objectives of fiscal policy of stabilisation and growth.
5. Where tax policies are used to achieve other objectives such as encourage investment in certain sectors of the economy, interference with the equity of the system should be minimum.

## Public Expenditure Structure and Growth

The size of public expenditure may be defined in relation to the National Income Accounts, such as Gross National Product (GNP), National Income (NY) and Personal Income (PY). Public expenditure has risen tremendously all over the world, developed as well as developing countries. The reasons are not far to seek. There has been increasing political pressure for social justice and progress. Changing social structures, attitudes and political forces are also behind the rising share of transfers and redistribution oriented programmes.

Expenditure in absolute as well as relative terms *i.e.* as a ratio of GNP, has indeed risen over the years. Defence and civil expenditures have both risen. However, the composition of civilian expenditure has been undergoing changes.

Depending on the stage of a country's economic development, the structure of capital formation requires more public investment. Demographic and technological factors are also responsible for a changing public expenditure share in GNP.

## Fiscal Crisis

A fiscal crisis is generally related to the excessive growth of public expenditure. However, the size of public expenditure is not the root cause of a fiscal crisis, it is the manner of financing public expenditure that is more important. A fiscal crisis basically means that the Government is unable to finance its expenditure out of its income, either because it has made commitments to supply public goods and services far beyond its means, or because it is unable to make people pay for the public goods and services either through taxation or through user cost.

NOTES

## Fiscal Deficit

A fiscal deficit is the excess of Government expenditure over its revenue. A fiscal crisis may result from excessive fiscal deficits. There are different perspectives of fiscal deficit, and each has different implications for the economy. In the present literature on public finance and policy, the gross fiscal deficit is given prominent importance, though this is not the best concept of fiscal deficit.

## Gross Fiscal Deficit (GFD)

This is the difference between Government revenue, including the total borrowing by the Government from various sources (households, financial and external), and expenditure. It is well known that Government expenditure increases aggregate expenditure or demand by the famous Keynesian multiplier effect. Government tax revenue, on the other hand, reduces aggregate demand also by a multiplier effect. The values of these two multipliers, however, need not be equal.

# *8.4 THE INTERNATIONAL MONETARY FUND*

International Monetary Fund (IMF) Structural Adjustment Policy loans, for instance, are tied to the reduction of gross fiscal deficit.

## Revenue Deficit

Revenue deficit measures the difference between Government revenue expenditure and tax and non-tax current revenues. It measures the extent to which the Government borrows to finance its current expenditure. At this stage it is useful to distinguish between Government revenue (or current expenditure) and capital expenditure. When Government expenditure affects only the current income of the economy, it is called revenue expenditure. In contrast, capital expenditure affects not only the current but also the future income of the economy. Defence expenditure has no impact on the future income of the economy and therefore, is a perfect example of revenue expenditure. On the other hand, public investment in industry would generate future income and therefore, it would be classified as capital expenditure.

NOTES

### Monetised Deficit

This measures the monetary expansion on account of the Government budget.

It is also popularly called deficit financing. It is generally the most regressive form of public borrowing.

### Public Debt-concept and Measurement

All forms of fiscal deficit increase public debt. Public debt can be defined in various ways. In the narrowest sense it can be defined as the debt of the Government proper. A somewhat wider definition would be the debt of the Government plus the debt of the core (departmental) public enterprises.

## *8.5 ECONOMIC REFORMS AND CONTROL OF INFLATION*

Government's inflation record has been quite satisfactory. India's inflation in the past has been triggered by exogenous shocks such as droughts and adverse terms of trade exchanges and more particularly import bill of oil.

But a more reliable index which measures the cost of living is the Consumers Price Index (CPI). The CPI for agricultural labourers which is the most pervasive index for our country has shown a rise by 15.4 per cent and that of industrial workers by 12.9 per cent during 1995-96 the year for which the Government claims to have brought inflation under control.

## *8.6 ECONOMIC REFORMS AND THEIR IMPACT ON POVERTY*

A recent study shows that rural poverty declined from 31.6% in 1993-94 to 28.8% in 1999-2000 and urban poverty declined only by 0.5% during 1993-2000. Differences among various studies on decline in poverty range from the official 10% to 3% during the period 1993-2000.

## *8.7 ECONOMIC REFORMS AND EMPLOYMENT*

According to the Report of the Planning Commission (2003) "Targeting ten million employment opportunities per year in the Tenth Five Year Plan", unemployment rate in India has increased significantly since 1993-

NOTES

94 and was above 7.3% in 1999-2000 compared to 6 per cent in 1993-94 on current daily status basis.

The Report sums up the employment strategy for future as follows: to meet the Plan's employment goals is to encourage the use of labour intensive and capital saving technology, in general and to rejuvenate the growth of the unorganised sector in particular, which at present contributes 92 per cent to the country's employment and enjoys more than 10 times labour intensity per unit of production, as compared to the organised sector.

*Table: Growth of Employment: Usual Status and Current Daily Status*

| Industry | Usual | Status | Current Daily Status (% annum) | |
|---|---|---|---|---|
| | Principal and Subsidiary (% per annum) | | | |
| | 1983 to 1993-94 to 1999-2000 | | 1983 to 1993-94 to 1999-2000 | |
| Agriculture | 1.51 | -0.34 | 2.23 | 0.02 |
| Mining & Quarrying | 4.16 | -2.85 | 3.68 | -1.91 |
| Manufacturing | 2.14 | 2.05 | 2.26 | 2.58 |
| Electricity, Gas and Water | 4.50 | -0.88 | 5.31 | -3.55 |
| Construction | 5.32 | 7.09 | 4.18 | 5.21 |
| Trade | 3.57 | 5.04 | 3.80 | 5.72 |
| Transport, Storage and Communication | 3.24 | 6.04 | 3.35 | 5.53 |
| Financial Services | 7.18 | 6.20 | 4.60 | 5.40 |
| Community, Social and Personal Services | 2.90 | 0.55 | 3.85 | -2.08 |
| Total Employment | 2.04 | 0.98 | 2.67 | 1.07 |

***Source:*** Planning Commission (2001) for usual estimates and Planning Commission (2002) for current daily estimates.

## *8.8 ECONOMIC REFORMS AND FOREIGN INVESTMENT*

One of the major achievements of the new economic reforms was that it provided a big boost to the inflow of foreign investment. Since 1991

NOTES

continuous efforts have been made to liberalise and simplify the norms and procedures pertaining to FDI. It would be desirable to make an objective analysis of the facts in this regard.

### Economic Reforms Since 1991

During the year 2001-02, computers, electronics, electrical equipments accounted for 34%, while services accounted for around 38% of total FDI (excluding NRI investments). Although India took significant steps towards inviting FDI in pursuance of its policy of emphasising non-debt creating capital inflows during the reform period, the actual FDI inflows in India remained low compared to the other emerging market economies. India's failure to attract FDIs significantly clearly underlines the need for further reforms in this context.

*Table: Foreign Investment Flows by Category*

*(in US $ million)*

| **Item** | **2000-01** | **2001-02** | **April - December (P) 2001-02** | **2002-03** |
|---|---|---|---|---|
| | **1** | **2** | **3** | **4** |
| **A. Direct Investment** | 2339 | 3904 | 2712 | 2256 |
| (a) Government (SIA/FIPB) | 1456 | 2221 | 1581 | 925 |
| (b) RBI | 454 | 767 | 564 | 598 |
| (c) NRI | 67 | 35 | 33 | — |
| (d) Acquisition of Shares | 362 | 881 | 534 | 733 |
| **B. Portfolio Investment** | 2760 | 2021 | 1343 | 386 |
| (a) GDRs/ADRs | 831 | 477 | 477 | 537 |
| **(b) FfIs @** | 1847 | 1505 | 827 | -151 |
| **(c) Off-shore funds and others** | | 39 | 39 | — |
| **Total (A+B)** | **5099** | **5925** | **4055** | **2642** |

***Source:*** Report on Currency and Finance 2001-02.

## *8.9 ECONOMIC REFORMS AND INDIA'S EXTERNAL DEBT*

Data about the growth of India's external debt from 1991 to 2002 — the period of intensive economic reforms — show that India's external debt rose from US $ 83.8bn in 1991 to US $ 98.5bn in 2002, indicating a growth rate of 11.5 per cent per annum. Prudent external debt management is also reflected in the proportion of short-term debt to total debt declining

NOTES

from 10.2% in 1991 to 2.8% in 2002 and the ratio of short-term debt to foreign exchange reserves from a high of 146.5% in the crisis period of 1991 to only 5.1 per cent in 2001 - 2002.

*Total: Foreign Technology Agreements and Foreign Direct Investment Approvals*

| Year | No of FTAs approved | No of FDI approvals | Amount Approved (₹ in crore) | Actual inflow FDI (₹ in crore) |
|---|---|---|---|---|
| 1991 | 661 | 289 | 534 | 351 |
| 1992 | 828 | 692 | 3888 | 675 |
| 1993 | 691 | 785 | 8859 | 1787 |
| 1994 | 792 | 1062 | 14187 | 3289 |
| 1995 | 982 | 1355 | 32072 | 6820 |
| 1996 | 744 | 1559 | 36147 | 10389 |
| 1997 | 660 | 1665 | 54891 | 16425 |
| 1998 | 595 | 1191 | 30814 | 13340 |
| 1999 | 498 | 1726 | 28367 | 16868 |
| 2000 | 418 | 1726 | 37039 | 19342 |
| 2000* | 339 | 1494 | 32631 | 13810 |
| 2001* | 247 | 1590 | 23266 | 16127 |
| **Total ##** | **7116** | **13640** | **270064 #** | **105413 @** |

**Notes:**

# includes approvals for Euro Lssues {American Depository Receipts (ADRs)/Global Depositor) Receipts (GDRs)/Foreign Currency Convertible Bonds (FCCBs)}

## Totals may not tally because of rounding off on an annual basis @ Includes SIA/FIPB/RBI/RBIs NRI Schemes, acquisition of shares, ADRs/GDRs/Pending issues of shares, *etc*.,

* January - October

**Source:** Economic Survey 2001-2002.

NOTES

## 8.10 ECONOMIC REFORMS AND INDIA'S FOREIGN TRADE

Rightly sensing the necessity for moral bilateral trade arrangements to ward off any hick ups due to the WTO agreement, the BJP-lead coalition went into Regional Trade agreements with Sri Lanka, Malaysia, ASEAN countries and Singapore etc. The strategy demonstrated the negotiating strength of India with its neighbourhood and the recognition that India is a country to reckon within international trade.

## 8.11 NEGLECT OF AGRICULTURE — THE MAJOR SIN OF ECONOMIC REFORMS

Indian Agriculture has come a long way since independence. Its performance over the last fifty years has, however, revealed both its strengths and weaknesses. While its main success story has been output growth, particularly of food grains (a record production of over 200mt in 2001), this achievement has been counterbalanced by several other factors: declining growth rates in productivity for major crops, slow expansion of irrigated areas, falling public investment in agriculture, inadequate extension services, extremely low investment allocations for agricultural research, ineffective utilisation of land and water resources along with degeneration of the natural resource base, the problems of dry land agriculture which accounts for 89m.ha. (63% of Net).

*Economic Reforms Since 1991*
*A: Selected Economic Indicators*

| | 90-91 | 91-92 | 92-93 | 93-94 | 94-95 | 95-96 | Average Annual Growth Rate |
|---|---|---|---|---|---|---|---|
| Gross Domestic Product (1980-81 Prices) | 212.6 | 214.2 (0.9) | 224.9 (5.0) | 236.1 (4.5) | 251.0 (6.7) | 266.5 (6.3) | 4.7 |
| Industrial Production (Trie. 1980-81=100) | 212.6 | 213.9 (0.6) | 218.9 (2.3) | 232.0 (5.6) | 252.0 (8.6) | 262.3 (4.0) | 4.3 |

NOTES

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Agricultural Production Index (1980-81 =100) | 148.8 | 145.5 (-2.0) | 151.5 (4.1) | 156.9 (3.5) | 164.1 (4.5) | 163.9 (-0.2) | 2.0 |
| Foodgrains Production Index (Trie. 1980-81=100) | 143.7 | 137.6 (-4.2) | 144.3 (4.8) | 150.2 (4.1) | 155.3 (3.4) | 154.4 (-0.6) | 1.4 |
| Wholesale Price Index Average of Weeks (1981-82=100) | 182.7 | 207.8 (13.7) | 228.7 (10.1) | 247.8 (8.8) | 274.7 (10.8) | 289.7 (8.7) | 10.3 |
| Primary Articles | 185 | 218 (17.8) | 235 (7.8) | 251 (6.8) | 283 (12.7) | 307 (8.7) | 10.6 |
| Food Articles | 201 | 241 (19.9) | 271 (12.4) | 284 (4.8) | 313 (10.2) | 342 (9.3) | 11.2 |
| Non-food articles | 194 | 229 (18.0) | 229 (0.0) | 249 (8.7) | 299 (20.1) | 320 (7.0) | 10.5 |
| Fuel, Power Light & Lubricants | 176 | 199 (13.1) | 227 (14.0) | 262 (15.4) | 280 (6.9) | 284 (1.4) | 10.0 |
| Manufactured Products | 183 | 203 (10.9) | 226 (11.3) | 243 (7.5) | 269 (10.7) | 297 (10.4) | 10.1 |

*Index Numbers of Wholesale Prices (1993-94 = 100)*
*(Variation per cent) : point to point*

| | **1998-99** | **1999-2000** | **2000-01** | **2001-02** | **2002-03** |
|---|---|---|---|---|---|
| All Commodities | 5.3 | 6.5 | 5.5 | 1.6 | 6.5 |
| Primary Articles | 7.6 | 4.0 | 1.5 | 3.9 | 6.1 |
| Food Articles | 9.3 | 7.1 | -0.2 | 5.2 | 0.8 |
| Non-Food Articles | 2.7 | -3.5 | 5.7 | 0.6 | 22.1 |
| Fuel, Power, Light and Lubricants | 3.2 | 26.7 | 15.1 | 3.9 | 10.8 |
| Manufactured Products | 4.9 | 2.4 | 4.0 | 0.0 | 5.1 |
| Food Products | 9.2 | -0.3 | -3.1 | 0.3 | 8.7 |
| Food Index | 9.3 | 4.0 | -1.3 | 3.3 | 3.9 |

NOTES

## 8.12 SUMMARY OF THE UNIT

The fiscal policy changes has a considerable impact on the economy. The main thrust of 1991 reforms were to ensure credit to assist industrial growth. However, there were advantages as well as some shortcomings.

- The three major functions of a fiscal policy are; the allocation function, the distribution function and the stabilisation function.
- The objectives of economic policy are complementary as well as conflicting.
- Social goods are goods, which are consumed by all citizens and increase the welfare society.
- The market fails to provide the economy with social goods. The state must take up this activity.
- Taxes, charges and borrowings are the three major sources of revenue for a government.
- A good tax structure satisfies the requirements of equity, efficiency and low administrative costs.
- The benefit principle is an approach to tax equity according to which each individual pays in proportion to the benefits he/she receives from the social goods in question. This principle is not practicable (except in certain special cases).
- The ability-to-pay approach requires tax payers to pay according to their economic capacity.
- The ability to pay principle requires the tax burden to be in proportion to horizontal and vertical equity.
- Vertical equity can be measured in terms of the equal sacrifice principle.
- Tax incidence refers to the distributional effects of the tax burden.
- Tax incidence has effects on the uses as well as sources.
- Public expenditure in all economies has exhibited an upward trend.
- A fiscal crisis results from excessive fiscal deficits.
- Public debt is debt of the Government proper and the debt of departmental public enterprises.

NOTES

- It is internal as well as external in nature, the latter being a more serious problem.

## *8.13 GLOSSARY*

- **Monetised deficit:** This measures the monetary expansion on account of the government budget, also known as deficit financing.
- **Public debt:** Debt of the government.
- **Capital asset:** Property of any kind held by an assessee connected with business.

## *8.14 KEY TERMS*

- **Monetary Supply:** Supply of money in the economy.
- **Stock Market:** Place to trade shares and stocks.
- **Bank Rate** is the rate at which Reserve Bank of India provides credit to the schedule Banks.

## *8.15 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. The reforms failed to solve the problems of ______and _______.
2. The reforms failed to maintain stability in ________.
3. Internal debt is the amount of Loan raised by the government within the_________.

### (B) True or False

1. The economic reforms suggested reduction in Bank Rate.
2. The reforms had considerable impact in the economy.
3. Reforms induced development of Production.

NOTES

## *8.16 KEY TO CHECK YOUR ANSWER*

(A) 1. unemployment and poverty, 2. prices, 3. country.

(B) 1. True, 2. True, 3. True.

## *8.17 TERMINAL AND MODEL QUESTIONS*

1. Explain the meaning of monetary policy.
2. What are the objectives of the monetary policy.
3. Why reforms in the economic policy were necessary?
4. Explain the merits of fiscal policy.

## *8.18 REFERENCE BOOKS*

1. Misra S.K: 'Indian Economy', 'H P H', Mumbai.
2. Paul H.: "Economic way by thinking", Pearson, Delhi.

# UNIT 9 INDUSTRIAL POLICY AND INDUSTRY LICENSING

## Structure:

9.1 Introduction
9.2 Foreign Investment Promotion Board (FIPB)
9.3 Project implementation
9.4 Impact of Industrial Policy 1991
9.5 Government – Machinery for Indian Industrial Economy
9.6 Overview of new Industrial Policy of 1991 in India
9.7 New Industrial Policy of 1991
9.8 Summary of the Unit
9.9 Glossary
9.10 Key Terms
9.11 Check Your Progress (Multiple Choice/Objective Type Questions)
9.12 Key to Check Your Answer
9.13 Terminal and Model Questions
9.14 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Understand Industrial policy 1991
- Know the requirement for international competitiveness
- Understand the scope of private sector
- You will know the importance of different types of reforms.

NOTES

## 9.1 INTRODUCTION

Foreign Investment Promotion Board (FIPB) was set up with the purpose of speeding up the approval process for foreign investment. Its approach is liberal for all sectors and all types of proposals. Automatic approval for technological agreement has been made possible in high priority industries. This is done under Foreign Trade Agreement (F.T.A). There are various approvals necessary to set up an industrial unit.

## 9.2 FOREIGN INVESTMENT PROMOTION BOARD (FIPB)

### Objective

FIPB is set up with the purpose of speeding up the approval process for proposals relating to foreign investment in India.

### Composition

FIPB was initially headed by Principal Secretary to the Prime Minister and the members comprised, the Finance Secretary, the Commerce Secretary and the Secretary of Industrial Development. Secretaries of the ministries concerned with the specific investment proposals were also invited.

### Application Procedure

No special application form is needed for applying to FIPB. Proposals can be sent directly or through any India's diplomatic missions abroad.

### Scope and Methods

FIPB has the flexibility to examine all proposals in totality, free from predetermined parameters or procedures. Its approach is liberal for all sectors and all types of proposals. A large number of proposals cleared till date by FIPB involved 100 per cent equity participation by the foreign investor. FIPB clearance for foreign investment proposals is based on the investment proposed, the technology to be inducted, the export potential or the import substitution factors, the foreign exchange balance sheet and the employment potential. The totality of the package proposed is examined and approved on merits.

NOTES

## Foreign Trade Agreements (FTA)

To inject the desired level of technological dynamism, automatic approval for technology agreement has been made possible in high priority industries. R.B.I. accords automatic approval to foreign technology agreements within prescribed monetary limits:

- Lump sum payment up to ₹ 10 million.
- Royalty payments up to 5 per cent of domestic sales and 8 per cent of exports over a period of 10 years from the date of the agreement or over a period of 7 years from the date of commencement of production.
- These payments are subject to an overall ceiling of 8 per cent of total sales over a period of 10 years from the date of agreement of commencement cf commercial production.

The prescribed rates are net of Indian taxes.

## Repatriation of Capital

Foreign capital invested in India is allowed to be repatriated with capital appreciation, if any, after the payment of taxes due to them. The disinvestment is permitted in accordance with terms of the letters of approval granted at the time of approving the foreign collaboration.

## Repatriation of Sale Proceeds

Repatriation of sale proceeds of assets held in India is allowed with prior RBI approvals subject to the payment of applicable taxes.

Indian companies that enter into agreements with foreign companies are permitted to remit payments towards know-how and royalty in terms of the foreign collaboration agreement approved.

## Technical Service Fees

Companies can hire the services of foreign technicians, and make remittances for technical services fees, subject to the terms approved by RBI. On the whole, IP 1991, introduced radical changes in India's foreign investment policy. As a result, the entry of foreign enterprises into the Indian market has been made much easier. *Thus, Indian industry has been exposed not only to domestic competition but to foreign competition as well.* This is likely to exert more pressure on domestic industrial units to raise quality as well as productivity. The liberalised foreign investment

NOTES

policy is aimed at augmenting foreign investment inflow and bridge the technology gaps between Indian industry and that of the international. The liberalisation with respect to industrial licensing and foreign investment has made implementation of a project far easier.

## *9.3 PROJECT IMPLEMENTATION*

The implementation of a project in India, whether domestic investor or foreign investor (after obtaining approvals for investing in India) has to undergo the same regulations.

### Incorporating a Company in India

Companies incorporated in India and branches of foreign enterprises are regulated by the Companies Act, 1956. The name of the company can be registered and the company incorporated as a private or a public limited company with the Registrar of Companies (R.O.C). A certificate of commencement of business is obtained from ROC on the fulfilment of certain conditions.

### Industrial Licence/Industrial Entrepreneurs

If an Industry, in which investment is sought, comes under the purview of licensing, an application has to be submitted for an industrial licence. A foreign investor can submit such an application along with the foreign investment proposal. In such cases, they are considered in a composite manner by the FIPB and a composite approval is granted.

In the case of delicenced industries, companies are required to file an Industrial Entrepreneurs Memoranda with the Secretariat of Industrial Approvals and another memorandum at the commencement of commercial production.

### Raising Finances in India

Investors can raise a substantial portion of funds in India through debt and equity instruments. Long term loans can be obtained from state and national financial institutions and working capital from commercial banks or through instruments such as participation certificates, commercial paper, fixed deposits *etc*. Investors can also raise finances through capital markets through shares and debentures.

## Starting Operations

NOTES

There are various approvals necessary from different authorities to set up an industrial unit. Legislative provisions differ from state to state. However, they are similar in relation to fundamental aspects.

## Clearances Required

**(A) Clearances required by all Industrial units**

**Land for Project**

Allotment of plot/shed in Industrial estate

Allotment of Government land Notified Authority Permission.

**Construction of Building**

Plan approval in Industrial Estate Plan approval in other area. Water Requirement in Industrial Estate River/Public sendee.

Power Requirement

**(B) Other Clearances — Environmental Clearance**

No objection Certificate applicable to polluting industries like, chemicals, pharmaceuticals etc.

Site Clearance Certificate

Applicable to 22 highly polluting Industries.

Incentives

Investment subsidy for industrial units coming up in the backward areas of the state Sales tax exemption/eligibility certificate.

## Clearance for Specific Projects

Pharmaceuticals and Cosmetics Project

## Permission under Boilers Act

Permission to be obtained for installation of boiler to meet safety requirements.

### Mining

Permission for extraction of minerals: Permission to be obtained for lease and setting up mineral based industry.

NOTES

**Port location**

**Permission to locate a project near the seashore**

**(c) Clearance before going into production Registration as Factory**

Under the Factories Act, for the safety of the workmen.

**Sales Tax Registration**

**Authority**

State Industrial Development Corporation (SIDC)

District Collector or District Development Authority

Local authority SIDC

Department of Water Resources State Electricity Board

State Pollution Control Board

Office of the Industries Commissioner (IC)

District Industries Centre (DIC)

Food and Drugs Control Administration

Chief Inspector of Steam Boilers

Director, Geology & Mining

**Port Department/State Maritime Board**

Chief Inspector of Factories

Sales Tax Officer with obtaining conditions of competition with free entry. In order to improve competition, and thus contain the distortions caused by monopoly power, the Competition Act, 2002 has been enacted in December, 2002. It is a landmark legislation that aims at promoting competition through prohibition of anti-competitive practices, abuse of dominance and through regulation of companies beyond a particular size. This Act has replaced MRTP Act.

## *9.4 IMPACT OF INDUSTRIAL POLICY 1991*

The all-round changes introduced in the industrial policy framework have given a new direction to the future industrialisation of the country. The industrial reforms resulted out of the Industrial policy 1991 have already led to encouraging trends on diverse fronts. Industrial growth, which

NOTES

decelerated in 1991-92 due to measures like high interest rate, import compression and credit squeeze, has been picking up from year to year. Industrial growth was 1.7 per cent in 1991-92, 4.4 per cent in 1992-93, 4.3 per cent in 1993-94, 8.6 per cent in 1994-95, and 11.7 per cent in 1995-96.

A convincing impact of industrial reforms is reflected in multiple increase in investment envisaged, both domestic and foreign. Project investment plans have more than doubled during 1990-93. This is due to encouraging response from the private sector. As a result, the ownership pattern of investment projects is undergoing a transformation.

Investments in power generation in power sector surged from players of various sizes in different states depending on the environment created by the respective states through the well-drafted power purchase agreements and the pricing mechanisms.

Net inflow of FDI, which was just $133 million in 1991-92 has increased to $5025 million in 1997-98.

*Table 9.1: Foreign Direct Investment*

*(in US $ million)*

| | **1991-92** | **1992-93** | **1993-94** | **1994-95** | **1995-96** | **1996-97** | **1997-98** | **1998-99** |
|---|---|---|---|---|---|---|---|---|
| Direct investment | 129 | 315 | 586 | 1314 | 2133 | 2696 | 3197 | 1562 |
| Portfolio investment | 4 | 224 | 3567 | 3824 | 2748 | 3312 | 1828 | -682 |
| Total foreign investment | 133 | 559 | 4153 | 5138 | 4881 | 6008 | 5025 | 880 |

An interesting feature of foreign investment inflow is that it has flowed into different segments of industry such as:

(a) basic goods industries comprising of aluminium, cement, chemicals, fertilizers, metallurgy, power generation *etc*.

(b) capital goods industries comprising of engineering, telecom, machine tools, computer hardware, textiles machinery, *etc*.

(c) intermediate goods industries consisting of paper and paper pulp, petrochemicals, plastics, refineries, rubber, glass, industrial gas, electrodes *etc*.

NOTES

(d) consumer goods industries which include, among others, detergents, domestic appliances, electronics, food processing, textiles, pharmaceuticals, *etc*.

(e) automobiles, consisting of auto ancillaries, automobiles, tyres and tubes.

The total inflow of FDI during July, 1991 to March 1996 amounted to more than ₹ 10,000 crores (Table). Of these, more than 50 per cent is accounted for by basic goods, capital goods, automobiles and intermediate goods industries. Such an investment pattern will have a far reaching impact in further diversifying the industrial structure of the country for accelerated industrialisation. Another noteworthy feature is that India has attracted most of the prominent Multi National Corporations (MNCs) from all over the world. Some of the MNCs which have entered in 90s are General Electric, Kellogs, McDonalds, Daewoo, Dupont, Electrolux, Daimle-Benz, Marubeni, Seagram, among others. As a result the image of India as the investment destination for foreign investors is likely to get a further boost.

*Table 9.2: Total inflow of FDI*

| Sector | ₹ Crores | % to Total |
|---|---|---|
| Basic goods | 125.24 | 12.3 |
| Capital goods | 1,928.21 | 19.2 |
| Intermediate goods | 1,248.48 | 12.5 |
| Consumer goods | 2,549.31 | 25.4 |
| Service Sector | 2,111.33 | 21.1 |
| Automobiles | 711.06 | 7.1 |
| Miscellaneous | 244.95 | 2.4 |
| **Total** | **10,028.58** | **100.00** |

## *9.5 GOVERNMENT – MACHINERY FOR INDIAN INDUSTRIAL ECONOMY*

Form the standpoint of having an idea about the non-market institutional environment within which Indian industry and business operates, we may refer here to a few selected organisational set ups.

## The Ministry of Industry

NOTES

The Ministry of Industry was constituted on August 24, 1976. It comprises of two Departments:

(i) Department of Industrial Development

(ii) Department of Heavy Industry/Public Sector Undertakings.

The Department of Industrial Development is the primary Government agency for the formulation and implementation of Government's industrial policy including the promotion and Industrialisation of the country in accordance with the Government's industrial policy, the national priorities and the objectives the five-year plans. The Department reviews from time to time the measures which are needed for the promotion of industrialisation including balanced regional development, promotion of small-scale. Village and rural industries as also for securing higher employment generation and maximising production. One of the instruments employed for securing these objectives is industrial licensing which stems the Industries (Development and Regulation Act, 1951) and the rules made hereunder. The Act and the rules are also administered by this Departments. A number of promotional regulatory, technical and advisory functions are also discharged by this Department.

The principal functional division/desks in the Department is also administering certain industries as allocated to it under the Allocation of Business Rules of the Government of India.

The principal functional divisions/desks in the Department of Industrial Development are:

- Secretariat for Industrial Approvals
- Policy Desk for the Formulation and Implementation of Industrial and Licensing Policies
- Industries Division
- Finance Division
- Administration and General Division

Let us describe each of them separately

- The Secretariat for Industrial Approvals is functioning as an unified agency for processing applications for *(a) industrial licenses, (b) foreign collaboration,* and *(c) import of capital*

NOTES

*goods*. This division is also an Entrepreneurial Assistance Unit for assisting entrepreneurs and for redressal of public grievances.

- The Policy Desk for Formulation and Implementation of Industrial and Licensing Policy oversees, the effect of the policy measures taken from time to time and formulates the changes that may be called for in the licensing policy, procedures for industrial approvals, protective measures needed for the small-scale sector, reduction of disparities in regional development, promoting of investment in the desired channels, *etc*.
- The Industries Division is concerned with promotion of industrial growth in the large, medium and small scale sectors for industrial productivity and industrial management. Besides, it deals with certain industries specifically allocated to the Department.
- The Finance Division is headed by a Financial Advisor of the status of additional secretary and handle work relating to budget and accounts, financial advice, methods and work measurement studies, *etc*. This division also conducts internal audit to ensure both accuracy in accounts and efficiency in operation.
- The Administration and General Division deals with personnel and establishment functions and allied matters such as Career Management and Training, Vigilance, Security, Welfare, *etc*.

The Department of Heavy Industry or what is now called the **Department of Public Sector** Undertakings is exclusively concerned with basic and capital goods industries. One of the important activities of the Department relates to coordination with other ministries and agencies responsible for the growth of the infrastructure or of producer goods industries. An important piece of our Government's control mechanism is the CG (Capital Goods) clearance effected through this department.

There are other developmental and promotional organisations under the Ministry of Industry. The organisational set up and functions of some of these units are on follows.

## The Directorate-General of Technical Development (DGTD)

The Directorate-General of Technical Development (DGTD) is the technical advisory organisation in the industrial field to various ministers/departments of the Government. It gives technical advice on matters relating to industrial technology and licensing, foreign collaboration, capital goods requirements, import and export policy, tariff

NOTES

structure and other related matters in respect of most of the industries excepting iron and steel, textiles, jute, sugar and vanaspati.

The organisation has two functional wings — Engineering and non-Engineering including Chemicals. Each wing has two Deputy Directors — Generals and a number of Industrial Advisers who look after different industries disciplines.

Regional offices of the DGTD have been established at Chennai and Kolkata. These offices render technical assistance to entrepreneurs and advise the Joint Chief Controller of Imports and Exports, the Department of Customs and other organisations regarding import of capital goods up to the value of ₹ 20 lakhs. In conjunction with the state directorates of industries, they also provide information to the headquarters on the progress of various schemes and provide feedback information on technology, quality upgradation, standardisation and development of ancillaries.

The Technology Information Centre in the DGTD collects data on technology, R&D and consultancy. Such data are utilised in processing proposals for foreign collaboration, entrepreneurial guidance, choice of technologies, *etc*.

The Technology Development Division of the DGTD acts as the secretariat for the Technical Evaluation Committee for examining all proposals for foreign collaboration and technical consultancy services, *etc*. In order to take an objective view of foreign collaboration proposals from the angle of availability of indigenous know-how, and the feasibility for horizontal transfer or indigenous technology.

## The Office of the Economic Adviser

It is an attached office under the Department of Industrial Development in the Ministry of Industry. It assists in the formulation of Industrial and Import policies and renders advice and assistance on allocation of foreign exchange for the import of raw materials and other maintenance inputs.

The office of the economic Adviser deals with macro-aggregates such as industrial production and trends in industrial growth and capacity utilisation. The office prepares monthly review of industrial production and examines and monitors trends in industrial production and capacity utilisation.

Relevant issues concerning industrial finance and resource availability and mobilisation with reference to plan targets for the industrial sector are delt

NOTES

by this office. Matters pertaining to credit policy, credit planning and availability with reference to the industrial sector and specific industries are examined in this office. Fiscal proposals in general and duty levies in particular are examined, keeping in view the need for stimulating investment and industrial production in the context of overall economic development.

This office complies and publishes the official Wholesale Price Index in India and also reviews trends in wholesale prices periodically. It brings out weekly and monthly indices of wholesale prices, a quarterly Bulletin of Industrial Statistics and a monthly Economic Review.

Additionally this office collects compiles and analyses information on employment of Indians and non-Indians in companies with foreign majority shareholding and of non-Indians in public and private sector companies in India. Finally, the office prepares from time to time analytical notes on different aspects pertaining to the Industrial sector.

## Bureau of Industrial Costs and Prices (BICP)

In pursuance of a recommendation made by the Administrative Reforms Commission, the Government of India established in 1970 the Bureau of Industrial Costs and Prices (BICP). It is an attached office under the Department of Industrial Development. It advices the Government on a continuing basis on various aspects of the price structure in relation to industrial costs, cost reduction and productivity.

## The Directorate General of Industrial Contingency

The Directorate General of Industrial Contingency (DIGC) was established in December 1976 so that industrial production in the country does not suffer on account of strikes, threats of strikes, lay-offs and lock-outs, *etc*. Contingency plans are drawn up on the advice of this directorate in public sector and important private sector undertakings and the Director-General of Industrial Contingency ensures effective implementation of these plans. The Directorate keeps a close watch on the labour situation to repent any interruption in production by getting the genuine grievances of the workers redressed by the management initiative. It helps provide effective assistance from state, civil and police administrations, so also from the Labour Department for the implementation of the contingency plans.

NOTES

## Directorate-General of Supplies and Disposals (DGS &D)

India's huge government machinery is a potentially important and of growing customer. The DGS & D is the Government's central purchasing organisation. It buys all kinds of products from brooms to heavy machinery on behalf of all Central Government ministries and agencies. State, local, quasi-public, statutory, and public sector may also use DGS D, if they so wish.

Certain products (*e.g.*, food, leather goods, coal and wooden furniture) fall outside the scope of DGS&D, and several Government or quasi-government bodies (*e.g.* Air India, Indian Airlines, and the Oil and Natural Gas Corporation do their own buying.

The DGS & D uses the following four basic contract types:

1. Fixed quantity contracts, usually termed "Acceptance to Tender", call for the firm to supply a specific quantity of items at agreed-upon prices and delivery schedule.
2. Rate contracts set specific rates and contract period but do not mention quantities. The contractor is bound to fill any order placed during the contract period.
3. Running contracts set quantity, price and a fixed term of usually a year, but the ordered quantity may vary usually by 25 per cent of the contracted quantity. Some contracts include price variation clauses.
4. Price agreements specify prices for monthly rate of supply and serve as a standing offer to the purchaser.

## Development Commissioner (Small-Scale Industries)

This is an office attached to the Ministry of Industry. It is the nodal agency to coordinate the policies and programmes for the development of small-scale industries. It provides a wide range of facilities and services including consultancy in the techno-managerial aspects to small units through the network of Small Industries Service Institution (SISI), Production Centres, Testing Centres, Product-cum-Process Development Centres, *etc*.

## The Ministry of Civil Supplies

The current strategy of industrial development in India is to place heavy emphasis on heavy industry and at the same time to ensure large-scale

NOTES

production (or distribution) of mass-consumption goods. Production is conducted by the availability of required inputs, and form this point of view, the purchase function is important. We have already referred to the role of the purchasing organisation which functions under the above ministry, *i.e.*, DGS & D.

## The Ministry of Commerce

Here is another Government organ affecting the politico-economic environment of business indicia. The ministry is vested with the task of formulating and guiding India's trade policy. The ministry consists of the Department of Commerce and the Department of Textiles.

The Department of Commerce is the primary Government agency responsible for India's foreign trade introducing commercial relations with other countries state trading, trade promotional measures, and regulation of certain export-oriented industries and commodities.

The functional division of the department of Commerce are:

(i) Administrative and General Division;

(ii) Finance Division;

(iii) Economic Division;

(iv) Trade Policy Division;

(v) Foreign Trade Territorial Division;

(vi) Export products Division;

(vii) Export Industries Division;

(viii) Export Services Division, and

(ix) Vigilance Division

There are a number of **autonomous bodies** under the Department, like Commodity Boards, Export Promotion Council's Export Inspect Council, Trade Development Authority, Trade Fair Authority, *etc*.

A number of **public sector** undertakings are functioning under the direct administrative control of the department like the State Trading Corporation (STC), the Minerals and Metals Trading Corporation (MMTC), the Project and Equipment Corporation, The Export Credit and Guarantee Corporation, *etc*.

Some of the attached and **subordinate** offices under the Department are: (i) Office cf the Chief Controller of Imports and Exports, (ii) Directorate

NOTES

General of Commercial Intelligence and Statistics, (iii) Development Commissioner, Kendal Free Trade Zone, *etc*.

- Factory Legislations.
- Social Security Enactments.
- Laws for Consumers' Protection.

This list is not exhaustive, it is just illustrative. There are many more legislations which are important from the standpoint of business and industry in India.

## *9.6 OVERVIEW OF NEW INDUSTRIAL POLICY OF 1991 IN INDIA*

### Introduction

In India as early as the First Five Year Plan the economic policy adopted was that the State must not only assume the responsibility for providing the infrastructure facilities, but also undertake direct production work. The need for the intervention of the state in the industrial field was recognised and the development of basic and strategic industries was earmarked for the public sector. At the same time, policy of nationalisation of the private sector was given up; as it was clear that the task before the country was so large that the initiative of both public private sectors was necessary to secure maximum growth. A complementary role was assigned to the private sector and a large field of operation was left open for private sector activities. The concept of mixed economy was evolved, envisaging the operation of both public and private sectors with an expanding role to the former. Over a greater part of the activities including not only the organised industries but also agriculture, small-scale industries, trade and construction, individual effort and private initiative were regarded as necessary and desirable.

### Industrial Policy Resolution 1956

The concept of mixed economy was given a concrete shape and policy direction at the commencement of the Second Five-Year Plan by the announcement of the Industrial Policy Resolution of April 1956. This Policy Resolution with same amendments made from time to time continued till 1991 when the policy of liberalisation was adopted.

NOTES

The basic consideration underlying Industrial Policy Resolution of 1956 was that public sector should venture into new field and to provide the country with the foundations of economic development by strengthening the basic industrial structure of the country. This implied long-term programme and substantial investment by the State not only for the development of basic and heavy industries such as iron and steel, machine building, fertilizers and chemicals, but also providing essential infrastructure such as irrigation, power, transport and communications. The Government was also to undertake direct promotional work of providing finance, marketing facilities, technical advice and other assistance to promote industrial development in the private sector.

The Industrial Policy Resolution, 1956 spelt out the role expected to be played by the private and public sectors. As the Resolution puts it, 'the need for planned and rapid development requires that all industries of basic and strategic importance or in the nature of public utility services should be in the public sector. Other industries which are essential and require investment on a scale which only the State, in the present circumstances, could provide, have also to be in the public sector. The *State has, therefore, to assume direct responsibility for the future development of the industries over a wide area".*

Two schedules were drawn up: Schedule 'A' consisting of 17 industries, the future development of which was the *exclusive responsibility of the State* and Schedule 'B' containing a list of 12 industries which were to be progressively State-owned in which the State would, therefore, generally take the initiative in establishing new industries. But in this schedule 'B' private enterprise was also expected to supplement the efforts of the State. All the remaining industries were in general left to the initiative and enterprise of the private sector. This classification was, however, not rigid. The Resolution had left open considerable flexibility so as to permit the entry of the private sector wherever necessary in the fields which were generally allotted to public sector, and *vice versa.*

Within the broad framework of the Industrial Policy Resolution 1956, the *Industries (Development and Regulation) Act, 1951* provided the main instruments through which the development of the industries in the Private Sector was regulated. The industrial licensing system was designed to canalise investment in the desired directions in accordance with Plan priorities and targets, so as to prevent concentration of economic power and to bring about progressively economic and technological improvements in the industries in the Private Sector.

NOTES

The roles of public sectors as described in the Industrial Policy Resolution of 1956 continued for 35 years though some modifications and amendments, especially in the licensing policy, were made from time to time. In the industrial policy statements of 1980 and 1985 licensing system was liberalised so that it should not work as an obstacle to the industrial production in the private sector. But in 1991 when Congress Party came into power again under the leadership of Narasimha Rao with Dr. Manmohan Singh as Finance Minister, industrial policy was drastically revised. As shall be discussed below, in the Industrial Policy 1991, the role of public sector has been greatly reduced and policy of liberalisation has been adopted. Under the policy of liberalisation, private sector has been given greater role in the industrial development of the Indian economy.

## Need for Revision of Industrial Policy in 1991

It is important to know why industrial policy had to be revised drastically in 1991. In the late eighties it was felt that importance given to the public sector in the strategy of industrial development and stiff controls over the working and expansion of the private sector were obstructing economic growth and *promoting inefficiency.* Further, India experienced serious problems of a *high rate of inflation* on the one hand and *huge deficit in the balance of payments* on the other. To overcome these problems some economists such as I.M.D. Little, Jagdish Bhagwati, Bela Balassa who had been advisors of World Bank and IMF argued for the adoption of the policy of economic liberalisation by India and other developing countries to promote growth, check inflation and solve the problem of balance of payments. They advocated that *free markets and greater role of private sector (including foreign investors) would ensure efficiency by encouraging competition.*

The experiment of a mixed economy as described in the Industrial Policy Resolution of 1956 and later amendments made in it wherein public sector was given a prominent role in industrial development of the Indian economy seemed to be a success in the beginning. It was through public sector investment a lot of infrastructure such as irrigation, transport, power was developed. Many basic and basic heavy industries such as steel, fertilizers, machine-making industries were built by the public sector. But during the eighties several shortcomings of the working of public sector were observed. First, the *public sector which was expected to generate adequate resources* for the growth of the economy not only failed to do so but *in fact was incurring huge losses* which raised the expenditure of the

NOTES

Government. The losses of the public sector were said to be due to the inefficiency of the public sector enterprises. Secondly, the *problem of macroeconomic imbalances,* both in the internal and external sectors, emerged and assumed serious proportions in 1990-91. The huge budget deficits of the Government and expansion in money supply led to the serious problem of inflation. On the external front, higher commercial borrowing from abroad at higher rates of interest resulted in the serious problem of persistent deficit in the balance of payments. This caused a *sharp decline in the foreign exchange reserves.* The foreign exchange reserves fell to such a meagre amount that it could meet the payments for imports only for 15 days. This compelled the Government to approach IMF, and World Bank for necessary help to tide over the foreign exchange crisis. IMF and World Bank agreed to help only if policy of economic liberalisation is adopted and accordingly greater role be assigned to the private sector in boosting industrial investment and production in a competitive environment. *It was believed that competition would ensure efficiency and stimulate economic growth.*

Thus the year 1991 is a landmark in the economic history of India. The country faced a severe economic crisis triggered in part by a serious economic situation. Through fundamental changes in economic policy, this crisis was converted with an opportunity. The objective of new industrial policy was to improve the efficiency of the economic system by eliminating the regulatory mechanism that involved various licenses and permits which reduced competition even in private sector. To quote Dr. C. Rangarajan, “The thrust of the new economic policy was towards creating a more competitive environment in the economy as a means to improving the productivity and efficiency of the system. This is to be achieved by removing the barriers to entry and restrictions on growth of the firm. While the industrial policy seeks to bring about a greater competitive environment domestically, the trade policy seeks to improve international competitiveness subject to the protection offered by tariffs which are coming down”.

## *9.7 NEW INDUSTRIAL POLICY OF 1991*

We discuss below the new industrial policy decisions regarding industry announced in 1991 under the following heads:

1. Abolition of Licensing and Role of Private Sector.
2. Public Sector and Privatisation.

NOTES

3. MRTP Policy and Role of Large Business Houses.
4. Foreign Investment and Foreign Technology.

**1. Abolition of Industrial Licensing**

Until the early 1980s, the Indian industrial sector had functioned under a system of tight controls and regulations, represented by industrial licensing which was meant to allocate the scarce resources towards building the industrial base of the economy. Now that the Indian Industrial economy had acquired quite a wide and diversified base, the new industrial policy of 1991 abolished all industrial licensing irrespective of the level of investment except for 18 industries for which licence was still required. Later, in April 1993 more industries were dereserved and thrown open to the private sector. These three industries dereserved later were: 1. motor cars, 2. white goods (such as domestic refrigerators, working machines, microwave ovens, airconditioners) and 3. raw hides, skins and leather. *The remaining fifteen industries which remain reserved for the public sector are those which are essential for security and strategic reasons, safety purposes and for protection of environment.* For granting of licences for even these 15 industries procedure has been greatly simplified. For getting licences only certain vocational guidelines are to be fulfilled so that polluting industries should not cluster around the major urban centres.

The 15 specified industries which continue to be subject to compulsory licensing are:

1. Coal and Lignite
2. Petroleum (other than crude) and its distillation products
3. Distillation and Brewing of Alcoholic drinks
4. Sugar
5. Animal Fats and Oils
6. Cigars and Cigarettes of Tobacco and Manufactured Tobacco Substitutes
7. Asbestos and Asbestos based Products
8. Raw hides and skins, leather
9. Tanned or dressed furskins
10. Paper and Newsprint except bagasse based units
11. Electronic aerospace and defence equipment (all types)

NOTES

12. Industrial explosives, safety fuse, gun powder and matches
13. Drugs and Pharmaceuticals
14. Plywood and other wood-based products
15. Hazardous chemicals.

Industrial policy, 1991 hoped that with the removal of licensing control for most of the industries, the Indian industries would benefit by becoming more competitive, more efficient and modern which would ensure its rightful place in the world of industrial progress.

- Freedom to Create new Capacity and Manufacture any Product. It is worth noting that with the abolition of licensing control, existing private industrial enterprises have been allowed to expand and create new capacity according to the demand in the market without obtaining prior permission or capacity clearance from the Government. Further, in the earlier licensing system existing private enterprises were required to produce specific products. With the abolition of industrial licensing, firms will now be free to manufacture any article in response to market demand (except for those subject to compulsory licensing). Big industrial houses have been allowed to expand, diversify, merge and takeover.

**2. Role of Public Sector and Privatisation**

In the earlier industrial policy public sector investment was a crucial element in the strategy of industrial development. It was planned that public sector would occupy the commanding heights of the Indian economy Public Sector was originally given importance because it was required to make adequate investment in infrastructure (power, irrigation, transport and communication) and basic heavy industries so as to lay the basis for future industrial growth. Besides, role of Public sector was considered essential to prevent the concentration of economic power in a few private hands, and to promote balanced regional development.

But after the initial success in its original role some problems emerged in the working of public enterprises. Low productivity and inefficiency, poor project management, overstaffing, lack, continuous upgradation, lack of concern for R&D are some of the problems faced by public sector enterprises. But the most important problem was that public sector enterprises suffered heavy losses and were yielding a very low rate of return. As a result, instead of being a source of investible surplus for

NOTES

industrial development, public sector enterprises became a burden on the Government rather than being an asset.

It may also be noted *over a period of time public sector made a departure from its original role.* First, for protecting the interests of workers, the Government had to takeover the sick industrial units from the private sector. This category of public sector enterprises accounts for about one-third of the losses of the central public sector enterprises. Second, the public sector had also entered into the production of consumer goods and service sectors such as cars, hotels etc.

In view of the above, Industrial Policy of 1991 adopted a new approach to the public sector. According to this new approach, *the priority areas for future growth of public enterprises are:*

1. Production of essential infrastructure goods and services.
2. Exploration and exploitation of oil and mineral resources.
3. *Technological development* and investment in manufacturing capabilities in areas *which are essential for long-term development* of the economy and where private sector will not make adequate investment.
4. Manufacturing products which are of paramount importance on account of *strategic considerations.*

**De-Reservation of Industries of the Public Sector.** The new industrial policy 1991 far-reaching structural reforms had been initiated to lead industries away from excess direct controls and regulations to a free, market oriented economic system. The list of industries reserved for the public sector has been pruned. In the Industrial Policy of 1956, 17 industries were reserved for investment by the public sector. Now, only 8 industries remain reserved for the public sector. Among the industries reserved earlier included many core industries like iron and steel, electricity, air transport, ship building, heavy machinery industries such as heavy chemical plants and telecommunication cables and instruments. The new industrial policy of 1991 threw open all these industries for the private sector for investment and growth. Thus the *new policy of 1991 indicates the Government's intentions to invite a greater degree of participation by the private sector* in important areas of the economy. From March 1993, the two more industries, namely, (1) mining of iron ore, manganese ore, sulphur, gold and diamond and (2) mining of copper, lead, zinc, tin *etc.* were dereserved. The six remaining industries reserved for the public

NOTES

sector are (1) Arms and Ammunition, other defence equipment, warships, aircraft (2) Atomic Energy, (3) Coal and Lignite (4) Mineral Oils (5) Minerals used for producing atomic energy (6) Railway transport. Thus, six industries which continue to be reserved for the public sector are *in areas where security and strategic considerations predominate.* According to new policy, as stated above, *the resources in the public sector are now to be used for strategic, high technology and essential infrastructure areas.*

New Industrial Policy 1991 stipulated that the Government would strengthen those public enterprises which fall in the reserved areas for public sector operation or belong to high priority areas or are yielding reasonable profits. To strengthen them, such public enterprises will be given a *much greater degree of management autonomy* through the system of Memorandum of Understanding (MoU). *Competition will also be induced* in these areas by inviting private sector participation.

**Public Sector Disinvestment.** Another important decision of Industrial Policy of 1991 was that in case of *selected public sector companies,* a part of the Government holdings in the equity share capital of these will be disinvested. Apparently this disinvestment was to subject them to market discipline so that they can increase their efficiency. These selected enterprises would be those which are non-essential and commercial in nature. In accordance with this year, beginning from 1991 a target of realising an amount through public disinvestment is set. Revenue so raised is used to reduce budget deficit. So far disinvestment in BALCO, Modern Bread, Indian Tourism Development Corporation, Asoka Hotel, Hotel Corporation of India, Maruti Udyog Limited, IPCL *etc*. has been carried out and more are in queue for this purpose.

**3. MRTP Policy and Large Business Houses**

Removal of Investment Controls on Large Business Houses. Under the Monopolies & Restrictive Trade Practices Act (MRTP Act), all firms with assets above a certain size (₹ 100 crores since 1965) were classified as MRTP firms. Such firms were permitted to enter selected industries only and this also on a case-by-case approval basis. In addition to control through industrial licensing separate approval from MRTP Commission was required by such large firms for any investment proposals. This produced a significant adverse effect on the freedom of many of the large private firms in their planning for growth and diversification. In the Industrial Policy 1991, the threshold limits of assets in respect of MRTP and dominant undertakings were removed. These firms will now be at par

NOTES

with others and no prior approval from the Government for investment in the delicensed industries was required.

This is a significant change in the policy regarding the Government control on growth of big business and private monopolies through MRTP Act 1991. According to this policy, to achieve economies of scale by the firms and thereby to ensure higher productivity and competitive advantage, the check by the Government through *Monopoly and Restrictive Trade Practices Act* (MRTP) was not needed. Therefore, Industrial Policy 1991 limited and restricted the role of MRTP Act. The following decisions were taken in this regard:

1. Prior Government approval of investment proposals regarding expansion of present undertaking and establishment of new undertaking by big industrial companies which came within the purview of *MRTP Act was not required.*
2. It was decided to repeal the provisions which prohibited the companies for merger, amalgamation and takeover other firms by a firm.
3. It was decided that emphasis would now be on controlling monopolistic, restrictive and unfair trade practices. In accordance with this, provisions of MRTP Act were strengthened in order to enable MRTP Commission to take appropriate action in respect of monopolistic, restrictive and unfair trade practices.

Accordingly, the newly appointed monopoly commission would be asked to investigate the complaints received from industrial consumers or various other specific classes of consumers.

## Foreign Trade Liberalisation

Prior to 1991 India followed the policy of *import substitution* under which goods were produced within the country instead of importing them. A significant policy reform was to free trade, that, is to reduce tariffs on imports and remove tight *quantitative restrictions on imports.* Besides, *export-oriented* industrial policy was adopted so as to boost exports of India to raise growth of both output and employment. Prior to 1991 imports of consumer goods were banned. Capital goods, raw materials and intermediates were freely importable, subject to indigenous unavailability. The criteria for issuing of licences were non-transparent; delays were endemic and corruption to unavoidable. The first series of economic

NOTES

reforms sought to phase out import licensing and also to reduce import duties.

Import licensing was abolished relatively early for capital goods and intermediates in 1992 simultaneously with the switch to a flexible exchange rate regime. "Import licensing had been traditionally defended on the grounds that it was necessary to manage the Balance of Payments, but the shift to a flexible exchange rate enabled the government to argue that any balance of payments impact would be dealt with through Exchange Rate Flexibility". Removing quantitative restrictions on finished goods was much more difficult because the number of domestic produce's was very large. Quantitative restrictions on imports of consumer goods and agricultural produce were finally removed on April 1, 2001 in phases primarily because of a ruling of WTO Dispute Panel on a complaint brought by the US.

**4. Foreign Capital and Foreign Technology**

The new Industrial Policy 1991 also made a significant change towards the approach to foreign capital and technology. Till 1991 the import of foreign technology was strictly regulated. In case of Foreign Technology Transfer Agreements sought by the Indian firms, it was necessary to obtain specific prior approval from the Government for each project. This involved delays and hampered business decision making for the import of technology by Indian firms. With a view to promoting technological advancement of the Indian industry, Industrial Policy 1991 announced that *now the Government would provide automatic approval to technological agreements relating to high-priority industries within specified guidelines.* Similar facilities will also be available for other industries as well if technology agreements do not require expenditure offered foreign exchange. Indian companies were given freedom to negotiate the terms of technology transfer with the foreign companies according to their own commercial judgement.

The new Industrial Policy 1991, emphasised that opportunities for foreign investment in India should also be utilised to ensure rapid industrial growth. It welcomed foreign capital to supplement domestic efforts for mobilisation of resources. In keeping with this approach Government liberalised its policy regarding foreign investment. To attract foreign direct investment (FDI), it decided to grant automatic approval to private foreign investors to hold equity in Indian companies up to 51 per cent of the total equity shares of a company in 34 high priority industries. This facility

NOTES

would be available to those firms which are able to finance their capital equipment imports through their foreign equity. This is a major departure from the previous policies which required a case-by-case approval of foreign investment normally limited to 40 per cent equity participation. The priority sector industries include power generation and petroleum refining. Further, the Government has given a guarantee 16 per cent return on foreign investment in priority sectors.

Foreign capital flows are not only of the type of foreign direct investment (FDI) but also of *portfolio capital* type. Under portfolio capital Foreign Institutional Invertors (FIIs) invest in our equity (*i.e.,* shares) of the Indian companies and also in bonds or securities of government and corporate sector. Portfolio capital flows are generally *volatile,* they come in when market conditions in a country are favourable and go out when uncertainty prevails in the domestic economy or in the international business environment.

## 9.8 SUMMARY OF THE UNIT

The primary objective of Industrial Policy of 1991 is to achieve international competitiveness, in addition to that of IPR 1956. To achieve these objectives the policy introduced far reaching changes with respect to licensing, foreign investment and technology, MRTP Act, public sector enterprises, *etc*. The scope for private sector, both domestic and foreign, is widened dramatically; licensing is virtually scrapped; threshold limit on assets of large undertakings is removed; mergers, acquisitions and amalgamations are allowed, financial performance of public sector is accorded prominence, and retrenchment and redeployment of labour wherever necessary to improve industrial efficiency is encouraged. These reforms have started yielding positive results. Industry has reached double digit growth and the growth is likely to get further momentum. There is a spurt in domestic and foreign investments across the industry.

## 9.9 GLOSSARY

- **MRTP:** Monopolies and Restrictive Trade Practices
- **Licence Raj:** A period restrictions, red-tapism and corruption
- **FIPB:** Foreign Investment Promotion Board

NOTES

## *9.10 KEY TERMS*

- **Foreign Investment:** Investment from foreign corporate, individuals and NRIs
- **Licensing:** Industrial development through regulations and controls
- **EOU:** Export Oriented Units
- **TDC:** Technology Development Cell

## *9.11 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. Industrial Licensing act applies to whole of India including ____________.
2. Government continues to provide ____________ to small scale sector.
3. The control on public sector was through ____________ Act.

### (B) True or False

1. NRI holding up to 100% was permitted in all sectors.
2. The industries of different categories were held in water tight compartments.
3. The basis of national economic policy recognised mixed economy.

## *9.12 KEY TO CHECK YOUR ANSWER*

(a) 1. Jammu and Kashmir, 2. protection, 3. M.R.T.P.

(b) 1. False, 2. False, 3. True.

## *9.13 TERMINAL AND MODEL QUESTIONS*

1. Explain the salient features of Industrial policy 1977.
2. Discuss the Industrial policy statement 1991.

3. Explain the role of private sector.
4. Discuss the merits and demerits of licensing.

NOTES

## *9.14 REFERENCE BOOKS*

1. Sen Gupta A. K.: Government & Business, 'Vikas', Delhi.
2. Mankar V. G.: Business Economics, 'Macmillan', Delhi.

MS 105

# Business Environment

**Volume II**

**Block III Industrial Financial Institutions**

**Block IV Foreign Polices and Globalisation**

## UTTARAKHAND OPEN UNIVERSITY

**SCHOOL OF MANAGEMENT STUDIES AND COMMERCE**

University Road, Teenpani By pass, Behind Transport Nagar, Haldwani- 263 139

Phone No: (05946)-261122, 261123, 286055

Toll Free No.: 1800 180 4025

Fax No.: (05946)-264232, e-mail: info@uou.ac.in, som@uou.ac.in

http://www.uou.ac.in

www.blogsomcuou.wordpress.com

## Board of Studies

**Professor Nageshwar Rao**
**Vice-Chacellor,**
Uttarakhand Open University
Haldwani

**Professor R.C. Mishra**
**Director**,
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani

***Professor Neeti Agarwal***
Department of Management Studies
IGNOU, New Delhi

***Dr.L.K. Singh***
Depatment of Management Studies,
Kumaun University, Bhimtal

***Dr. Abhradeep Maiti,***
Indian Institue of Management,
Kashipur

***Dr. K.K. Pandey,***
O.P. Jindal Global University,
Sonipat

***Dr. Manjari Agarwal***
Department of Management Studies
Uttarakhand Open University, Haldwani

***Dr. Gagan Singh***
Department of Commerce
Uttarakhand Open University, Haldwani

***Dr. Sumit Prasad***
**Assistant Professor,**
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani

**Programme Coordinator**

***Dr. Manjari Agarwal***
Assistant Professor, Department of Management Studies
Uttarakhand Open University, Haldwani

| **Units Written by** | **Unit No.** |
| --- | --- |

**Dr. Sunil Purohit**
M.Sc., LL.M., MBA, Ph.D., FICCE
**Adv. Sandhya Purohit**
M.A. (Economics), LL.B.

**Editor**

***Er. Sumit Prasad***
Assistant Professor,
School of Management Studies and Commerce,
Uttarakhand Open University, Haldwani

| | |
| --- | --- |
| **ISBN** | **: 978-93-85740-11-4** |
| **Copyright** | **: Uttarakhand Open University** |
| **Edition** | **: 2016 (Restricted Circulation)** |
| **Published by** | **: Uttarakhand Open University, Haldwani, Nainital – 263 139** |
| **Printed at** | **: Himalaya Publishing House Pvt. Ltd** |

# SYLLABUS

**Course Name: Business Environment**

**Course Code: MS 105**

**Course Credits: 6**

**Course Objective:**

This course aims at providing students the knowledge of basic framework and intricacies of Indian and International business environment.

## Block I Macro Economic Concepts and Macro Environment

| | |
|---|---|
| Unit I | Contemporary Global and Indian Environment |
| Unit II | Consumerism and Business |
| Unit III | Macro Economic Environment and Modern Theories of Economic Growth |
| Unit IV | Aggregate Demand and Supply |
| Unit V | Inflation |
| Unit VI | Unemployment |

## Block II Economic Reforms and Industrial Policy

| | |
|---|---|
| Unit VII | Economic Reforms in India |
| Unit VIII | Economic Planning in India and New Economic Policy |
| Unit IX | Industrial Policy and Industry Licensing |

## Block III Industrial Financial Institutions

| | |
|---|---|
| Unit X | Public Sector Enterprises and Small and Medium Enterprises |
| Unit XI | Industrial Financial Institutions: IDBI, IFCI, ICICI, IRBI, SFC |
| Unit XII | Institutions for Investments and Small Industry: UTI, LIC, GIC, SSIDC, SIDBI and Commercial Banks |

## Block IV Foreign Polices and Globalisation

| | |
|---|---|
| Unit XIII | Foreign Trade: Theories, Issues and Modern Context |
| Unit XIV | FDI and FII |
| Unit XV | Foreign Exchange Rates and Foreign Exchange Markets |
| Unit XVI | Globalisation, Liberalisation and Privatisation |
| Unit XVII | Regional Trading Blocks |
| Unit XVIII | World Trade and Emerging Environment |

# CONTENTS


| | Block III: Industrial Financial Institutions | |
|---|---|---|
| **10.** | **Public Sector Enterprises and Small and Medium Enterprises** | **154 – 168** |
| | 10.1 Introduction<br>10.2 Forms of Organisation of Public Enterprises<br>10.3 Importance of Public Sector Enterprises<br>10.4 Small Scale and Medium Enterprises<br>10.5 Summary of the Unit<br>10.6 Glossary<br>10.7 Key Terms<br>10.8 Check Your Progress (Multiple Choice/Objective Type Questions)<br>10.9 Key to Check Your Answer<br>10.10 Terminal and Model Questions<br>10.11 Reference Books | |
| **11.** | **Industrial Financial Institutions: IDBI, IFCI, ICICI, IRBI, SFC** | **169 – 176** |
| | 11.1 Introduction<br>11.2 Objectives and Functions of Industrial Finance Corporations of India (I.F.C.I.)<br>11.3 State Financial Corporations (SFCs)<br>11.4 Summary of the Unit<br>11.5 Glossary<br>11.6 Key Terms<br>11.7 Check Your Progress (Multiple Choice/Objective Type Questions)<br>11.8 Key to Check Your Answer<br>11.9 Terminal and Model Questions<br>11.10 Reference Books | |
| **12.** | **Institutions for Investments and Small Industry: UTI, LIC, GIC, SSIDC, SIDBI and Commercial Banks** | **177 – 228** |
| | 12.1 Introduction<br>12.2 Role for Funding Enterprises<br>12.3 Development Function<br>12.4 Industrial Finance Corporation of India (IFCI)<br>12.5 The Industrial Development Bank of India (IDBI)<br>12.6 Finance for Industry<br>12.7 The National Bank for Agriculture and Rural Development: (NABARD)<br>12.8 The Small Industries Development Bank of India (SIDBI)<br>12.9 Investment Trusts<br>12.10 Unit Trust of India (U.T.I)<br>12.11 Nature of the Trust: Unit Trust of India: UTI<br>12.12 Industrial Credit and Investment Corporation of India (ICICI)<br>12.13 Life Insurance Corporation of India (LIC)<br>12.14 General Insurance Corporation of India (GIC) | |

| | | |
|---|---|---|
| | 12.15 Export-Import Bank of India — EXIM<br>12.16 Khadi and Village Industries Commission (KVIC)<br>12.17 National Small Industries Corporation Ltd. (NSIC)<br>12.18 State Industrial Development Corporations (SIDCs)<br>12.19 State Small Industries Development Corporations (SSIDCs)<br>12.20 State Financial Corporations (SFCs)<br>12.21 Commercial Banks<br>12.22 Indian Financial System: An overview (RBI)<br>12.23 Structure<br>12.24 Industry assistance<br>12.25 Non-banking Financial Institution<br>12.26 Summary of the Unit<br>12.27 Glossary<br>12.28 Key Terms<br>12.29 Check Your Progress (Multiple Choice/Objective Type Questions)<br>12.30 Key to Check Your Answer<br>12.31 Terminal and Model Questions<br>12.32 Reference Books | |
| | **Block IV Foreign Policies and Globalization** | |
| **13.** | **Foreign Trade: Theories, Issues and Modern Context** | **229 – 254** |
| | 13.1 Introduction<br>13.2 India's Foreign Trade: Trends<br>13.3 India's Foreign Trade: Composition<br>13.4 India's Foreign Trade: Direction<br>13.5 Theory of International Trade<br>13.6 Some Implications of Traditional Trade Theory<br>13.7 Confrontation with Reality<br>13.8 Scale Economies<br>13.9 Product Differentiation<br>13.10 Oligopoly<br>13.11 Summary of the Unit<br>13.12 Glossary<br>13.13 Key Terms<br>13.14 Check Your Progress (Multiple Choice/Objective Type Questions)<br>13.15 Key to Check Your Answer<br>13.16 Terminal and Model Questions<br>13.17 Reference Books | |
| **14.** | **Foreign Direct Investment and Foreign Institutional Investors** | **255 – 273** |
| | 14.1 FDI – Introduction<br>14.2 Foreign Direct Investment (FDI) in Multi-brand Retail Sector<br>14.3 Foreign Direct Investment<br>14.4 FDI Policy<br>14.5 Industrial Credit<br>14.6 Industrial Relations | |

| | | |
|---|---|---|
| | 14.7 The Securities and Exchange Board of India Act of 1992<br>14.8 Foreign Institutional Investors (FII)<br>14.9 Summary of the Unit<br>14.10 Glossary<br>14.11 Key Terms<br>14.12 Check Your Progress (Multiple Choice/Objective Type Questions)<br>14.13 Key to Check Your Answer<br>14.14 Terminal and Model Questions<br>14.15 Reference Books | |
| **15.** | **Foreign Exchange Rates and Foreign Exchange Markets** | **274 – 285** |
| | 15.1 Introduction<br>15.2 Foreign Exchange Markets in India – a Brief Background<br>15.3 Features of the Forward Premium on the Indian Rupee<br>15.4 Intervention in Foreign Exchange Markets<br>15.5 The Foreign Exchange Market<br>15.6 The Market for Foreign Exchange<br>15.7 The Demand for Currency<br>15.8 The Supply of Currency<br>15.9 Exchange Rates<br>15.10 Changes in Exchange Rates<br>15.11 Exchange Rates and Interest Rates<br>15.12 Summary of the Unit<br>15.13 Glossary<br>15.14 Key Terms<br>15.15 Check Your Progress (Multiple Choice/Objective Type Questions)<br>15.16 Key to Check Your Answer<br>15.17 Terminal and Model Questions<br>15.18 Reference Books | |
| **16.** | **Globalisation Liberalisation and Privatisation** | **286 – 296** |
| | 16.1 Introduction to Economics Policy – Reforms<br>16.2 Globalisation<br>16.3 Liberalisation<br>16.4 Privatisation<br>16.5 Conclusion<br>16.6 Summary of the Unit<br>16.7 Glossary<br>16.8 Key Terms<br>16.9 Check Your Progress (Multiple Choice/Objective Type Questions)<br>16.10 Key to Check Your Answer<br>16.11 Terminal and Model Questions<br>16.12 Reference Books | |
| **17.** | **Regional Trading Blocks** | **297 – 305** |
| | 17.1 Introduction<br>17.2 Regional Trade Blocks | |

| | | |
|---|---|---|
| | 17.3 Trading Blocks<br>17.4 The Main Advantages for Members of Trading Blocks<br>17.5 The Main Disadvantages of Trading Blocks<br>17.6 Development<br>17.7 Summary of the Unit<br>17.8 Glossary<br>17.9 Key Terms<br>17.10 Check Your Progress (Multiple Choice/Objective Type Questions)<br>17.11 Key to Check Your Answer<br>17.12 Terminal and Model Questions<br>17.13 Reference Books | |
| **18.** | **World Trade and Emerging Environment** | **306 – 316** |
| | 18.1 Introduction<br>18.2 Foreign Trade Policy of India<br>18.3 Salient Features of EXIM Policy<br>18.4 Emerging Environment<br>18.5 Foreign Exchange Reserves (QR – Quantitative Restrictions)<br>18.6 Phased Removal of QRs<br>18.7 Removal of QRs: Implications<br>18.8 Special Provisions of WTO Agreement<br>18.9 Conclusion<br>18.10 Summary of the Unit<br>18.11 Glossary<br>18.12 Key Terms<br>18.13 Check Your Progress (Multiple Choice/Objective Type Questions)<br>18.14 Key to Check Your Answer<br>18.15 Terminal and Model Questions<br>18.16 Reference Books | |

# UNIT 10 PUBLIC SECTOR ENTERPRISES AND SMALL AND MEDIUM ENTERPRISES

**Structure:**

10.1 Introduction

10.2 Forms of Organisation of Public Enterprises

10.3 Importance of Public Sector Enterprises

10.4 Small Scale and Medium Enterprises

10.5 Summary of the Unit

10.6 Glossary

10.7 Key Terms

10.8 Check Your Progress (Multiple Choice/Objective Type Questions)

10.9 Key to Check Your Answer

10.10 Terminal and Model Questions

10.11 Reference Books

**Objectives**

After reading this Unit, you will be able to:

- Understand the basic character of Public Sector.
- Know the aim of the industrial policy to protect public interest.
- Know the importance of statutory corporation such as LIC, UTI, IFC *etc*.

## *10.1 INTRODUCTION*

In the past business activities were in the hands of individual and private organisations. Government held important services *e.g.* railways, electricity, postal, *etc*. Slowly the Government went into direct

NOTES

participation in business and set up private enterprise. The regulation of the private enterprises, was with the Government. The public sector was to protect public interest. The concept of small scale industry was a result of the Industrial Policy Resolution 1956.

Traditionally, business activities were left mainly to individual and private organisations, and the government was taking care of only the essential services such as railways, electricity supply, postal services *etc*. But, it was observed that private sector did not take interest in areas where the gestation period was long, investment was heavy and the profit margin was low; such as machine building, infrastructure, oil exploration, *etc*. Not only that, industries were also concentrated in some regions that had certain natural advantages like availability of raw materials, skilled labour, nearness to market. This led to regional imbalances. Hence, the government while regulating the business activities of private enterprises went in for direct participation in business and set up public enterprises in areas like coal industry, oil industry, machine building, steel manufacturing, finance and banking, insurance *etc*. These units are not only owned by central, state or local government but also managed and controlled by them and are termed as Public Sector Enterprises.

## Meaning

Thus, the business units owned, managed and controlled by the central, state or local government are termed, as public sector enterprises or public enterprises. These are also known as public sector undertakings.

A pubic sector enterprise may be defined as any commercial or industrial undertaking owned and managed by the government with a view to maximise social welfare and uphold the public interest.

Public enterprises consist of nationalised private sector enterprises, such as, banks, Life Insurance Corporation of India and the new enterprises set up by the government such as Hindustan Machine Tools (HMT), Gas Authority of India (GAIL), State Trading Corporation (STC) *etc*.

## Basic Characteristics

Looking at the nature of the public enterprises their basic characteristics can be summarised as follows:

- **Government Ownership and Management:** The public enterprises are owned and managed by the central or state government, or by the local authority. The government may

NOTES

either wholly own the public enterprises or the ownership may partly be with the government and partly with the private industrialists and the public. In any case the control, management and ownership remains primarily with the government. For example, National Thermal Power Corporation (NTPC) is an industrial organisation established by the Central Government and part of its share capital is provided by the public. So is the case with Oil and Natural Gas Corporation Ltd. (ONGC).

- **Financed from Government Funds:** The public enterprises get their capital from Government Funds and the government has to make provision for their capital in its budget.
- **Public Welfare:** Public enterprises are not guided by profit motive. Their major focus is on providing the service or commodity at reasonable prices. Take the case of Indian Oil Corporation or Gas Authority of India Limited (GAIL). They provide petroleum and gas at subsidised prices to the public.
- **Public Utility Services:** Public sector enterprises concentrate on providing public utility services like transport, electricity, telecommunication *etc*.
- **Public Accountability:** Public enterprises are governed by public policies formulated by the government and are accountable to the legislature.
- **Excessive Formalities:** The government rules and regulations force the public enterprises to observe excessive formalities in their operations. This makes the task of management very sensitive and cumbersome.

## Objectives

The public sector refers to economic and social activities undertaken by public authorities. The enterprises in public sector are set up with the main aim of protecting public interest. Profit earning comes next.

Besides the difference in the objective, the enterprises in both these sectors also differ in many other aspects, This section let us know The differences between the enterprises of public sector and private sector.

NOTES

| Basis of Difference | Private Sector Enterprises | Public Sector Enterprises |
|---|---|---|
| • Ownership | Owned by individuals. | Ensures balanced Government Management. |
| • Management | Managed by owner and professional managers. | Owned by Government. Managed by Government. |
| • Capital | Raised by owners' sources and public issues. | Raised from Government funds and sometimes through public issues. |
| • Area of Operation | Operates in all areas with adequate return on investment. | Operates in basic and public utility sectors. |
| • Objective | Maximum profit | Development |

## *10.2 FORMS OF ORGANISATION OF PUBLIC ENTERPRISES*

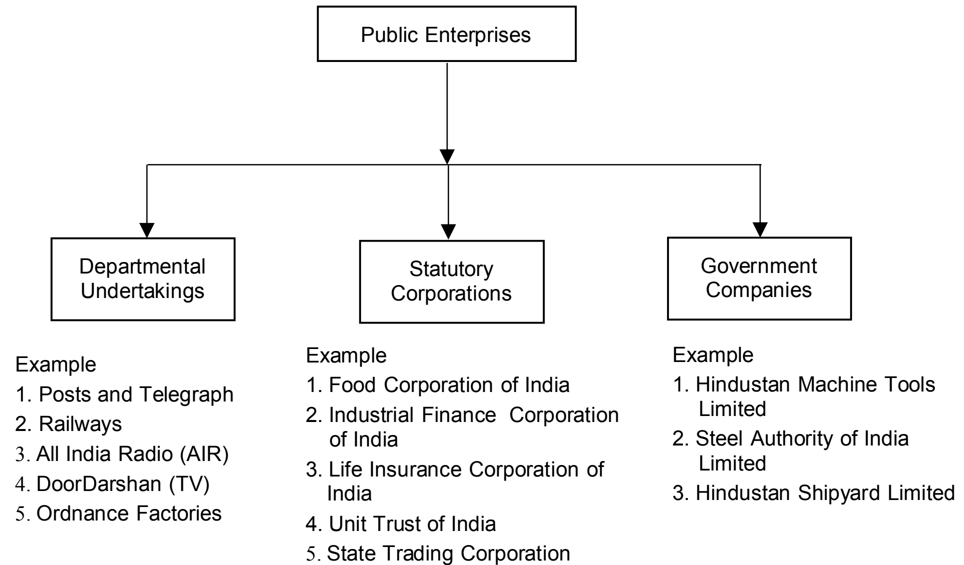
There are three different forms of organisations used for the public sector enterprises in India. These are (1) Departmental Undertaking; (2) Statutory (or Public) Corporation, and (3) Government Company.

**Departmental Undertaking** form of organisation is primarily used for provision of essential services such as railways, postal services, broadcasting *etc*. Such organisations function under the overall control of ministry of the Government and are financed and controlled in the same way as any other government department. This form is considered suitable for activities where the government desires to have control over them in view of the public interest.

**Statutory Corporation** (or public corporation) refers to a corporate body created by the Parliament or State Legislature by a special Act which define its powers, functions and pattern of management. Statutory corporation is also known as public corporation. Its capital is wholly provided by the government. Examples of such organisations are Life Insurance Corporation of India, State Trading Corporation *etc*.

**Government Company** refers to the company in which 51% or more of the paid-up capital is held by the government. It is registered under the Companies Act and is fully governed by the provisions of the Act. Most business units owned and managed by government fall in this category.

NOTES




Departmental undertakings are the oldest among the public enterprises. A departmental undertaking is organised, managed and financed by the Government. It is controlled by a specific department of the government. Each such department is headed by a minister. All policy matters and other important decisions are taken by the controlling ministry. The Parliament lays down the general policy for such undertakings.

## Features of Departmental Undertakings

The main features of departmental undertakings are as follows:

- It is established by the government and its overall control rests with the minister.
- It is a part of the government and is managed like any other government department.
- It is financed through government funds.
- It is subjected to budgetary, accounting and audit control.
- Its policy is laid down by the government and it is accountable to the legislature.

## Merits of Departmental Undertakings

The following are the merits of departmental undertakings:

- **Fulfilment of Social Objectives:** The government has total control over these undertakings. As such it can fulfil its social and economic objectives. For example, opening of post offices in far

NOTES

off places, broadcasting and telecasting programmes, which may lead to the social, economic and intellectual development of the people are the social objectives that the departmental undertakings try to fulfil.

- **Responsible to Legislature:** Questions may be asked about the working of departmental undertaking in the parliament and the concerned minister has to satisfy the public with his replies. As such they cannot take any step, which may harm the interest of any particular group of public. These undertakings are responsible to the public through the parliament.
- **Control Over Economic Activities:** It helps the government to exercise control over the specialised economic activities and can act as instrument of making social and economic policy.
- **Contribution to Government Revenue:** The surplus, if any, of the departmental undertakings belong to the government. This leads to increase in government income. Similarly, if there is deficiency, it is to be met by the government.
- **Little Scope for Misuse of Funds:** Since such undertakings are subject to budgetary accounting and audit control, the possibilities of misuse of their funds is considerably reduced.

## *10.3 IMPORTANCE OF PUBLIC SECTOR ENTERPRISES*

All enterprises in our country are not public enterprises. There is mixed economy in our country and the private as well as the public sector contribute to the development of our economy. However, there are only some selected areas in which the government establishes its enterprises for a balanced development of the economy and promote public welfare. There are several areas where huge investment of capital is necessary but the margin of profit is either small or it can be obtained only after a long period as in case of generation and supply of electricity, machine building, construction of dams, *etc*. The private businessmen hesitate to establish their enterprises in these areas but they cannot be neglected in public interest. As such these enterprises are established and run by the government. Similarly the public enterprises also help in balanced regional development by promoting industries in every part of the country. For

NOTES

example, with the establishment of Bhilai Steel Plant in Madhya Pradesh, several new small industries have come up in that state.

Industrial progress is of utmost importance for the development of the country and for this, it is necessary that some basic industries like oil, coal, gas, iron, steel, production of heavy electrical goods, *etc*., are to be fully developed. Public enterprises give impetus to the development of these basic industries and also help in the development of the private sector with their products and services. There are some industries which require heavy capital investment on account of technical reasons. Electricity, power, production of gas, heavy machinery tools, production of telephone *etc*., are such industries.

The development of public enterprises also prevents concentration of economic power in the hands of an Individual.

## Overview of Performance and Policy

The public sector has been central to India's Industrialisation within the mixed framework. The Industrial policy Resolution, 1956 accorded a strategic role to public enterprises. Accordingly, areas of strategic importance and core sectors were exclusively reserved for public sector enterprises. Public enterprises were accorded preference even in areas where private investments were possible. Public enterprises grew dominantly in terms of units and investment, both at the Central and state levels. In 1992, number of Central Public Enterprises stood at 237 with an investment of ₹ 1,47,000 crores.

However, the performance of public sector enterprises has been far from satisfactory. Its protected growth over a period of time, has resulted in many shortcomings:

- insufficient growth in productivity
- poor project management
- inadequate attention to research and development
- low rate of return on investment

As a result, many public enterprises became a burden rather than an asset. Nationalised sick units accounted for one-third of the public enterprises. A number of public enterprises had come up in non-strategic, non-core, consumer goods and service sectors. By 1993, only about 60% of the total investment in public enterprises was in areas originally envisaged as the "commanding heights". All these necessitated a change in approach. IP,

NOTES

1991, emphasised that the public enterprises must be growth oriented and technologically dynamic. Therefore, IP 1991 set the future priorities for public enterprises as follows:

- essential infrastructural goods and services for exploration and exploitation of oil and minerals.
- manufacturing of goods of strategic importance such as defence equipments *etc*.
- development of technology and manufacturing capabilities in crucial areas for long-term economic development.

Thus, public sector would be confined to strategic, high tech industries and essential infrastructure. Chronically sick and unviable public sector units would be referred to Board for Industrial and Financial Reconstruction (BIFR).Workers of such units would be protected. In February, 1992, the government established a Non-statutory National Renewal Fund (NRF) to provide assistance to cover the cost of retraining and redeployment of labour and also provide compensation to labour affected by the closure of unviable public sector units, *etc*.

Government's share holding in public enterprises would be brought down. The shares would be offered to mutual funds, financial institutions, workers and the public to raise resources and to encourage wider public participation.

As a part of the measures to improve the performance of public enterprises, more and more of public sector units would be brought under the purview of Memorandum of Understanding (MoU) system. A memorandum of understanding is a performance contract, a freely negotiated document between the Government and a specific public enterprise. MoU aims at moving management of public enterprises from management by controls and procedures to management by result and objectives. MoU was started in 1987-88 with 4 public enterprises. As of now, more than 100 central public enterprises are covered by MoU system, accounting for more than 90% of the total public sector turnover. In 1995-96, financial performance was accorded 60% weightage in MoUs.

Many areas previously reserved for the public sector have been opened up to the private sector. Although its share has declined in the past ten years, the public sector still accounts for 25% of India's GDP, 31% of capital investment and 17% of the final consumption expenditure in the country. At the start of the reforms 18 important industries, including iron and steel,

NOTES

heavy plant and machinery, telecommunications and telecom equipment, mineral oils, mining of various ores, air transport services, and electricity generation and distribution, were reserved for the public sector. This list has been reduced to 6, covering industries on arms and ammunition, atomic energy, mineral oils, atomic minerals, hazardous chemicals and industrial explosives, and railway transport. Because of this liberalisation, private investment including foreign investment has flown into areas such as steel, telephone services, electricity generation, petroleum exploration development and refining, coal mining and air transport, none of which would have been possible earlier because of public sector reservation. Part of the government equity in selected public sector enterprises is being disinvested. While such disinvestment helps reduce the fiscal deficit, it does not indicate a change in management as government intends to remain a majority stakeholder in public sector enterprises.

Public sector reforms have done little in the cases of units that have been loss making. These units have been making losses for a very long period of time and are very unlikely candidates for revival. The successive governments have ruled out closure of these units and decided instead that the scope for reviving each unit would be carefully examined and only those units where revival was found to be economically feasible would be revived while others would be closed down. Many sick public sector units have been referred to the Board for Industrial and Financial Reconstruction (BIFR) for rehabilitation or, where necessary, for winding up. The latter option has been rarely exercised. The public sector is still hamstrung by excessive government and bureaucratic controls. The option of privatisation has not yet been seriously considered. Several public sector units have been identified as fit for closure through this process, and subsequently the government has even decided on closure in many cases, but no unit has been actually closed because the decision has been challenged in the courts by labour unions.

An important area where domestic liberalisation has made some progress is the policy of reserving certain items for production in the small-scale sector. The policy that used to “protect” small-scale units by barring the entry of larger units into reserved areas, also in a way preventing existing small-scale units from expanding beyond a maximum permissible value of investment in plant and equipment, has been modified to reduce the area of protection by two measures: by redefining small-scale in sectors like apparels, garment manufacturing *etc*., and by withdrawing reservation to a

NOTES

few. As of June 2002, the number of such reserved items for this sector stood at 749.

The present regulations for retrenchment of surplus labour are far too rigid.

While the government has made some progress on this front by proposing to allow companies with no more than 1000 employees to retrench labour without prior permission of the government, but this amendment to the Industrial Disputes Act (IDA), 1947, is yet to get Parliamentary approval. Similarly, industrial units require government permission before they can close down and such permission is rarely secured. There has been no progress whatsoever on putting in place an exit policy for firms. In this context, it is noteworthy that while the industrial policy reforms in India have removed virtually all the entry barriers that had existed prior to 1991, however, not allowing firms to exit, if their business conditions so demand, is an entry barrier in itself.

## Objectives of MRTP Act

- Prevention of concentration of economic power and control of monopolies.
- Prohibition of monopolistic, restrictive and unfair trade practices.

The thrust of Industrial policy, 1991 is more on controlling unfair or restrictive business practices. The provisions relating to merger, amalgamation and takeover have been repealed. Threshold limits of assets on private sector companies have been removed.

Accordingly MRTP Act has been restructured and pre-entry restrictions have been removed with respect to new undertaking, expansion and amalgamation, merger, takeover registration *etc*. under sections 20-26 of part A of chapter III of the act.

Under section III of the act 1969 the act shall now apply to all undertakings and financial institutions, both public and private. However, units, which are owned by or controlled by a Government company or Government engaged in the production of arms, ammunition, atomic energy, minerals, *etc*. are exempted.

The basic objective is to curb and regulate monopolistic, restrictive and unfair trade practices, which are prejudicial to public interest.

To summarise, though Industrial policy 1991, renewed its commitment to the basic objectives of IPR 1956, the policy brought out substantial changes on the industrial policy framework. The regulatory and controlling

NOTES

mechanism has been largely diluted towards creating a competitive environment in domestic industry. Protective barriers have been removed and industry has been exposed to competition, both internal and external. Industrial delicensing liberal foreign investment policy, removal of threshold limits on the assets of dominant firms, drastic reduction on the number of industries reserved for public sector, steps towards granting more autonomy to the public enterprises, measure to reduce the Government share holding in public enterprises *etc*. formed the significant features of industrial policy, 1991. These marked a clear deviation from the path adopted in the earlier decades of Industrialisation. The IP 1991 recognised the growth of private sector in terms of size, resources and ability to play a more significant role in industrialisation; the vital role of foreign investment and technology in supplementing India's ingestible resources and overcoming technology deficiencies; and the importance of public sector restructuring and functioning on commercial lines to generate resources.

Accordingly, vast areas of economic activities have been thrown open to private sector investments, both domestic and foreign and steps have been initiated to confine the role of public sector and strategic areas and to improve its financial performance.

In recent decades, the focus of industrial policy has increasingly emphasised the importance of competition as a tool for disciplining firms, and fostering allocative efficiency. However, in many industries, there are innate problems.

## *10.4 SMALL SCALE AND MEDIUM ENTERPRISES*

### Small Scale Industries (SSI)

The concept of Small Scale Industries (SSIs) was brought to fore by the Industrial Policy Resolution, 1956. The various arguments that were put forward for the SSIs were as follows:

1. **More Employment per Unit of Capital:** The emergence of SSI was propagated through the principle of self-employment. Small enterprises are labour-intensive and thus create more employment per unit of capital. Even as SSIs have low output employment ratio than the large sector, its employment generation capacity has been found to be 8 times that of the large sector.

NOTES

It is not only the employment but also the productivity per unit of capital in SSIs which have been found to be higher than that of large sector.

2. **Ensures More Equitable Distribution of Wealth:** Also, it was found that income generated by SSIs are more widely dispersed in the community than the income generated in a few large enterprises.

3. **Regional Dispersal of Industries:** Large enterprises are normally concentrated in the metropolitan cities. However, the industrialisation of a country can be completed only if it permeates into the remote areas of the country. Hence, the development of SSIs has been given major thrust in all the industrial policies.

   Various industries such as watches, food processing, animal feeds and textiles were reserved under the SSIs. The contribution of these industries to total SSIs output can be seen from Table 10.1 below.

   Over the years, significant support was given to the SSI sector and village industries in the five years plans.

*Table 10.1: Allocation of Resources for SSI Sector Under Plan Periods*

| Plan | Allotment |
|---|---|
| First Plan | ₹ 42 crores allotted to SSI and village industry |
| Second Plan | ₹ 187 crores allotted to SSI and village industry |
| Third Plan | ₹ 241 crores were spent on the SSIs |
| **Annual Plans (1966-69)** | |
| Fourth Plan | ₹ 251 crores allocated |
| Fifth Plan | ₹ 388 crores allocated |
| Sixth plan | ₹ 1952 crores allocated |
| Seventh plan | Increase in production with very high annual average growth rate achieved |
| Eighth Plan | Provided growth impetus in infrastructure facilities, financial support measures, *etc*. |

***Source:*** Ministry of Small Scale Industries document, Government of India.

NOTES

*Statistics on Small Scale Industries in India*

| Characteristics | ASI | Third sensus of Small Scale Industries (2001-2002) |
|---|---|---|
| No. of Units as per ASI 2001-02 | 128866 | 5897321 |
| Employment as per ASI 2001-02 | 7915960 | 16710510 |
| Output ( ₹ Lakhs) as per ASI 2001-02 | 94076302 | 7901536 |
| Fixed Capital (₹ Lakhs) as per ASI 2000-01 | 39960422 | 6255660 |
| Per Unit Employment | 61 | 3 |
| Per Unit Output (₹ Lakhs) | 730 | 422 |
| Per Unit Investment (₹ Lakhs) as per ASI 2000-01 | 304 | 2.04 |
| Employment per ₹ One Lakh Investment as per ASI 2000-01 | 0.2 | 1.39 |
| Output per Employee as per ASI 2001-02 | 11.88 | 1.49 |
| Investment to Output as per ASI 2000-01 | 0.43 | 0.48 |

Annual Survey of Industries.

***Source:*** **Final Results:** Third All India Census of Small Scale Industries, 2001-2002, Ministry of Small Scale Industries, Govt, of India.

*Comparison of Small Scale Industries Sector with Organised Sector in India (2001-2002)*

| Percentage Distribution of Gross Output by Industry (Registered SSI Sector) in India (2001-2002) | |
|---|---|
| **Description** | **Percentage of Gross Output** |
| Manufacture of Grain Mill Products, Starches and Starch Products, and Prepared Animal Feeds | 13.64 |
| Manufacture of Other Chemical Products | 6.32 |
| Manufacture of Basic Iron & Steel | 6.15 |
| Production, Processing and Preservation of Meat, Fish, Fruits, Vegetables, | 5.98 |
| Manufacture of Other Fabricated Metal Products | 5.36 |
| Metal Working Service Activities | 5.00 |
| Manufacture of Plastic Products | 4.63 |
| Manufacture of Wearing Apparel, Except fur Apparel (Includes Tailoring) | 3.31 |

NOTES

| Manufacture of Structural Metal Products, Tanks, Reservoirs and Steam | 2.99 |
|---|---|
| Manufacture of Non-metallic Mineral Products n.e.c. | 2.9 |
| Spinning, wearing and finishing of textiles | 2.67 |
| Others | 46.05 |
| Total | 100 |

***Source:*** Handbook of Statistics on Indian Economy, RBI, 2003.

SSIs have been handicapped due to an inequitable allocation of scarce raw materials and imported components, lack of provision of credit at low interest rate, low technical skill and managerial ability and lack of marketing contracts. This resulted in sickness of SSIs.

## *10.5 SUMMARY OF THE UNIT*

The Indian industries had potential to meet production targets but it required protection from government. Both private and public sectors were encouraged by the government by providing facilities.

## *10.6 GLOSSARY*

- **Public welfare**: Public enterprises not guided by profit motive e.g. GAIL.
- **Public utility services:** Transport, electricity, telecommu-nications

## *10.7 KEY TERMS*

- **Private sector:** Entrepreneurs who are invited to invest in basic industries.
- **Infrastructure:** The basic requirements to conduct business i.e. Power, water, technology and transport.
- **Industrialisation:** From traditional way to technological way of production.

NOTES

## *10.8 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. Departure from agriculture makes Indian economy ____________.
2. About ____________ % of population in India depends on agriculture.
3. Small enterprises are ____________ intensive, therefore creates more jobs.

### (B) True or False

1. India ranks No.1 in terms of advances in science and technology.
2. The private sector dominates in industries in India.
3. More strikes means better economic status.

## *10.9 KEY TO CHECK YOUR ANSWER*

(A) 1. uastable, 2. 60%, 3. Labour.

(B) 1. False, 2. True, 3. False.

## *10.10 TERMINAL AND MODEL QUESTIONS*

1. Write short notes on:
   (a) Industrial sickness
   (b) Industry empowerment
   (c) Role of small sector in employment
2. What do you understand by industrialisation? Explain.

## *10.11 REFERENCE BOOKS*

1. Justin Paul: 'Foreign Direct Investment, 'Udyog Pragati', Delhi.
2. Pramod Verma – 'Competitiveness of Indian Industries', 'Wisdom', Delhi.

# UNIT 11 INDUSTRIAL FINANCIAL INSTITUTIONS: IDBI, IFCI, ICICI, IRBI, SFC

**Structure:**


11.1 Introduction

11.2 Objectives and Functions of Industrial Finance Corporations of India (I.F.C.I.)

11.3 State Financial Corporations (SFCs)

11.4 Summary of the Unit

11.5 Glossary

11.6 Key Terms

11.7 Check Your Progress (Multiple Choice/Objective Type Questions)

11.8 Key to Check Your Answer

11.9 Terminal and Model Questions

11.10 Reference Books


## Objectives

After reading this Unit, you will be able to:

- Understand difficulties faced by Industrial sector.
- Explain that the gap between demand and supply for finance was filled by these institutions.

## *11.1 INTRODUCTION*

SFIs – i.e. Specialised Financial Institutions were set up by Government mainly to provide medium and long term financial assistance to industries. These are called development banks – These Institutions raise funds from Capital Markets.

SFIs are institutions set up mainly by the government for providing medium and long-term financial assistance to industry. As these

NOTES

institutions provide developmental finance, that is, finance for investment in fixed assets, they are also known as 'development banks' or 'development financial institutions'. These institutions receive funds for their financing operations primarily from the government or other public institutions. These institutions also raise funds from the capital market.

## Objectives

The need for establishing SFIs arose mainly because of the following reasons:

1. It was difficult for industry in general to procure sufficient long-term funds in the capital markets. There were no other institutions to supply long-term finance to industry. Traditionally, only short term finance could be availed from commercial banks. SFIs were established to ensure that industry get sufficient long-term funds and in the desired sectors in accordance with planned priorities.
2. Certain particular sections of the industry faced greater difficulties than others in procuring long-term finance. These included (a) Small and medium sized concerns, (b) new concerns set up by new entrepreneurial groups, (c) specific industries, such as cotton and jute, which required funds for modernisation, (d) concerns involved in innovation and new technological developments, (e) concerns requiring extraordinarily large amounts of finance with a long gestation period, (f) concerns in backward regions. SFIs were established to meet the long-term financial requirement of such concerns, on economic and social ground.

In general it can be said that the gap between the demand for and supply of industrial finance is sought to be filled through term loans by development financial institutions. Due to this role, they have been called gap-fillers.

## Importance of SFIs

The importance of SFIs may be attributed to the following:

1. They constitute an important source of long-term finance to industry. Over a period of time, there has been a steady growth in the number of industrial units assisted, and in the amount of loan sanctioned and distributed by SFIs.
2. SFIs have played an important role in the development of (a) Small scale industry, and (b) Projects in backward areas.

NOTES

3. They have helped new and small entrepreneurs in setting up industry.
4. Through their operations involving underwriting of and direct subscription to the issue of shares and debentures, they have been important players in the capital market. These operations have a favourable impact on the ability of industrial concerns to raise funds from capital market.
5. These institutions have improved the allocation of funds to industry and thus, have aided in better use of the available resources for the economic development of the country.
6. SFIs have been a source of technical and managerial advice to the industry. They have also helped in identification, evaluation and execution of new investment projects.
7. These institutions have been helpful in the establishment of concerns which require extraordinarily large amounts of finance for their projects with a long gestation period.

## Types of Specialised Financial Institutions

Specialised financial institutions may be divided into the following types:

(a) All India Development Banks

1. Industrial Development Bank of India (IDBI)
2. Small Industries Development Bank of India (SIDBI)
3. Industrial Finance Corporation of India (IFCI)
4. Industrial Credit and Investment Corporation of India (ICICI)
5. National Bank for Agriculture and Rural Development (NABARD)
6. Industrial Investment Bank of India Ltd. (previously, Industrial Reconstruction Bank of India)

(b) State-level Institutions

1. State Financial Corporations (SFCs)
2. State Industrial Development Corporations (SIDC)
3. State Industrial Investment Corporations (SIIC)

NOTES

(c) Investment institutions

1. Unit Trust of India (UTI)
2. Life Insurance Corporation of India (LIC)
3. General Insurance Corporation (GIC)

## *11.2 OBJECTIVES AND FUNCTIONS OF INDUSTRIAL FINANCE CORPORATIONS OF INDIA (I.F.C.I.)*

IFCI was established as a statutory corporation on 1st July 1948 by a special Act of Parliament, IFCI Act, 1948. It was converted into a public limited company on July 1, 1993. Its main object is to provide medium and long term credit to eligible industrial concerns in corporate sectors of the economy, particularly to those industries to which banking facilities are not available.

### Objectives

The primary role of IFCI is to provide 'direct financial assistance' on medium and long term basis to industrial projects in the corporate and co-operative sectors. Over the years, the scope of activities of the corporation has widened. The objectives of the corporation are stated below:

(a) To provide long and medium-term credit to industrial concerns engaged in manufacturing, mining, shipping and electricity generation and distribution.

(b) The period of credit can be as long as 25 years and should not exceed that period;

(c) To grant credit to a single concern up to a maximum amount of rupees one crore. This limit can be exceeded with the permission of the government under certain circumstances;

(d) Guarantee loans and deferred payments;

(e) Underwrite and directly subscribe to shares and debentures issued by companies;

(f) Assist in setting up new projects as well as in modernisation of existing industrial concerns in medium and large scale sector;

(g) Assist projects under co-operatives and in backward areas.

NOTES

### Functions

The main functions of I.F.C.I. are as under:

1. Granting loans and advances for the establishment, expansion, diversification and modernisation of industries in corporate and co-operative sectors.
2. Guaranteeing loans raised by industrial concerns in the capital market, both in rupees and foreign currencies.
3. Subscribing or underwriting the issue of shares and debentures by industries. Such investment can be held up to 7 years.
4. Guaranteeing credit purchase of capital goods, imported as well as purchased within the country.
5. Providing assistance, under the soft loans scheme, to selected industries such as cement, cotton textiles, jute, engineering goods, *etc*.
6. Providing technical, legal, marketing and administrative assistance to any industrial concern for the promotion, management and expansion of the industrial concern.
7. Providing equipment (imported or indigenous) to the existing industrial concerns on lease under its equipment leasing scheme.
8. Procuring and reselling equipment to eligible existing industrial concerns in corporate or co-operative sectors.
9. Rendering merchant banking services to industrial concerns.

In 1995-96, 67% of the total financial assistance distributed by IFCI was in the form of rupee term loans, while foreign currency loans accounted for approximately 17% of total financial assistance. Thus the two types of assistance accounted for a total of 84% of the total financial assistance by IFCI. The remaining 16% of financial assistance, was in the form of underwriting, direct subscription, guarantees and equipment leasing.

## *11.3 STATE FINANCIAL CORPORATIONS (SFCs)*

### Objectives and Functions

IFCI was established to cater to the financial needs of industrial concerns in large scale corporate and co-operative sectors. Small and medium sized enterprises were outside the purview of IFCI. To meet the financial needs

NOTES

of small and medium enterprises, the government of India passed the State Financial Corporation Act in 1951, empowering the State governments to establish development banks for their respective regions. Under the Act, SFCs have been established by State governments to meet the financial requirements of medium and small sized enterprises. There are 18 SFCs at present.

## Objectives

The objectives of state financial corporations are as under:

1. Provide financial assistance to small and medium industrial concerns. These may be from corporate or co-operative sectors as in case of IFCI or may be partnership, individual or joint Hindu Family Business. Under SFCs Act, "industrial concern" means any concern engaged not only in the manufacture, preservation or processing of goods, but also mining, hotel industry, transport undertakings, generation or distribution of electricity, repairs and maintenance of machinery, setting up or development of an industrial area or industrial estate, *etc*.
2. Provide long and medium-term loan repayable ordinarily within a period not exceeding 20 years.
3. Grant financial assistance to any single industrial concern under corporate or co-operative sector with an aggregate upper limit of rupees Sixty lakhs. In any other case (partnership, sole proprietorship or Joint Hindu Family) the upper limit is rupees Thirty lakhs.
4. Provide Financial assistance generally to those industrial concerns whose paid up share capital and free reserves do not exceed ₹ 3 crore.
5. To lay special emphasis on the development of backward areas and small scale industries.

Functions of State Financial Corporation (SFCs)

The functions of SFCs include:

1. Grant of loans and advances to or subscribe to debentures of, industrial concerns repayable within a period not exceeding 20 years, with option of conversion into shares or stock of the industrial concern.

NOTES

2. Guaranteeing loans raised by industrial concerns which are repayable within a period not exceeding 20 years.
3. Guaranteeing deferred payments due from an industrial concern for purchase of capital goods in India.
4. Underwriting of the issue of stock, shares, bonds or debentures by industrial concerns.
5. Subscribing to, or purchasing of, the stock, shares, bonds or debentures of an industrial concern subject to a maximum of 30 per cent of the subscribed capital, or 30 per cent of paid up share capital and free reserve, whichever is less.
6. Act as agent of the Central government, State government, IDBI, IFCI or any other financial institution in the matter of grant of loan or business of IDBI, IFCI or financial institution.
7. Provide assistance for management and expansion
8. Planning and assisting development.

## 11.4 SUMMARY OF THE UNIT

Specialised Financial Institutions (S.F.I) were set up to finance industry. Since the finances were provided for development, they are also called development Banks. They are IDBI, ICICI, IFCI and SFC. They provide finance to industries where banking facilities are not available.

## 11.5 GLOSSARY

- **NTP:** New Trade Policy
- **NDC:** National Development Council

## 11.6 KEY TERMS

- **SFC:** State Financial Corporations.
- **ICICI:** Industrial Credit and Investment Corporation of India.
- **IDBI:** Industrial Development Bank of India.
- **IFCI:** Industrial Finance Corporation of India.

NOTES

## *11.7 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. ________is the apex Bank for financing in agriculture.
2. _______Bank looks after export import trade.
3. ICICI provides loans in rupees and _________currency.

### (B) True or False

1. SFI do not finance small scale industries.
2. SFI acts as agent of Central Government.
3. Credit period given by IFCI cannot be more than 10 years.

## *11.8 KEY TO CHECK YOUR ANSWER*

(a) 1. NABARD, 2. EXIM, 3. Foreign.

(b) 1. False, 2. True, 3. False.

## *11.9 TERMINAL AND MODEL QUESTIONS*

1. Explain the importance of Industrial Financial Institutions.
2. Give the objectives of Financial Corporation of India (FCI).
3. Write short note on various financial institutions.

## *11.10 REFERENCE BOOKS*

1. Gupta S.B.: Monetary Planning, ‘Chand’, Delhi.
2. RBI reports.

# UNIT 12 INSTITUTIONS FOR INVESTMENTS AND SMALL INDUSTRY: UTI, LIC, GIC, SSIDC, SIDBI AND COMMERCIAL BANKS

**Structure:**


12.1 Introduction

12.2 Role for Funding Enterprises

12.3 Development Function

12.4 Industrial Finance Corporation of India (IFCI)

12.5 The Industrial Development Bank of India (IDBI)

12.6 Finance for Industry

12.7 The National Bank for Agriculture and Rural Development: (NABARD)

12.8 The Small Industries Development Bank of India (SIDBI)

12.9 Investment Trusts

12.10 Unit Trust of India (U.T.I)

12.11 Nature of the Trust: Unit Trust of India: UTI

12.12 Industrial Credit and Investment Corporation of India (ICICI)

12.13 Life Insurance Corporation of India (LIC)

12.14 General Insurance Corporation of India (GIC)

12.15 Export-Import Bank of India — EXIM

12.16 Khadi and Village Industries Commission (KVIC)

12.17 National Small Industries Corporation Ltd. (NSIC)

12.18 State Industrial Development Corporations (SIDCs)

12.19 State Small Industries Development Corporations (SSIDCs)

NOTES

12.20 State Financial Corporations (SFCs)

12.21 Commercial Banks

12.22 Indian Financial System: An overview (RBI)

12.23 Structure

12.24 Industry assistance

12.25 Non-banking Financial Institution

12.26 Summary of the Unit

12.27 Glossary

12.28 Key Terms

12.29 Check Your Progress (Multiple Choice/Objective Type Questions)

12.30 Key to Check Your Answer

12.31 Terminal and Model Questions

12.32 Reference Books

## Objectives

- Know about the requirement of the small scale industries for financial support.
- To understand the structure of these institutions.
- To know the objectives for which the institutions provide finance.
- To understand the banking structure in India.
- To understand the differentiation between different types of financial institutions.

## *12.1 INTRODUCTION*

The development, scope of operation of Entrepreneurs in small scale industry has necessitated assistance at different levels. These institutions play a key role in providing finance. There is an institutional framework for funding.

NOTES

## *12.2 ROLE FOR FUNDING ENTERPRISES*

### Introduction

With the quickened pace of economic development under the impetus of the Five-Year Plans, the most striking change in the Indian economy has been the initiation of an industrial revolution and the re-emergence of small-scale industries. Further, during the past decade, there has been a deepening as well as widening of the entrepreneurial structure as well as the small-scale pre-industrial structure. Not only have the established small industries increased their installed capacity and output, but a wide range of new small industries has also come into being. During the last two decades, there is a boom of entrepreneurial activities in the country. Thus, in the field of capital and product goods industries, enterprises manufacturing such items as machine tools, electrical and engineering equipment, chemicals *etc*., which provide the foundation for a self (sustained growth of the economy have been set-up. Amongst the consumer goods industries, small units producing such items as—bicycles, sewing machines, plastic products, *etc*. are forgoing ahead.

These far reaching developments and the scale and scope of operation of entrepreneurs, particularly in small-scale industries, have brought to the importance of provision of administrative and institutional assistance at various levels.

Over the years, financial institutions are playing a key role in providing finance and counselling to the entrepreneurs to start new ventures as well as more diversify and even rehabilitate sick enterprises. In this context, we shall discuss the scale and scope of operation of various development banks (institutions) that have been rendering financial assistance, directly or indirectly, to entrepreneurs and their various ventures.

## *12.3 DEVELOPMENT FUNCTION*

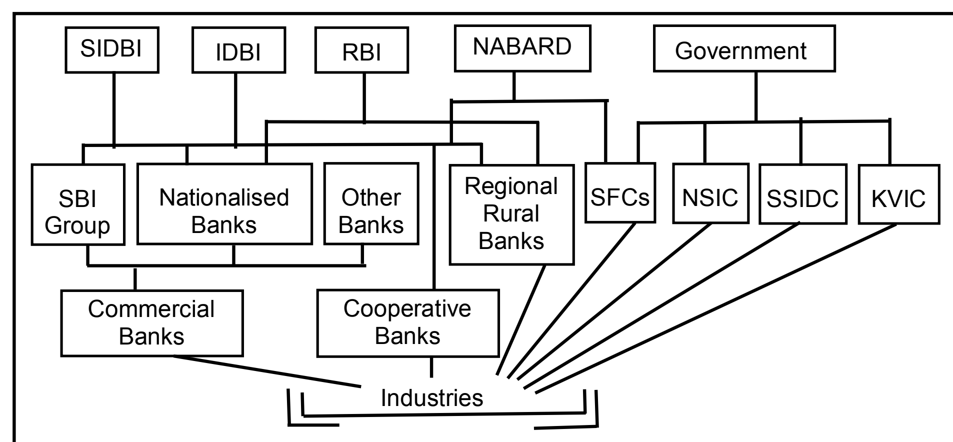
Development being the function of capital, as the tempo of development grows, so does the requirement for capital. The need for capital is continuous and also boundless. However, capitals is not only necessary for development but capital, also generated by development. Economic progress creates its surpluses with which further deployment is achieved, often at an accelerated rate. India's Five-Year Plans are a proof in themselves that substantially larger resources used is each successive plan

NOTES

same from the economic growth resulting from investment in the preceding plans. Only a relatively small part of the resources came from external sources though they were crucial to development. Similarly, in consonance with the development activities in the country, the development banks activities are on higher scale as well as diversified in multi-directional way.

## Institutional Finance

With the launching of the Five Year Plans, in the absence of a sufficiently broad domestic capital market, there was need for adopting and enlarging the institutional structure to meet the medium and long-term credit requirements of the industrial sector. It was in this context that the RBI took the initiative in setting-up statutory corporations at the all-India and' regional levels to function as specialised financial agencies purveying term credit.




## Institutional Framework for Industry

Institutional finance for — large, medium, small and tiny industries by commercial banks — the State Bank of India group, nationalised banks, private sector banks and development corporations which have been especially established to provide industrial finance. In addition, the Reserve Bank of India gives credit guarantees and the ECGC gives export guarantees to the small-scale sector. By its refinance operations, the Industrial Development Bank of India, too, plays a significant role in the promotion of the small scale-sector for it has enabled the SFCs SSIDC/SSIACS and commercial banks to extend a large quantum of financial assistance to this sector. The National Small Industries Corporation offers financial assistance is the form of its hire-purchase schemes.

NOTES

This apart, a host of newly cropped up institutions such as mutual funds, lease companies, financial service institutions, investment companies, merchant banks, asset management companies *etc*. provide financial assistance and financial services to industries. Some of them go to the extent of conceiving a project and see through its progress till the end.

In India, long-term loans are provided for a host of financial institutions of the five all-India develop merits IDBI and SIDBI are apex banks providing refinance facilities to other institutions. Likewise, NABARD is an apex bank for agricultural finance and Exim Bank of export import trade. Then industrial development banks, special institutions, saving and investment institutions, financial service institutions and regulatory institutions. RBI, SEBI, and NSEIL are three regulatory bodies.

In the cumulative sanctions by AFIs up to end-March 1998, IDBI (including resource support to other FIs) claimed the largest share (33.6%), followed by ICICI (25.7%), IFCI (11.1 %), SIDBI (8.2%) and LIC (1.4%). UTI and LIC (including resource support to other FIs) accounted for 11.6% and 4.8% respectively, followed by GIC (1.7%). Of the state-level institutions, SFCs and SIDCs claimed 6.5% and 3.5% respectively.

The area of operation of development almost covers all key sectors of the economy, i.e., agriculture, small industries, rural industries medium and large industries, infrastructure, housing, export and import trade, shipping, ‘capital market stock exchange, saving, investment, insurance, credit guarantee, financial service *etc*. Special institutions have cropped up to foster development a special area of activities. The financial institutions have even setup institution to rehabilitate sick enterprises.

*By and large, a greater slice of domestic savings are mopped up by commercial banks* (₹ 4,75,000 crores), Unit Trusts of India (₹ 65,000 crores), Life Insurance Corporation (₹ 90,000 crores), General Insurance (₹ 20,000 crores), and mutual funds and other financial companies (₹ 1,00,000 crores). Even IDBI, ICICI, SIDBI have commenced mopping up deposits from the public. The aggregate resources available for investment with financial institutions adds up to over 7,50,000 crores. Sources of funds (long-term funds) for development are given in the following:

(I) Financial assistance to entrepreneurs is granted by commercial banks, State Financial Corporations, State Directorate of Industries, National Small Industries Corporation, state Small Industries Corporations, and all-India development banks.

NOTES

(II) Credit facilities granted, by commercial banks and State Financial Corporations are covered under the Credit Guarantee Scheme for Industries, which offers protection to credit institutions against possible loss on their lending to this sector.

(III) Institutional agencies grant financial assistance to SSI all-scale industrial units for:

1. Participation in equity capital.
2. Acquisition of fixed assets by way of term loans; and
3. Working capital.

## *12.4 INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)*

### Incorporation and Purpose

The Industrial Finance Corporation of India (IFCI) was established in 1948 under an Act of Parliament with the object of providing medium and long-term credit to industrial concerns in India. IFCI transformed into a corporation from 21st May, 1993 to, provide greater flexibility to respond to the needs of the rapidly changing financial system.

*Management*

The Board of Directors consists of a whole-time Chairman and twelve directors.

The Chairman is appointed by the Central Government after consultation with the IDBI. Two directors are nominated by the Central Government and four by the IDBI. Six Directors are elected by shareholders other than the IDBI.

*Financial assistance provided by the IFCI can be in one or more of the following forms:*

- Rupee and foreign currency term loans.
- Underwriting of share and debenture issues.
- Direct subscription to equity.
- Guarantees.
- Soft loans.
- Equipment financing.

Projects costing up to ₹ 300 lakh are financed by the State Financial Corporations, State Industrial Development Corporations and Commercial

NOTES

banks under the refinance scheme of the IDBI. Only projects costing in excess of ₹ 300 lakh are considered for assistance by the IFCI.

## Forms of Assistance

Section 23 of the IFCI Act outlines the types of activities, which the Corporation is authorised, to undertake. These are indicated below with the year in which it was authorised to undertake each type of activity shown within the brackets.

1. Granting loans on subscribing to debentures repayable within a period not exceeding 25 years. (1948).
2. Underwriting the issue of stock, shares, bonds or debentures by industrial concerns provided that it does not retain any shares, *etc*., which it may have had to take up in fulfilment of its underwriting liabilities beyond a period of 7 years except with the permission of the Central Government (now the IDBI).
3. Guaranteeing loans raised by industrial concerns, which are repayable within a period not exceeding 25 years and are floated in the market. raised by industrial concerns from Scheduled Banks or State Cooperative Banks (1960).
4. Guaranteeing deferred payments due from any industrial concern
   (a) In connection with the import of capital goods from outside India.
   (b) In connection with the purchase of capital goods within India.
5. Guaranteeing loans (with the prior approval of the Central Government) raised from, or credit managements made with, any bank or financial institution in any country outside India by Industrial concerns in foreign currency (1960).
6. Acting as agent for the Central Government or, with its approval, for the International Bank for Reconstruction and Development (IBRD) in respect of loans granted or debentures subscribed by either of them (1952).
7. Subscribing to the stock or shares of any industrial concern (1960).

## Functions and Lending Policies

Any limited company or co-operative society incorporated and registered in India which is engaged, or proposes to engage itself, in the manufacture, preservation or processing of goods, or in the shipping, mining or hotel

NOTES

industry, or in the generation or distribution of electricity or any other form of power, is eligible for financial assistance from the Cooperation on the same basis as industrial projects in the private and joint sectors.

Public sector projects are also eligible for financial assistance from the Corporations on the same basis as industrial projects in the private and joint sectors.

The assistance may take the form of long-term loans both in rupees and foreign currencies, the underwriting of equity, preference and debenture issues; subscribing to equity, preference and debenture capital; guaranteeing of deferred payments in respect of machinery imported form abroad or purchased in India. And guaranteeing of loans aided in foreign currency from foreign financial institutions, financial projects and for the expansion, diversification, renovation or modernisation of existing ones.

Financial assistance on concessional terms is available for the setting-up of new industrial projects in industrially less developed districts in the States/Union Territories notified by the Central Government.

## Sources of Funds

The main sources of funds of the Corporation other than its own capital retained earnings, repayment of loans and sale of investments are borrowings from the market by the issue of bonds, loans from the Central Government and foreign credits.

In its development role, the Industrial Finance Corporation has undertaken various promotional activities. The resources for financing such activities come from the benevolent ‘Reserve Fund which was created in terms of an amendment of the IFC Act in 1972, and from the allocation of the Interest Differential Funds by the Government. The Interest Differential Funds are received in the form of loans and grants on a 50:50 basis under an agreement entered into by the Government of India with the Government of the Federal Republic of Germany in respect of lines of credit from the Kreditrnstalt für Wiederaufbau allocated to the Corporation from time to time. The promotional activities undertaken by the Corporation which are, no doubt, still modest in their scope are in consonance with the measure which need to be taken to achieve the objective of broadening the entrepreneurial bases in the country, particularly in less developed areas. The promotional activities, undertaken by the Corporation are briefly reviewed here.

NOTES

The Corporation's Technical Assistance Scheme for training middle level executives of the State financial and development agencies and the senior executives of these organisations continues to elicit a good response because it has been found to be very useful. Since the inception of the scheme in 1971, 78 middle level executives from 33 state level institutions and 43 senior executives from 28 state level institutions have availed themselves of the scheme, which aims at acquainting them with the policies, procedures and practices of the Corporation.

## New Promotional Schemes

In 1989, the Corporation framed two new schemes of promotional activities, which encourage new entrepreneurs and technologists to set up their own industries, and which assist in the growth of indigenous technology and small industries. The scheme for encouraging the development of ancillary industries was liberalised.

The present positions is that IFCI has fourteen Promotional Schemes, of which eight are consultancy fee subsidy schemes, four interest subsidy schemes and two entrepreneurship development schemes, as per details given below:

## Consultancy Fee Subsidy Schemes

- Scheme of subsidy to small entrepreneurs in the rural, cottage, tiny and small sectors for meeting cost of feasibility studies, *etc*.
- Scheme of subsidy for consultancy to industries relating to animal husbandry, dairy farming, poultry farming and fishing.
- Scheme of subsidy for consultancy to industries based on or related to agriculture, horticulture, sericulture and pisciculture.
- Scheme of subsidy for promotion of ancillary and small-scale industries.
- Scheme of subsidy to new entrepreneurs for meeting cost to market research surveys.
- Scheme of subsidy for Providing Marketing Assistance to Small Scale Units.
- Scheme of subsidy for Consultancy on Use of Non-Conventional Sources of Energy and Energy Conservation Measures.
- Scheme of Subsidy for Control of Pollution in the Village and Small Industries Sector.

NOTES

- Own generation by way of repayment of past borrowings and plough-back of profits.

### Interest Subsidy Schemes

- Scheme of Interest Subsidy for Self-Development and Self-Employment of Unemployed Young Persons.
- Scheme of Interest Subsidy for Women Entrepreneurs.
- Scheme of Interest Subsidy for Encouraging Quality Control Measures in Small Scale Sector.
- Scheme of Interest Subsidy for Encouraging the Adoption' of Indigenous Technology.

### Entrepreneurship Development Schemes

- Scheme for Encouraging Entrepreneurship Development in Tourism and Tourism-related Activities.
- Scheme for Encouraging Self-Employment amongst Persons Rendered Jobless due to Retrenchment or Rationalisation in a Sick Industrial Unit in the Organised sector Undergoing a Process of Rehabilitation/Revival.

The Consultancy for Subsidy Schemes is aimed at providing subsidised consultancy services to industrial units, largely in Village and Small Industries' (VSI) Sector through Technical Consultancy Organisations (TCOs). The Interest Subsidy Schemes are intended to provide encouragement to self-development and self-employment to unemployed youths, women entrepreneurs adoption of quality control measures, amassing the indigenously available technology *etc*. The Entrepreneurship Development Schemes envisage 'giving impetus to self-employment in tourism related activities in the small scale sector, and help in mitigating the suffering of people, who have to face retrenchment due to implementation of modernisation, rehabilitation and revival plans in the case of potentially viable sick units, by process of retaining or self-employment avenues.

## *12.5 THE INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)*

The Industrial Development Bank of India (IDBI) was established on 1 July, 1964 under the Industrial Development Bank of India act, as a

NOTES

wholly owned subsidiary of the reserve bank of India. In terms of the public financial institutions laws (Amendment) Act, 1975, the ownership of the IDBI has been transferred to the Central Government with effect from 16th February 1976. The most distinguishing feature of the IDBI is that It has been assigned the role of the principal financial institution for co-ordinating, in conformity with national priorities, the activities of the institutions engaged in financing, promotion or developing industry. The IDBI has been assigned a special role to play in regard to industrial development.

## Objectives

- To serve as an apex institution for term finance for industry, to co-ordinate the working of institutions engaged in financing, promoting or developing industries and to assist in the development of these institutions.
- To plan, promote and develop industries to fill gaps in the industrial structure in the country.
- To provide technical and administrative assistance for promotion, management or expansion of industry.
- To undertake market and investment research and surveys.
- Co-ordination, regulation and supervision of the working of other financial institutions such as IFCI, ICICI, UTI, LIC, Commercial Banks and SFCs.
- Supplementing the resources of other financial institutions and thereby widening the scope of their assistance.
- Planning, promotion and development of key industries and diversifications of industrial growth.
- Devising and enforcing a system of industrial growth that conforms to national priorities.

## Function

1. The IDBI has been established to perform the following functions
2. To grant loans and advances to IFCI, SFCs or any other financial institution by way of refinancing of loans granted by such institutions which are repayable within 25 year.

NOTES

3. To grant loans and advances to scheduled banks or state co-operative banks by way of refinancing of loans granted by such institutions which are repayable in 15 years.
4. To grant loans and advances to IFCI, SFCs, other institutions, scheduled banks, state co-operative banks by way of refinancing of loans granted by such institution to industrial concerns for exports.
5. To discount or rediscount bills of industrial concerns.
6. To underwrite or to subscribe to shares or debentures of industrial concerns.
7. To subscribe to or purchase stock, shares, bonds and debentures of other financial institutions.
8. To grant line of credit or loans and advances to other financial institutions such as IFCI, SFCs, *etc*.
9. To grant loans to any industrial concern.
10. To guarantee deferred payment due from any industrial concern.
11. To guarantee loans raised by industrial concerns in the market or from institutions.
12. To provide consultancy and merchant banking services in or outside India.
13. To provide technical, legal, marketing and administrative assistance to any industrial concern or person for promotion, management or expansion of any industry.
14. Planning, promoting and developing industries to fill up gaps in the industrial structure in India.
15. To act as trustee for the holders of debentures or other securities.

## Subsidiaries

The following are the subsidiaries of IDBI

1. Small Industries Development Bank of India (SIDBI)
2. IDBI Bank Ltd.
3. IDBI Capital Market Services Ltd.
4. IDBI Investment Management Company

## Capital Structure and Operations

NOTES

As on September 30, 1996, the authorised Capital of IDBI was ₹ 2,000 crores. Issued, subscribed and paid up share capital was ₹ 828.76 crores. Reserves were ₹ 6,309 crores. Loan funds were ₹ 35,450 crores. The total outstanding loans, investments and guarantee of IDBI stood at ₹ 39,221 crore as on 31st March 1996.

## Functions: Specials

(A) To act as lender of last resort and to finance all types of industrial concerns which are engaged, or which propose to be engaged, in the manufacture, processing or preservation of goods, or in mining, shipping, transport, hotel industries, or in the generation distribution of power, in fishing or in providing shore fishing, or in the maintenance, repairs, testing or servicing of machinery or vehicles, vessels, *etc*., or for the setting-up of industrial estates. The Bank may also assist industrial concerns engaged in the research and development of any process or product or in providing special or technical knowledge or other services for the promotion of industrial growth. Besides, it provides finance or the export of engineering goods and service on deferred payment basis.

(B) The IDBI has been playing a significant role in the promotion of small-scale industries. Its assistance has been channelled through its scheme for the refinance of industrial loans, and to a limited extent, through the Bills Rediscounting Scheme. Since its inception, the lost has been playing a significant role in the promotion of small scale industries.

Its assistance has been channelled through its scheme for the refinance of industrial loans, and to a limited extent, through the Bills Rediscounting Scheme. Since its inception, the IDBI has been operating a special scheme of concessional assistance to the small-scale sector. The procedure in respect of loans to the small-scale sector has been put on a semi automatic basis under the Liberalised Refinance Scheme (LRS). As a result of the progressive liberalisation and simplification of its refinance operations, its assistance to the small-scale sector has increased substantially since 1971-72. Its assistance to the small and medium industrial units flows through 18 SFCs and 28 SIDCs, commercial banks and regional rural banks.

NOTES

## IDBI Schemes

IDBI is having the following schemes for the benefit of enterprise and entrepreneurs in the small and medium scale sector:

### Direct Assistance

Project finance scheme (loans, underwriting, direct subscription and guarantees); Project Finance Scheme (loans, underwriting, direct subscription and guarantees).

Modernisation Assistance Scheme for all industries;

Textile Modernisation Fund Scheme;

Technical Development Fund Scheme;

Venture Capital Fund Scheme;

Energy Audit Subsidy Scheme;

Equipment Finance for Energy Conservation Scheme;

Equipment Finance Scheme;

Foreign Currency Assistance Scheme.

### Indirect Assistance

Refinance Scheme for Industrial Loans for Small and Medium Industries;

Refinance Schemes for Modernisation and Rehabilitation of Small and Medium Industries;

Equipment Refinance Scheme;

Bills: Discounting/Rediscounting Scheme;

Seed Capital Scheme;

Scheme for Concessional Assistance for Development of New-Industry in Districts and Other Backward Areas;

Scheme for Concessional Assistance for Manufacture and Industrialisation of Renewable Energy Systems;

Scheme for Investment Shares and Bonds of Other Financial Institutions.

### Sources of Funds

Capital Contribution from Government;

Loan Capital from Government;

NOTES

Loan Capital from RBI out of National Industrial Credit (Long Term Operation) Fund created out of its annual profits;

Borrowings by way of Government-guaranteed bonds from domestic market;

Borrowings in foreign currency from international capital market;

Deposits under Investment Deposit Account Scheme in lieu of investment allowance under Section 32-AB of Income-tax Act;

3-year IDBI Capital Bond Scheme. Own generation by way of repayment of past borrowings and plough-back of profits.

## Soft Loan Scheme

The IDBI extends soft loans to units in selected industry groups, namely, cotton textiles, jute, cement, sugar and specified engineering industries to enable them to overcome the backlog in modernisation, replacement and renovation of plant and machinery so that they may achieve higher and more economic levels of production and improve their competitiveness. The scheme is operated in participation with the IFCI and the ICICI, with the overall responsibility vesting in the IDBI. The IFCI is the lead institution for jute and sugar industries, the ICICI for engineering and the IDBI for cotton textiles and cement industries.

The loans under the Soft Loan Scheme are extended on concessional terms not only in regard to the interest but also in regard to the promoter's contribution, debt equity ratio, initial moratorium and repayment period. In pursuance of the decision taken by the Government of India, loans under this scheme have been exempted from the convertibility stipulation.

*ICICI The Industrial Credit and Investment Corporation of India:*

The ICICI (Industrial Credit and Investment Corporation of India) was conceived as a private sector development bank in 1955 with the primary function of providing development finance to the private sector. Its objectives now include:

- assisting in the creation, expansion and modernisation of such enterprises;
- encouraging and promoting the participation of private capital, both internal and external, in ownership of industrial investment and the expansion of investment markets.

NOTES

- Apart from its head office at Mumbai, the ICICI has four regional offices located at Mumbai, Kolkata, Chennai and New Delhi.

Financial assistance is being provided by ICICI in the following forms:

- Rupee and foreign currency term loans
- Underwriting of share and debenture issues
- Direct subscription to equity
- Guarantees
- Soft loans
- Suppliers line of credit for promoting sale of industrial equipment on deferred payment terms
- Lease financing
- Financial Indo-US joint ventures in research and development.
- In practice only such projects costing in excess of ₹ 300 lakhs are considered for financial assistance by the ICICI. However, for purpose of foreign currency loans, no minimum project cost restriction is imposed.

## *12.6 FINANCE FOR INDUSTRY*

Over the past thirty years, the ICICI, in pursuit of its objective of promoting industrial development, has provided financial assistance in various forms, such as:

- Underwriting of public and private issues and offers of sale of industrial securities ordinary shares, preference shares, bonds and debenture stock;
- Direct subscription to such securities;
- Securing loans in rupees, repayable over periods up to 15 years.
- Providing similar loans in foreign currencies for the payment for imported capital equipment and technical services;
- Guaranteeing payments for credits made by others;
- Providing credit facilities to manufacturers for the promotion of the sale of industrial equipment on deferred payment terms.

The primary purposes for which assistance is extended is the purchase of capital assets in the form of land, buildings and machinery. Of the

NOTES

alternative types of assistance provided by the ICICI, the one best calculated to assure the success of enterprise is chosen in each case.

Any company with a limited liability (or the promoter of such a company), any sole proprietary concern, partnership firm or any cooperative society may approach the ICICI for assistance in financing a sound proposal for the establishment, expansion or modernisation of an industrial enterprise.

*The applicant may be an Indian or foreigner;* his plans may provide for invent in any part of India; he may require assistance in any form. He must, however, be prepared to make a reasonable contribution to the resources required for the implantation of his proposal. The enterprise should have, or should undertake to obtain, experienced management and expert technical personnel and advice. Special consideration is given to projects promoted by new entrepreneurs and those who desire to set up industries in backward areas.

There are neither firm limits to the size of the enterprise the ICICI is prepared to assist, nor is there a maximum or a minimum limit to the assistance that it may offer. In practice, the lower limit of the finance provided by the ICICI is set at ₹ 5 lakh because there are other institutions which provide assistance for smaller amounts. However, to meet the requirements of industry for loans in foreign currency, the ICICI may offer assistance for smaller amounts. However, to meet the requirements of industry for loans in foreign currency, the ICICI may offer assistance below this limit. At the upper end, prudence requires that it limit the proportion of its resources, which it can safely invest in a single enterprise. However, no proposal is too large for the ICICI to handle, it is prepared to enlist the cooperation of other financial institutions, in India and abroad, to share in the investment.

In promoting industrial investment, the ICICI is anxious not only to invest, but also to encourage others to invest. Accordingly, it seeks to encourage other financial institutions and individuals, both Indian and foreign, to co-operate with it in its investment and lending operations.

In order to promote new industries, to assist in the expansion and modernization of existing industries, and to furnish technical and managerial assistance, the ICICI grants long term and medium term loans, subscribes to shares, underwrites new shares and debentures, guarantees loans from other private investment sources, and provides managerial and technical advice. ICICI also provides assistance by way of suppliers credit, equipment, leasing, installment sale and venture capital and renders merchant banking services. Technology, Development and Information Company of

NOTES

India Ltd. (TDICI), established by ICICI in 1988, provides technological information and finances technology intensive development activities including commercial R&D schemes. It also manages the venture capital fund of ₹ 20 crores that ICICI had established along with UTI in 1988.

## *12.7 THE NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT: NABARD*

The Preamble of the National Bank for Agriculture and Rural Development Act sets out the objectives for establishing the new institution. To quote, an Act to establish a bank to be known as the National Bank of Agriculture and Rural Development for providing credit for the promotion of agricultural, small-scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas, and for matters connected therewith or incidental thereto.

### Establishment of the National Bank

The establishment of the National Bank for Agriculture and Rural Development (commonly known as 'NABARD' and referred to as the National Bank in this book) was the outcome of the acceptance of the recommendation in this behalf contained in the - Interim Report of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development constituted by the Bank in consultation with the Central Government in 1979. The Bill for setting up the institution was passed by the Parliament in December 1981 and the National Bank came into existence on July 12, 1982.

The Committee envisaged that the new apex bank would be an organisational service for providing undivided attention, forceful direction and pointed focus to the, credit problem arising out of the integrated approach to rural development. The committee recommended that the new bank take over from the Reserve Bank the overseeing of the entire rural credit system, including credit for rural artisans and village industries, and the statutory inspection of co-operative banks and Regional Rural Banks on an agency basis; the Bank continuing to retain its essential controls.

The new bank was to have organic links with the Reserve Bank by virtue of the latter contributing half of its share capital (the other half being contributed by the Central Government), and three members of the Central

Board of Directors of the Reserve Bank being appointed on its board, besides a Deputy Governor of the Reserve Bank being appointed as its chairman. The Committee envisaged the role of the Reserve Bank as one of spawning, fostering and nurturing the new bank, in much the same way as it did earlier in the case of the Agricultural Refinance and Development Corporation.

NOTES

On its establishment, the National Bank has taken over the entire undertaking of the Agricultural Refinance and Development Corporation and has taken over from the- Reserve Bank its refinancing functions in relation to the State Cooperative Rural Banks. This Bank is now the coordinating agency in relation to the Central Government, planning Commission, state government institutions at all-India level and State level, engaged in the development of small-scale industries, village and cottage industries, rural crafts, *etc*., for giving effect to the various policies and programme relating to rural credit.

## Capital and Management

The capital of the National Bank is ₹ 500 crores, subscribed by the Central Government and the Reserve Bank in equal proportions. In terms of the Act, the Board of Directors will consist of fifteen members to be appointed by the Central Government in consultations with the Reserve Bank may maintain and will comprise, besides the chairman and the managing director, three directors from the Central Board of the Reserve Bank, three officials of the Central Government, two officials of the State Governments and five directors from among experts in rural economics, rural development, handicrafts and village and cottage industries, *etc*., and persons with experience in the working of co-operative banks and commercial banks. The Act provides for constitution by the Board of an Advisory Council consisting, of the directors of the National Bank and other persons having special knowledge of subjects which is considered useful to the bank, to tender advice and discharge many functions allotted to it. In effect, the Advisory Council will perform functions similar to those entrusted to the Agricultural Credit Board set up by the Reserve Bank.

## Operations

The National Bank is empowered to provide short-term refinance assistance for periods not exceeding 18 months to State co-operative banks, Regional Rural Banks and any financial institutions approved by the Reserve Bank in this behalf, for a wide range of purposes, including

NOTES

marketing and trading, relating to rural economy. These short-term loans granted to State cooperative banks and Regional Rural Banks, intofar as they relate to the financing of agricultural operations or marketing of crops, can be converted by the National Bank into medium term loans for periods not exceeding seven years under conditions of drought, famine or other natural calamities, military operations or enemy action.

Likewise, the National Bank may also provide assistance by way of loans and advances up to seven years to the financing institutions where it is satisfied that owing unforeseen circumstances the rescheduling of any short-term loans and advances made to artisans, small-scale industries, village and cottage industries *etc*., by the financing institutions is necessary. The, National Bank can grant medium-term loans to the State cooperative banks and Regional Rural Banks for periods extending from 18 months to 7 years for agriculture and rural development and such other purposes as may be determined by it from title to time subject, in the case of loans to State co-operative banks, to their, being fully guaranteed by the State Governments as to the repayment of principal and payment of interest. Such guarantees can, however, be waived by the National Bank in certain circumstances.

The national bank is empowered to provide by way of refinance assistance, long term loans extending up to a maximum period of 25 years including the period of rescheduling of such loans, to the state land development banks, regional rural banks, scheduled commercial banks, state co-operative banks or any other financial institutions approved by the reserve banks, for the purpose of making investment loans, as well as for give short term loans along with long term loans where such composite loans are considered necessary. Loans for periods not exceeding 20 years can be made to the state governments to enable them to subscribe directly or indirectly to the share capital of co-operative credit societies. Moreover, the new bank can contribute to the share capital or invest in the securities of any institution concerned with agriculture and rural development.

The outstanding amounts, as on the date of transfer of business to the national bank, in respect of loans and advances granted by the Reserve Bank to the state co-operative banks and regional rural banks under section 17 of the Reserve Bank of India. The outstanding loans and advances granted by the Reserve Bank out of the National Agricultural Credit (Long Term Operations) Fund and the National Agricultural Credit (Stabilisation) Fund to the State Governments, State co-operative banks and the

NOTES

Agricultural Refinance and Development Corporation have been transferred to the National Bank.

### Resources

For its short-term operations, the National Bank will borrow funds from the Reserve Bank in the form of a line of credit under Section 17 (4E) of the Reserve Bank of India Act, which permitted the Reserve Bank to grant short-term loans to the Agricultural Refinance and Development Corporation earlier, and which has now been amended suitably by the National Bank for Agriculture and Rural Development Act. For its term loan operations, the National Bank will draw funds, as the Corporation was doing earlier, from the Central Government, the World Bank/IDA and other multilateral and bilateral aid agencies the market and the National Rural Credit (Long Term Operations).

The balance in the National Agriculture Credit (Stabilisation) fund has been similarly transferred by the Reserve Bank to the National Bank for credit to the newly established National Credit (Stabilisation) Fund which will be maintained by annual contributions by both the Reserve Bank and the National Bank as well as by contributions from the Central and state Governments from time to time.

The methods of raising funds include sale of bonds and debentures, direct borrowing, acceptance of deposits, and receipt of gifts, grants, *etc*. The national bank may borrow foreign currency from any bank or financial institution in India or abroad with the approval of the Central Government which will guarantee such loans.

## *12.8 THE SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)*

The idea of setting up Small Industries Development Bank of India (SIDBI), in response to a long standing domain from the small scale sector as an apex level national institution for promotion, financing and development of industries in the small scale sector, embodied an opportunity to set up proactive, responsive and forward looking institution to serve the current and emerging needs of small scale industries in the country. As a precursor to the setting up of the new institution, the small industries development fund was cleared by industrial development fund created by Industrial Development Bank of India (IDBI) in 1986 exclusively for refinancing, bills rediscounting and equity support to the small scale sector.

NOTES

The outstanding portfolio of the order of ₹ 4,200 crore from IDBI was transferred to SIDBI in March 1990. SIDBI started off from a strong base; percentage of IDBI, banking of a special statute, the Small Industries Development Bank of India act of 1989, a large capital base of ₹ 450 crore, availability of experienced manpower endowed with development banking skills carved out of IDBIs professional staff and ready availability of a cast network of institutional infrastructure and enduring financial linkages with State Financial Corporations (SFCs), commercial banks and other institutions; all these augured well for the growth of the nascent institution. SIDBI became operational on April 2, 1990.

## The Environment

Indian economy has been in transition for most part of the last five years: the industrial policy, fiscal policy, public sector policy, foreign investment policy, trade policy and monetary and credit policies have been in various stages of liberalisation. Decontrol, deregulation and delicensing have given enormous scope for private initiative and market forces to come to play. New relationships within and between different sectors in the economy are being evolved; the small-scale sector has been an important constituent of such a liberalisation in the country. Government of India formulated a set of new policies aimed at harnessing the potential of the small-scale sector in August 1991 a year and-half after the establishment of SIDBI. The prescriptions of the policy focused at removal of implements affecting the growth of small-scale sector together. With consolidation of the strengths, in the context of the emerging economic order, SIDBI has been refining its strategies and business policies in alignment with the policy, changes that have been taking place at the national level.

## Operational Strategy

Stepping up of flow of credit to the units in the small scale sector through direct and indirect financing mechanisms and ensuring speedy disbursement have remained the, main plank of the operational strategy of SIDBI. Over the years, the share of direct assistance in the total assistance has steadily gone up.

Share: %

| | 1990-91 | 1991-91 | 1992-93 | 1993-94 | 1994-95 | 1995-96 | 1996-97 | 1997-98 |
|---|---|---|---|---|---|---|---|---|
| Indirect assistance | 95 | 91 | 79 | 59 | 41 | 66 | 64 | 64 |

NOTES

| Direct assistance | 5 | 9 | 21 | 41 | 59 | 34 | 36 | 36 |
|---|---|---|---|---|---|---|---|---|

### Shift in Business Mix

The new schemes designed and implemented were directed at filling the gaps in the existing credit delivery system focusing on new target groups and activities. These are targeted at addressing some of the major problems of SSIs, in areas such as marketing, infrastructure development, delayed realization of bills, ancillarisation, obsolescence of technology, quality improvement, export financing and venture capital assistance. The terms of assistance under various schemes have been substantially liberalised based on ongoing review process. The procedures have been simplified with gradual decentralization and progressive levels of operational efficiency and better customer service.

[SSIs on account of delayed payments, two factoring companies, *viz*., *SBI factors* and Commercial Services Pvt. Ltd. And can bank factors Ltd. have been established with SIDBI as a partner with 20% shareholding, SIDBI]

## *12.9 INVESTMENT TRUSTS*

### Meaning

Investment Trusts are investment institutions which are formed to provide to investors, particularly smaller ones having small savings, the benefits of diversified investment and skilled management in the sphere of investment in industrial securities.

These institutions sell their shares or units to small investors to mobilise their savings. These savings are invested in shares, debentures, bonds and loans of profit-making joint stock companies. The investments are diversified, that is, made in securities of a sufficiently large number of companies, generally from different industries, using professional management skills. This reduces the investment risk and ensures reasonable income from the investments. The trust receives income from investments by way of dividend on shares, interest on debentures, bonds and loans and profit on sale of securities. After meeting the management expenses, the income of the trust is distributed among the investors.

Thus the investment trusts, on the one hand, enable small investors to participate in the industrial prosperity of the country, and on the other hand,

NOTES

enable joint stock companies to obtain financial resources from wider sources.

### Types of Investment Trusts

Investment trusts are basically of the following two types:

1. *'Open-end' Investment Trusts*

   In U.K, such trusts are known as 'Unit Trust' while in USA, they are commonly known as 'Mutual funds'. The distinguishing characteristics of such trusts are:

   There is a definite arrangement under which the trust continuously offers to sell fresh shares or units at a price based on the net asset value of the underlying securities.

   There is also a definite arrangement under which the trust buys back its own shares or units at a price based on the net asset value of the underlying securities.

   The income of the trust is divided among the unit holders or shareholders of the trust after meeting management expenses.

2. *'Closed-end' Investment Trusts*

   The distinguishing characteristics are as under-

   These Trusts do not continuously sell their shares or units;

   They also do not buy back their shares or units;

   The shares or units of the trust are listed on stock exchanges and can be bought and sold like shares of any other company;

   The market value of shares or units of these trusts depends upon the market forces of demand and supply;

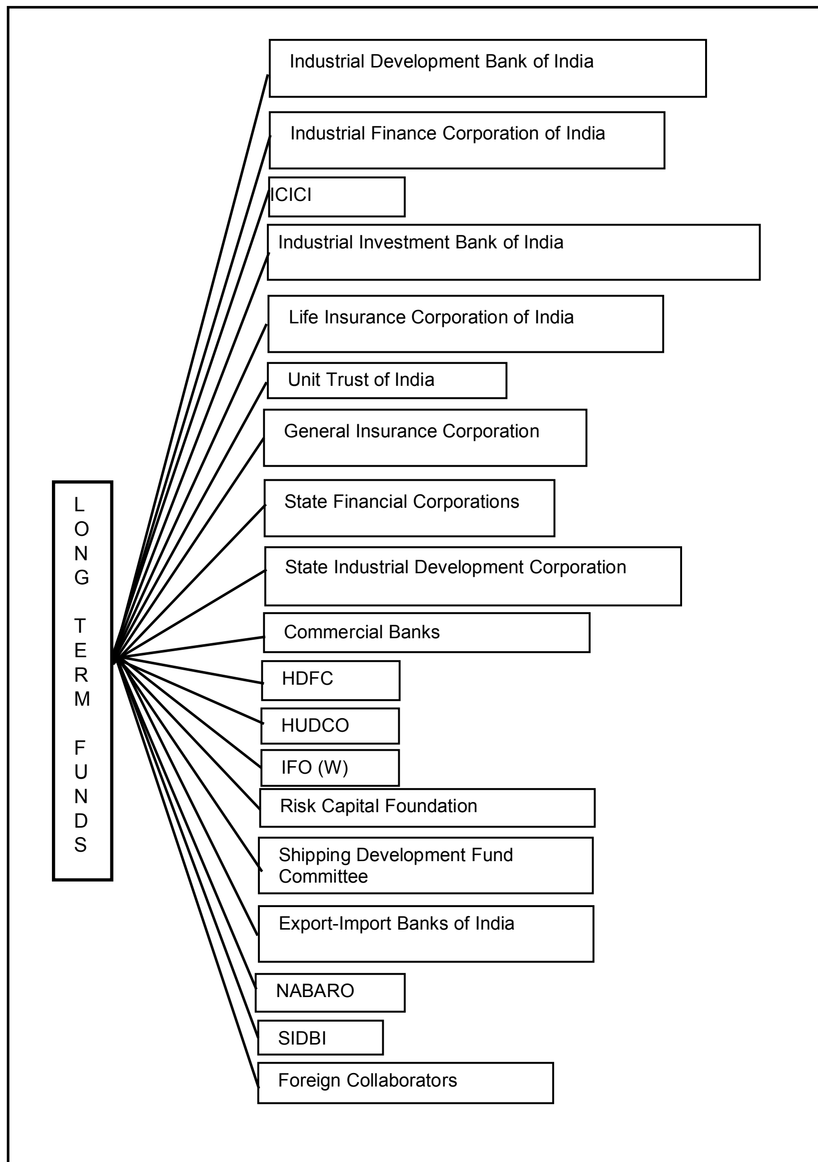
   Such institutions can also raise loans to make investments;

   They may plough back a part of their profits.

## *12.10 UNIT TRUST OF INDIA (U.T.I.)*

The Unit Trust of India is a statutory public sector investment institution established under the Unit Trust of India Act, 1963. From 1st July 1964. Capital : Source.

NOTES




With the amendment of the Public Financial Institutions Laws, the contribution made by RBI to the initial capital and the control exercised by it are vested in the IDBI with effect from *16th Feb. 1976.*

## 12.11 NATURE OF THE TRUST: UNIT TRUST OF INDIA: UTI

The Unit Trust of India is an investment trust. It mobilises the savings of people through sale of units. The savings as collected are invested in the shares and debentures of profit-making companies. The income received by the trust by way of interest and dividend is passed on to the unit holders by way of dividend after meeting management expenses of the trust. The

NOTES

small savers get benefit by participating in the investment schemes of UTI and thus in the industrial prosperity of the country. Investment through UTI results in lower risk of loss and higher return on investments due to professional management by UTI.

### What are units?

The total investment made by UTI in industrial securities (shares, debentures and bonds) is divided into smaller parts called 'units'. The Unit Trust of India sell units under different schemes and also buys back its own units at the purchase price fixed by it from time to time. Units have a face value of ₹ 10 each.

### Objectives

The main objectives of UTI are as under:

- To encourage savings of people belonging to middle and low income groups;
- To mobilise savings from the small savers;
- To channellise savings to industrial growth;
- To allow investors to participate in the prosperity of the industries.

### Functions

The main functions of UTI are as follows:

- To mobilise the savings of the community through sale of units;
- To invest the savings so mobilised in corporate securities such as shares and debentures, *etc*;
- To serve unitholders along the length and breadth of the country;
- To underwrite the issue of shares and debentures.

## *12.12 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)*

Industrial Credit and Investment Corporation of India was established as a joint stock company in the private sector in 1955. Its share capital was contributed by banks, insurance companies and foreign institutions including the World Bank. Its major shareholders now are Unit Trust of India, Life Insurance Corporation of India and General Insurance

NOTES

Corporation and its subsidiaries. They together hold approximately 50% of the paid up share capital of ICICI.

## Objectives

The ICICI has been established to achieve the following objectives:

- To assist in the formation, expansion and modernisation of industrial units in the private sector;
- To stimulate and promote the participation of private capital (both Indian and foreign) in such industrial units;
- To furnish technical and managerial aid so as to increase production and expand employment opportunities;
- To assist in the development of the capital market through its underwriting activities.

## Functions

The *primary function of ICICI* is to act as a channel for providing development finance to industry. In pursuit of its objectives of promoting industrial development, ICICI performs the following functions:

- It provides medium and long-term loans in Indian and foreign currency for importing capital equipment and technical services. Loans sanctioned generally go towards purchase of fixed assets like land, building and machinery;
- It subscribes to new issues of shares, generally by underwriting them;
- It guarantees loans raised from private sources including deferred payment;
- It directly subscribes to shares and debentures;
- It provides technical and managerial assistance to industrial units;
- It provides assets on lease to industrial concerns. In other words, assets are owned by ICICI but allowed to be used by industrial concerns for a consideration called lease rent.
- It provides project consultancy services to industrial units for new projects.
- It provides merchant banking services.

NOTES

- The corporation is empowered to provide any amount of financial assistance to any business unit in the private sector, public sector, joint sector or co-operative sector. Any company with limited liability, any sole proprietary concern, partnership concern and any co-operative society may approach the corporation for assistance in financing a sound project. Normally it provides such assistance within the range of self imposed limits. Accordingly, ₹ 5 lakhs is the minimum amount sanctioned by it to a single concern and normally it does not go beyond the maximum limit of Rupees one crore. However, no project is too large for ICICI to handle. In promoting industrial investment, ICICI seeks to encourage other financial institutions, both Indian and foreign, to collaborate in its lending operations.
- Financial assistance granted and disbursed by ICICI over the years have grown steadily. ICICI has disbursed a total financial assistance of ₹ 4,225 crores during the three months period from 1st April 1998 to 30th June 1998. The total amount sanctioned during this period is ₹ 9,135 crore.

ICICI has promoted the following institutions in recent years, showing widening scope of activities of ICICI:

1. ICICI Securities and Finance Co. Ltd.
2. ICICI Asset Management Co. Ltd.
3. ICICI Investors Services Ltd.
4. ICICI Banking Corporations Ltd.
5. Credit Rating Information Services of India Ltd. (CRISIL)
6. Technology Development and Information Company of India Ltd. (TDICI)
7. Programme for the Advancement of Commercial Technology and (PACER)

## *12.13 LIFE INSURANCE CORPORATION OF INDIA (LIC)*

The Life Insurance Corporation of India. (LIC) was set up under the LIC Act in 1956, as a wholly-owned Corporation of the Government of India, on nationalisation of the life insurance business in the country. LIC took

NOTES

over the life insurance business from private companies to carry on the business and deploy the funds in accordance with the Plan priorities. LIC operates a variety of schemes so as to extend social security to various segments of society and for the benefit of individuals and groups from the urban and rural areas. The Committee on Reforms in the Insurance Sector set up by the Government has recommended privatisation and restructuring of LIC with Government retaining 50% stake. The Committee has also suggested that foreign companies be allowed to conduct life insurance business in the country through joint ventures with India partners.

According to the investment policy of LIC, out of the accretion to its Controlled Fund, not less than 75% has to be invested in Central and State Government securities including Government-guaranteed marketable securities in the form of shares, bonds and debentures. LIC extends loans for the development of socially-oriented sectors and infrastructure, facilities like housing, rural electrification, water supply, sewerage and provides financial assistance to the corporate sector by way of term loans and underwriting/direct-subscription to shares and debentures. LIC also extends resource support to other financial institutions by way of subscription to their shares and bonds and also by way of term loans.

## *12.14 GENERAL INSURANCE CORPORATION OF INDIA (GIC)*

The General Insurance Corporation of India (GIC) was established in January 1973 on nationalisation of general insurance companies in the country. GIC has four subsidiaries, *viz*., National Insurance Co. Ltd., New India Assurance Co. Ltd., Oriental Fire & General Insurance Co. Ltd. and United India Insurance Co. Ltd. GIC and its subsidiaries operate a number of insurance schemes to meet the diverse and emerging needs of various segments of society. In the recent past, GIC and its subsidiaries devised several need-based covers to keep pace with the new liberalised economic environment. The investment policies of GIC and its subsidiaries have been evolved within the ambit of the provision 27(B) of the Insurance Act 1938 and guidelines issued by the Government from time to time. According to Government guidelines, 70% of the annual accretions to their investible funds are required to be invested in socially oriented sectors of the economy. Since April 1976, GIC has been participating with other financial institutions in extending term loans to industrial undertakings and

NOTES

providing facilities for underwriting/direct subscription to their shares and debentures.

## *12.15 EXPORT-IMPORT BANK OF INDIA — EXIM*

The Export Import Bank of India (Exim Bank) was set up on January 1, 1982 by an Act of Parliament as the principal financial institution for promotion and financing of India's International Trade. Exim Bank finances exporters and importers, co-ordinates the working of institution engaged in financing export and import of goods and services, finances export-oriented units and undertakes promotional activities necessary for international trade. It has a menu of 23 major programmes to meet the needs of different customer groups, *viz*., Indian exporters overseas entities and commercial banks. Exporters can avail of pre-shipment credit, suppliers credit, and overseas investment finance; export product development loans, loans for export marketing, bulk import finance and investment vendors development finance. Foreign Governments and agencies are offered buyers credit and lines of credit. To commercial banks in India, Exim Bank offers export bills rediscounting facility, refinance of suppliers credit and refining of term loans in respect of export-oriented units. It also participates in guarantees issued by commercial banks on behalf of Indian project exporters.

Besides providing finance, EXIM Bank promotes exports through advisory and information services to exporters on procurement practices and bidding procedures of multilateral institutions, country risk analysis, merchant banking and marketing focused on catalysing exports of non-traditional products to developed countries.

## *12.16 KHADI AND VILLAGE INDUSTRIES COMMISSION (KVIC)*

The Khadi and Village Industries Commission (KVIC), established by an Act of Parliament in 1956, is engaged in the development of khadi and village industries in rural areas. It has under its purview 26 village, industries besides khadi. After amendment to the KVIC Act in July 1987, the scope for coverage of activities was widened and as a consequence 70 more new village industries were identified and brought under its fold for implementation. The main objectives of the KVIC are providing employment in rural areas, skill improvement, transfer of technology,

NOTES

building up of strong rural community base and rural industrialisation. The significant characteristics of khadi and village industries under the purview of KVIC lie in their ability to use locally available raw materials, local skills, local markets, low per capita investment, simple techniques of production, which can be easily adopted by the rural people, short gestation period and above all production of consumer goods. KVI activities serve the poorest of the poor comprising scheduled castes, scheduled tribes, women, physically handicapped and minority communities in difficult, inaccessible hill and border areas.

The development programmes of khadi and village industries are implemented through 30 State Khadi and Village Industries Boards which are statutory organisations, set-up under State legislation. 2,320 institutions registered under Societies Registration Act, 1860 and 29,813 Cooperative Societies registered under State Co-operative Societies Act. KVIC also assists individuals through State KVI Boards. KVI programmes now cover more than 2.1 lakh villages in the country.

Some of the notable developments in KVI activities during 1991-92 are extension of special programme aimed at intensive development of KVI through area approach under tie up with District Rural Development Authority (DRDA) to more number of districts, improvement and up gradation of KVI technology and quality of products, establishment of linkage with an export company for exporting KVI technology on hand-made paper and gur khandsari on turn-key basis, initiation of steps for tapping distribution network of big business houses for marketing KVI products, introduction of fabric-painted Khadi ready-made garments, development of modified version of new model charkha by replacing all its metal parts with high quality nylon and reinforced fibre material and development of mini honey processing unit.

## *12.17 NATIONAL SMALL INDUSTRIES CORPORATION LTD.: (NSIC)*

The National Small Industries Corporation Ltd. (NSIC) was setup by the Government of India in 1955 with the objective of promoting and developing small scale industries in the country. Various activities undertaken by NSIC include supply of indigenous and imported machines on easy hire-purchase and lease terms, marketing of the products of small industries on consortia basis, export marketing of small industries products, developing export worthiness of small-scale units, enlistment of small

NOTES

scale units for participation in Government stores purchase programme, development and modernisation of prototypes of machines, equipment and tools, supply and distribution of indigenous and imported raw materials, training in various technical trades and co-operation with other developing countries in setting-up of small scale projects on turn-key basis.

## Activities of National Small Industries Corporation (NSIC)

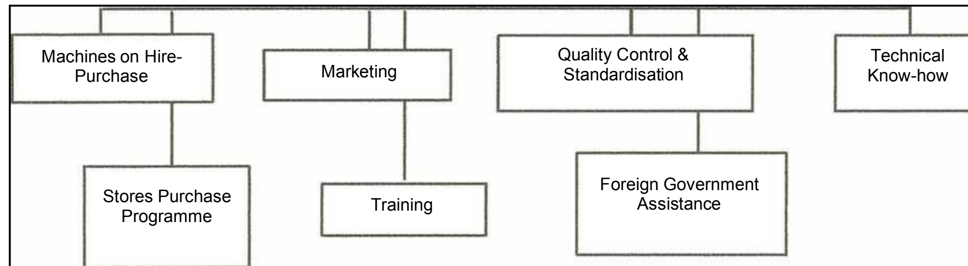
Formerly, the Corporation had four subsidiary corporations at Delhi, Mumbai, Kolkata and Chennai. However, since 1961, all the subsidiary corporations have been amalgamated with the main Corporation, and three Branch Offices have been set-up at Mumbai, Kolkata and Chennai. The Delhi subsidiary corporation has been merged with the parent Corporation, and its work is looked after by a separate Delhi Cell setup in it. The National Small Industries Corporation provides a complete package of financial assistance and support in the following areas:

- Supply of both indigenous and imported machines on easy hire-purchase terms. Special concessional terms have been introduced for units promoted by entrepreneurs from weaker sections of the society, women entrepreneurs, ex-servicemen and those units located in the backward areas.
- Marketing of small industries products within the country.
- Export of Small Industries products and developing export worthiness of Small Scale Units.
- Enlisting competent units and facilitating their participation in Government Stores Purchase Programme.
- Developing prototypes of machines, equipment and tools which are then passed on to Small-Scale Units for commercial production.
- Technical training several industrial trades, with a view to create technical culture in the young entrepreneurs.
- Development and up gradation of technology and implementation of modernisation programmes.
- Supply and distribution of indigenous and improved raw materials.
- Supply of both indigenous and imported machines on easy lease terms to existing units for diversification and modernisation.

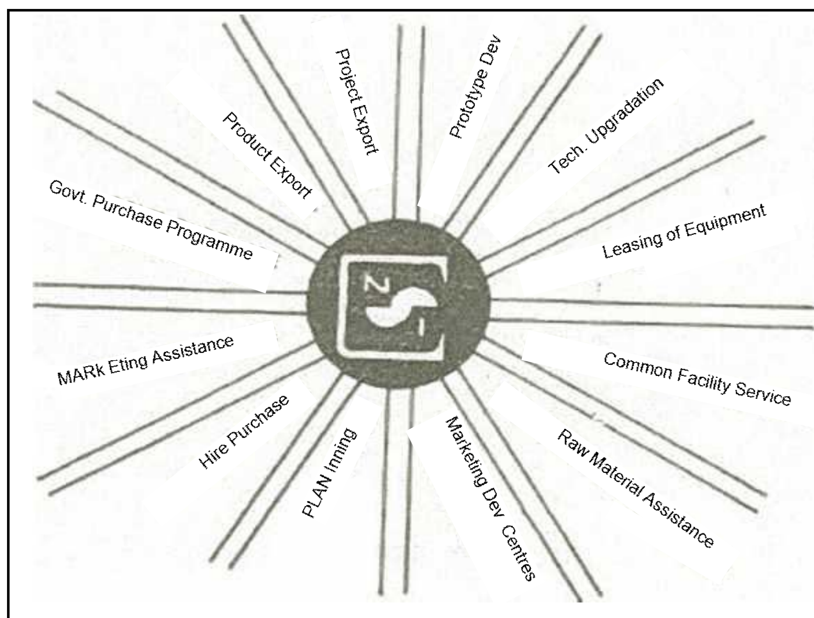
**NOTES**

- Providing of Common Facilities through Prototype Development & Training Centres.
- Setting-up Small-Scale Industries in other developing countries on turnkey basis.

*NSIC*




With a view to giving a fillip to development efforts and to supplement the activities of State Small Industries Corporations and District Industries Service Institutes, the NSIC has opened its offices in some of the States in which the (NSIC) Corporation has been hitherto under-represented. In the central region, offices have been opened in Bhopal and Raipur in Madhya Pradesh. Four development executives and six field inspectors have been, recently posted in the backward areas of the western region to serve as "contact points" and to work in close co-operation with DICs and other developmental agencies in the area. Of these, three field inspectors have been posted in Raigad, Ratnagiri, Satara, Yeomen, Chandrapur, Bhandara, Buldhana, Aurangabad, Nanded, Seed, Osmanabad, *etc*. all backward districts in Maharashtra.



NOTES

### A Unique Package of Assistance for Small Entrepreneurs

The NSIC has taken up the challenging task of promoting and developing small industries almost from the scratch and has adopted an "integrated approach" to achieve its socio-economic objectives. It has created a proper "industrial" atmosphere and has infused confidence in the small entrepreneurs to prepare schemes for the manufacture of products or identify the balancing equipment for purposes of modernisation and or diversification. The small unit, because it is small, is always short of resources. The NSIC therefore, supplies machinery and equipment, marketing inputs and technical support to small units. And so the seedling comes up as a "factory" which provides jobs for the unemployed or underemployed.

Over the years and particularly during this decade, the NSIC, with its deliberate and concentrated efforts, has developed an unsurpassed reputation of an effective and efficient nodal agency for providing assistance to the vibrant Small-Scale sector. All these years, through, its dynamic approach and the package of assistance, it has been significantly contributing to the development of entrepreneurs, building up of strong industrial base, spreading of technical culture, promoting balanced regional growth, development of rural and backward areas, *etc*. as well as in employment generation, in all parts of the country.

## *12.18 STATE INDUSTRIAL DEVELOPMENT CORPORATIONS (SIDCs)*

The State Industrial Development Corporations (SIDCs) were established under the Company Act, 1956 in the sixties and early seventies as wholly-owned State Government undertakings for promotion and development of medium and large industries. SIDCs act as catalysts for industrial development and provide impetus to further investment in their respective States. SIDCs provide assistance by way of term loans, underwriting and direct subscription to shares/debentures and guarantees. They undertake a variety of promotional activities such as preparation of feasibility reports, industrial potential surveys, entrepreneurship development programmes and developing industrial areas/estates. SIDCs are also involved in setting up of medium an large industrial projects in the joint sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. The SIDC's activities have now widened to include equipment leasing, providing tax benefits under State Government's Package Scheme of

NOTES

Incentives, merchant banking services and setting-up of mutual funds. Some of the SIDCs also offer a package of developmental services such as technical guidance, assistance in plant location and coordination with other agencies.

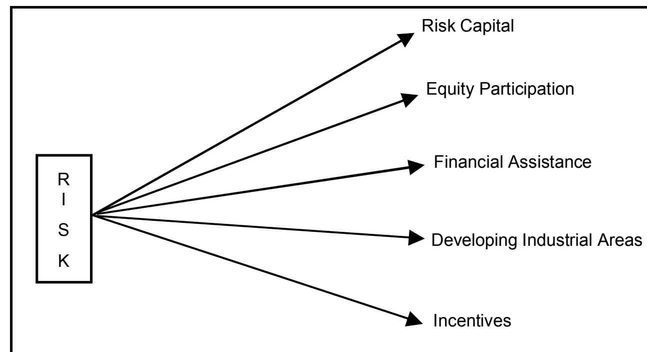
Of the 28 SIDCs operating in the country, nine are twin-function SDICs functioning also as SFCs to provide assistance to small-scale units as well as act as promotional agencies. The twin-function SIDCs are in Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Goa, Pondi-cherry and Sikkim. Seven SIDCs are also involved in infrastructure development and other extensions services for the small sector.

The SIDCs are agent of IDBI and SIDBI for operating its seed capital scheme. Under the scheme, equity type assistance is provided to deserving first generation entrepreneurs who possess necessary skills but lack adequate resources required towards promoter's contribution.

The major functions of these Corporations include:

- Providing risk capital to entrepreneurs by way of equity participation and seed capital assistance;
- Grant of financial assistance to industrial units by way of loans and guarantees.
- Administering incentive schemes of Central/State Governments;
- Promotional activities such as identification of project ideas through industrial potential surveys, preparation of feasibility reports, selection and training of entrepreneurs; and
- Developing industrial areas/estates by providing infrastructure facilities.
- Since the actual range of activities being undertaken by individual SIDC depends upon the specific responsibilities entrusted by the respective State/Union Territory, there is considerable diversity in activities among the different SIDCs.

NOTES




*Functions of: SIDCS*

## *12.19 STATE SMALL INDUSTRIES DEVELOPMENT CORPORATIONS (SSIDCs)*

The State Small Industries Development Corporations (SSIDCs) established under the Companies Act, 1956, are State Government undertakings, responsible for catering to the needs of the small, tiny and cottage industries in the State/Union Territories under their justification. SSIDCs enjoy operational flexibility and can undertake a variety of activities for development of the small sector. As at present, 18 SSIDCs are in operation.

Some of the important activities undertaken by SSIDCs includes:

(i) procurement and distribution of scarce raw materials, (ii)supply of machinery on hire-purchase basis, (iii) providing assistance for marketing of the products of small scale units, (iv) construction of industrial estates/sheds, providing allied infrastructure facilities and their maintenance, (v) extending seed capital assistance on behalf of the State Governments, and (vi) providing management assistance to production units.

A change in the role of SSIDCs has been prompted by the new Industrial Policy.

SSIDCs are gearing up to change themselves from raw material distributors to organisations that will take care of various aspects of small industry development, especially marketing. SSIDCs would, thus, help the tiny and small industries increase their market share. The new policy calls for establishment of counselling and common testing facilities and provision of a mechanism to allow corporation of the latest technology in the small sector. SSIDCs are also planning to set-up centres for display of/and information dissemination on SSI products, and for providing small office spaces for SSIs in need.

NOTES

Information for the analysis/discussion that follows, pertains to 11 SSIDCs located in Andhra Pradesh, Assam, Bihar, Goa, Gujarat, Jammu & Kashmir, Himachal Pradesh, Kerala, Punjab, Rajasthan and Tamil Nadu.

## *12.20 STATE FINANCIAL CORPORATIONS (SFCs)*

State Financial Corporations (SFCs), operating at the State-level, form an integral part or the development financing system in the country. They function with the objective of financing and. promoting small and medium enterprises for achieving balanced regional socio-economic growth, catalysing higher investment; generating greater employment opportunities and widening the ownership base of industry.

At present, there are 18 SFCs in the country, 17 of which were set up under the SFCs Act, 1951. Tamil Nadu Industrial Investment Corporation Ltd., set up in 1949 under the Companies Act as Madras Industrial Investment Corporation functions as a full-fledged SFC. SFCs extend financial assistance to industrial units by way of term loans, direct subscription to equity/debentures, guarantees, and discounting of bills of exchange. SFCs operate a number of schemes of refinance and equity type of assistance formulated by IDBI/SIDBI which include schemes for artisans, special target groups like SC/ST, women, ex-servicemen, physical handicapped, *etc*. and for transport operators, setting up hotels, tourism-related activities, hospitals and nursing homes, *etc*. Over the years, the SFCs have extended their activities and coverage of assistance.

### Concerns Eligible for Assistance

Industrial concerns eligible for financial accommodation under the State Financial Corporation Act, 1951 are those which are engaged in the following activities (a) Manufacture of goods; (b) preservation of goods; (c) processing of goods; (d) mining; (e) generation of distribution of electricity or any other form of power; (f) hotel industry; (g) transport of passenger or goods by road or by water or by air; (h) maintenance; repair, testing or servicing of machinery of any description of vehicles or vessels or motor boats or trawlers or tractors; (i) assembling, repairing or packing any partied with the aid of machinery or power; (j) the development of any contiguous area of land as an industrial estate; (k) fishing or providing shore facilities for fishing or maintenance thereof; (l) providing special or technical knowledge or other services for the promotion of industrial growth.

NOTES

SFCs extend financial assistance to industrial units buy way of term loans, direct subscription to equity/debentures, guarantees and discounting of bills of exchange. SFCs operate a number of schemes of refinance and equity type of assistance formulated by IDBI/SIDBI which include schemes for artisans, social target groups like SC/ST, women, ex-servicemen, physically handicapped, *etc*. and for transport operators, setting up hotels, tourism-related activities, hospitals and nursing homes, *etc*.

## Objectives and Functions

- The main function is to provide term loans for the acquisition of land, building, plant and machinery.
- Promotion of self-employment.
- To encourage new and technically/professionally qualified women entrepreneurs in setting up industrial projects.
- To finance expansion, modernisation and upgradation of technology in the existing units.
- To provide financial assistance for the rehabilitation of sick units financed by the Delhi Financial Corporation.
- To assist for the promotion or expansion of industry by the rural and urban artisans.
- To provide financial assistance for transport vehicles strictly for captive use, depending on the requirement of the projects.
- Providing seed capital assistance under the scheme of Industrial Development Bank of India.
- Providing short-term loan to cover the equity gap to help small-scale industrial units.
- Undertaking the various promotional activities, including the organisation of entrepreneurial development programmes and seminars *etc*.
- Interest subsidy for self-development, self-employment of young persons, adoption of indigenous technology in small and medium sector and encouraging quality control measures in small-scale industry is also admissible to the extent of ₹ 5 lakhs.
- To promote development institutions in the state/region which will accelerate the process of socio-economic growth.

NOTES

## Assistance

The state financial institutions offer a package of assistance to entrepreneurs to enable them to translate their project idea into a reality. The package of assistance may be broadly classified into two types of services, developmental and financial. In addition, some SFCs also implement package schemes of incentives to motivate and encourage entrepreneurs.

## *12.21 COMMERCIAL BANKS*

The Scheduled Commercial Banks (SCBs) in the country (299) comprise State Bank of India and its associate-banks (8), nationalised banks (19), private sector banks (34:) regional rural banks (196) and foreign banks, (42). During 1994-95, ten more banks were given the status of SCBs status entitles the banks to avail of certain over by Bank of India was excluded. The SCB status entitles the banks to avail of certain facilities from RBI such as refinance, loans and advances as also grand of authorised dealers licenses to handle foreign exchange business. Correspondingly, banks also have certain obligations such as maintenance of Cash Reserve Ratio, Statutory Equinity Ratio and follow various banking regulations. As on March 31, 1998, the total number of branches of SCBs stood at 64,267; of these 32,890 (51.1 %) of the total) were in rural areas.

Total outstanding gross bank credit (food and non-food) at ₹ 3,24,079 crore on March 31, 1998 was higher by 16.4% over the outstanding credit of ₹ 2,78,402 crore as on March 18, 1997 mainly due to marked expansion in non-food credit which rise by 15.1 % to ₹ 3,11,594 crore forming 96.1% of total outstanding gross bank credit as against 93.4% on March 18, 1994. Outstanding investments of banks in Government and other approved securities stood at ₹ 2,18,705 crore as on March 31, 1998. The outstanding gross bank credit to industrial sector at ₹ 1,61,038 crore as on March 31, 1998 was higher by 16.2% over ₹ 1,38,548 crore on March 18,1997.

## *12.22 INDIAN FINANCIAL SYSTEM: AN OVERVIEW (RBI)*

The structure of the Indian financial system may be summarised in the following schematic representation. Broadly the Indian financial system may be divided into organised and unorganised segments. The organised market consists of commercial banks, development banks, co-operative

NOTES

banks, post-office savings bank operations, stock markets *etc*. Unorganised financial market operations consist of hundis, money-lending, chit funds *etc*. They operate mainly in the rural areas. However in the urban areas also unorganised money market activities are quite significant. There is no precise estimate of the size of the unorganised money market. It is generally expected that the relative size of the unorganised money market transactions would decline over time.

## 12.23 STRUCTURE

The primary role of the RBI is to maintain a monetary equilibrium and balance in the economy by fonnulating various policies from time to time and controlling the financial instruments of the economy. The balance sheet identity for the RBI is as follows:

Monetary liabilities (ML) + Non-Monetary liabilities (NML) (High Powered)

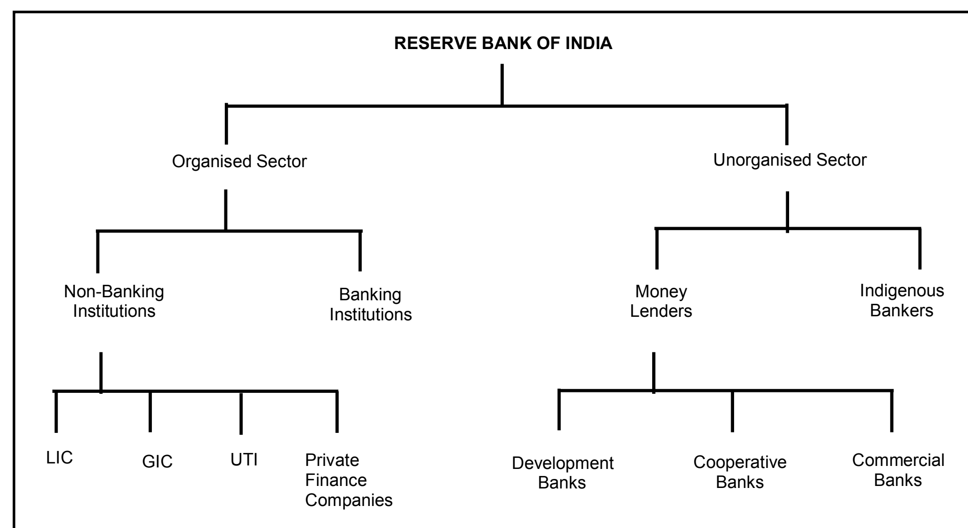
= Financial assets (FA) + other assets

If Net Non-monetary liabilities (NNML) = NML – other assets, then

ML = FA – NML

The monetary liabilities of the RBI are also called Reserve Money. In some text books on monetary economics it has also been referred to as high- powered money.

The monetary liabilities of RBI consist of currency in circulation (CUR) and commercial banks' deposits with the RBI (RES, also known as bank reserves). As against these the financial assets of the RBI consist of RBI (credit to the Government (RBCG)).




*Structure of Indian Financial System*

NOTES

RBI (RBCB), RBI credit to the development banks, such as National Bank for Rural Development (NABARD), National Housing Bank *etc*., and net foreign exchange assets of the RBI.

The variations in the reserve money, therefore, depend essentially on the RBI's financial assets and liabilities, which in turn are influenced by the government's fiscal policy and various other rules and regulations.

1. *Net RBI Credit to the Government*

   As banker to the government, RBI provides credit to both the Central Government and the State Governments. This it done by investing in government securities (including treasury bills of the Central Government) and through short-term advances to State Governments. Until recently the Central Government was empowered to borrow any amount from RBI through treasury bills and rupee securities. In recent years the government has made some restrictions on the amount of borrowing from RBI. In the case of state governments, however, RBI had put restrictions on borrowing even earlier.

2. *RBI Credit to Commercial Banks*

   RBI provides credit to commercial banks through loans and advances against government securities, use of bills or promissory notes as collateral and through purchase or discounting of internal commercial bills as well as treasury bills. However, the RBI does not regard its purchase or rediscounting of bills for banks as a part of its credit to banks. Instead it classifies it as RBC to whatever sector, commercial or government, which issued these bills in the first instance.

3. *RBI Credit to Development Banks*

   A large number of development banks had been established in the country through the initiative and help of RBI for the provision of long and medium term finance to industry and agriculture. RBI provides them credit by investing in their securities and through loans. Prominent development banks created through RBI are: Industrial Development Bank of India (IDBI), Industrial Financial Corporation of India (IFCI) and National Bank for Agriculture and Rural Development (NABARD).

NOTES

4. *Net Foreign Assets of RBI*

   These assets constitute foreign currency reserves of RBI and therefore represent RBC to the foreign sector (because of the financial liabilities of the foreign governments). Most of these assets held abroad are in the form of foreign securities and cash balances. The RBI comes to acquire them as the custodian of the country's foreign exchange reserves. As the controller of all foreign exchange transactions, whether on private or government account, it regularly buys and sells foreign exchange against Indian currency.

5. *Net Non-Monetary Liabilities of the RBI*

   The net RBC to the above four sectors viz, Government, commercial banks, development banks and foreign sector, is financed by RBI partly by creating its monetary liabilities and partly by its Net Non-Monetary Liabilities (NNML).

   FA or net RBC = ML + NNML

   NNML basically consists of the owned funds of RBI (capital and reserves and accumulated contributions to the National Funds) and compulsory deposits of the public. The larger these non-monetary resources of RBI, the lesser its dependence upon the creation of new ***H (high-powered** money)* (Reserve money) to finance its credit to various sectors. Hence this factor enters with a negative sign in the equation.

The current magnitude of different components of reserve money is shown, in table.

## Reserve Requirements

By the technique of varying the reserve requirements the central bank at its initiative can change the amount of cash reserves of banks and affect their credit creating capacity. It may be applied on the aggregate outstanding deposits or the increments after a base date or even on certain specific categories of deposits depending mainly on the origin of deposit expansion. Direct regulation of the liquidity of the banking system is made by the Reserve Bank by two complementary methods: depositing in cash with Reserve Bank of an amount equal to the percentage of deposits with each bank as prescribed from time to time (known as cash reserve ratio or CRR), and maintenance by the bank of a proportion of its deposit liabilities in the form of specified liquid assets (known as the statutory liquidity ratio or

NOTES

SLR). As a result of the application of reserve ratios, the free liquidity at the disposal of banks at any time for lending would be the difference between the total deposits and the total of the sums equivalent to the cash reserve ratio and the statutory liquidity ratios.

## Cash Reserve Ratio (CRR)

The RBI has been pursuing its medium-term objective of reducing the CRR to its statutory minimum level of 3.0 per cent by gradually reducing the CRR from 5611.0 per cent in August 1998 to 7.5% in May 2001. In October, 2001 mid-term review the CRR of scheduled commercial banks excluding RRBs and Local Area banks was reduced by 200 basis points to 5.5 per cent of their Net Demand and Time Liabilities (NDTL). All exemptions were withdrawn, except inter-bank liabilities, for the computation of NDTL (for requirement of CRR) with effect from the fortnight beginning Nov 3, 2001. In the Annual policy the CRR was furher reduced to 5% of NDTL. The CRR would continue to be used in both directions of liquidity management in addition to other instruments.

As on July 2014 CRR was 4% of total net demand and time liabilites.

## Liquidity Adjustment Facility (LAF)

In recent years, the thrust of monetary management has shifted towards development of indirect instruments of monetary policy to enable the Reserve Bank of India to transmit liquidity and interest rate signals in a flexible maimer. The LAF operated through daily repo and reverse auctions, is assigned the objective of meeting day to day liquidity mismatches in the system but not the funding requirements, restricting volatility in short-term money market rates and steering these rates consistent with monetary policy objectives. With effect from 12 July 2014 SLR for SCB and CCB reduced from 25% to 22.5%(NDTL)

## Statutory Liquidity Ratio (SLR)

The effective SLR of the scheduled commercial banks is estimated to have fallen to 25.0 per cent of their total net demand and time liabilities (NDTL) at end March 2002. Bank Rate has fallen to 6 per cent with effect from April 2003. All these measures have generated sufficient liquidity in the system.

Benchmark rate for the Prime Lending Rates was also worked out by the Indian Banks Association consequent on which the PLRs of various banks

NOTES

have come to signal a new approach to lending rate policy of the various players in the lending system.

## Development Banks

As the name suggests, development banks are development oriented. Development banks are specialised financial institutions which perform the twin functions of providing medium and long term finance to private entrepreneurs and of performing various promotional roles conducive to economic development. They are different from commercial banks in three ways:

They do not seek or accept deposits from the public

They specialise in providing medium and long-term finance (commercial banks specialise in providing short-term finance).

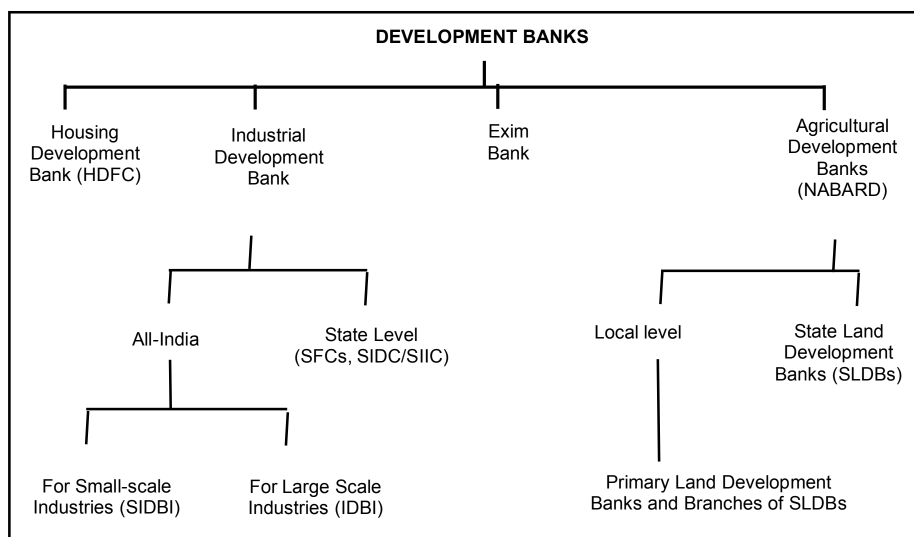
Their functions are confined to providing long-term finance.

The distinguishing role of development banks is the promotion of economic development by way of providing investment and enterprise in their chosen spheres (manufacturing, agriculture, *etc.*). The factors which led to the growth of development banks are the inability of the normal institutional structure to keep pace with the requirements of funds and entrepreneurship of the growing industrial sector.

1. Industrial development banks
2. EXIM (export-import) bank
3. Agricultural development banks (NABARD)
4. Housing Development banks

Except Land Development Banks (LDB) the rest are a post-independence phenomenon.The development banking institutions as a group have played a significant part in the economic development of India via the investment market and have emerged as the backbone of the financial system.

NOTES




*Development Banks*

## *12.24 INDUSTRY ASSISTANCE*

(a) term loans and advances

(b) subscription to shares and debentures

(c) underwriting of new issues

(d) guarantees for term loans and deferred payments

The first two forms place funds directly in the hands of companies as subscription to shares and debentures. The last two forms facilitate the raising of funds from other sources.

### Aggregative Role of Development Financing Institutions

Development Financing Institutions consist of Development Banks like the *IDBI, SIDBI, NABARD and the State Finance Corporations.* Three of the development financing institutions has exited from the market after the RBI announced its policy of harmonisation of the development and banking functions. They are: ICICI with a reverse merger with its offspring ICICI Bank Ltd., impending merger of IFCI with the Punjab National Bank, and the winding up of the IRBI due to its unsustainable nature. The IDBI is also slated for conversion to a Bank and the Parliament already gave its approval. The process is yet to commence.

*The role played by development banks is of two broad types.*

NOTES

## (A) Quantitative Role

This is the part played by development banks as a constituent of the industrial financing system in India and refers to the magnitude of funds provided by them jointly to industrial enterprises. The magnitude of industrial financing by these development banks has been considerable.

1. These banks have emerged as the single most important source of institutional finance to industry and have come to occupy a pre-eminent position in the institutional structure of the financial system. The annual average of sanctioned assistance by all the development banks during the three year period 1978-79 to 1980-81 touched an all time high of ₹ 1808 crores. At present, as much as one-third of the gross fixed capital formation in private industry is being contributed by development banks.
2. In India, their operations have the effect of improving the allocative efficiency of the financial system. The development banks perform the function of being a substitute for the capital market. When industrial enterprises are unable to raise funds from the normal channels, development banks fill the gap as well as restore or resuscitate the capital market.
3. As integral part of their lending operations, they thoroughly appraise projects as regards the priority aspect, financial viability and economic soundness and so on. The rigorous and exacting scrutiny by development banks tones up the quality of industrial projects and enables a more efficient use of available project resources.
4. Appraisal by the development banks is impersonal and objective. This results in financial assistance to diverse enterprises for a wide variety of purposes which would not otherwise have been possible. Included in this category are; new enterprises, small or medium-sized firms, enterprises in backward regions, and non-traditional industries.

## (B) Qualitative Role

Development banking in India has an overwhelmingly qualitative dimension too in terms of the recent orientation towards promotional or innovative functions in their operations. With the evolution of a meaningful strategy of industrial development, a more positive role has been assigned to, and it.being played by, development banks in India since

NOTES

1969-70. The essential elements of these are: (i) development of backward regions, (ii) encouragement to a new class of small entrepreneurs and enterprises, and (iii) rehabilitation of sick mills.

## Commercial Banks

Commercial banks are the single most important source of institutional credit in India.

There are two essential functions which make a financial institution a bank: (i) Acceptance of chequeable deposits from the public, and (ii) lending.

Acceptance of chequeable deposits is the most distinctive function or its unique function. Chequeable deposits have the following features;

- These are deposits of money and non-financial assets
- Deposits are accepted from public at large
- Deposits are repayable on demand and withdrawable by cheque

The second essential function related to the use of deposits (Lending includes direct lending to borrowers and indirect lending through investment in open market securities).

*Branches of Public Sector Banks and other Commercial Banks*

| | Bank Group | Branches (as on 30th June 2001) | 2013 |
|---|---|---|---|
| A. | State Bank of India & Associates | 13416 | 14000 |
| B. | Nationalised Banks | 32663 | 70421 |
| C. | Regional Rural Banks | 14452 | 17007 |
| | Total of Public Sector Banks (A+B+C) | 60531 | – |
| D. | Other Indian Scheduled Commercial Banks | 5206 | – |
| E. | Foreign Banks | 194 | 331 |
| | All Scheduled Banks | 65931 | – |
| F. | Non-scheduled Banks | 0 | – |
| | All Commercial Banks | 65931 | |

***Source:*** Economic Survey 2001-02.

NOTES

## 1. Indian Banks

The bulk of the banking business in India is done by the commercial banks owned and operated from India. Some Indian banks also operate in a few foreign countries. The Indian banks constitute both public and private sector banks.

### Public Sector Banks

They constitute the dominant part of commercial banking in India. The public sector banks constitute both nationalised commercial banks and Regional Rural Banks (RRBs). The public sector banks may also have some private by-owned shares.

(a) **Nationalised Banks:** In 1955, when the Imperial Bank of India became SBI. In addition, this bank has seven other state banks as its subsidiaries. By April 1980, 28 banks were nationalised in the public sector. Together they control more than 90 per cent of bank deposits.

(b) **Regional Rural Banks:** Regional Rural Banks are the newest form of banks that have been set up in the country on the sponsorship of individual nationalised commercial banks. These were set up with the express objective of developing the rural economy by providing credit and other facilities for agriculture and other productive activities of all kinds in rural areas. The paid up capital of a rural bank is ₹ 25 lakhs, 50 per cent of which is contributed by the Central Government, 15 per cent by the state government, and the remaining 35 per cent by the sponsoring commercial public sector bank.

(c) **Local Area Banks (LABs):** As a follow up of the Narasimham Committee Report - I, LABs were to be set up under Private or NGO initiative. It granted three licenses — one in Karnataka, and two in Andhra Pradesh in 2000. But their functional data is not available under separate head. It has become part of rural financial data.

## 2. Foreign Banks

These are banks which have been incorporated and have their head offices outside India. They occupy a place of importance in the Indian banking industry, especially in financing foreign trade and in the field of merchant banking.

NOTES

## 3. Co-operative Banks

Co-operative banks are so- called because they have been organised under the provisions of the co-operative societies law of the states. Under the law, co-operative societies may be organised for credit or for non-credit purposes. The co-operative banking system is much smaller than commercial banking. The major beneficiary of co-operative banking is the agriculture sector in particular and the rural sector in general. Despite several organisational weakness, village level primary cooperative credit societies are best suited to the socio-economic conditions of Indian villages.

*Deposits of Public Sector Banks and other Commercial Banks*
*(As at end March)*
*(₹ in crore)*

| Bank Group | 2002 | 2003 | 2011 |
|---|---|---|---|
| Public Sector Banks | 968623.57 | 1079393.81 | – |
| Nationalised Banks | 617550.78 | 688361.12 | – |
| State Bank Group | 351072.79 | 391032.69 | 1245862 |
| Private Sector Banks | 169432.92 | 207173.57 | – |

***Source:*** Report on Trend and Progress of Banking In India 2002-03.

The State Cooperative Banks (SCBs) and Central Cooperative Banks (CCBs) are also called the higher or central financing agencies (for the primary societies). At the apex are the SCBs. Primary Agricultural Credit Societies (PACS) lend to their individual borrowing members. An SCB does not lend directly to primary societies in areas where a CCB exists and the CCB lends only to primary societies and not to their members or other individuals (except in a few cases). This is in the interest of functional specialization, manageability and cost-effectiveness which is the rationale of the three-tier structure. The basic need for higher financing agencies arises because the PACS are not able to raise enough resources or funds by way of deposits from the public. In fact about 60 per cent of their working capital comes as loans from the CCBs who in turn borrow about from higher financing agencies.

Contrary to popular belief, the government is actually the net debtor to the co-operative banking system because:

A large part of the government's financial assistance (about 50 per cent) in the form of its contribution to the share capital of societies is advanced by NABARD.

NOTES

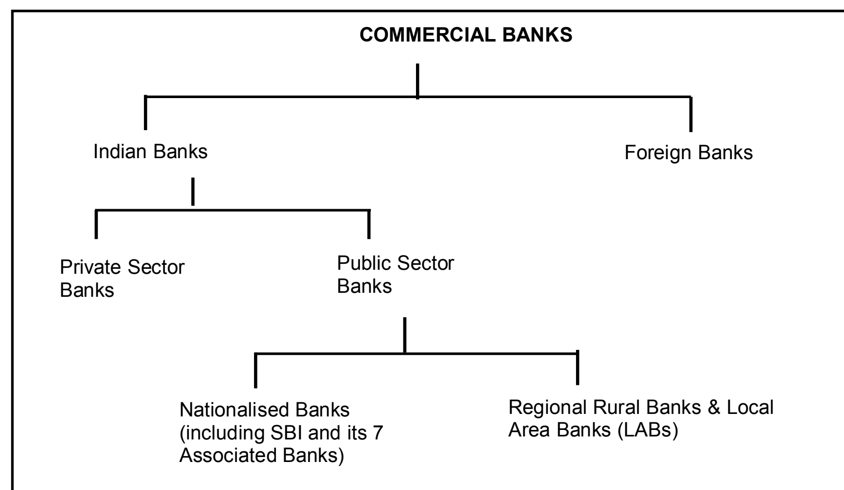
The cooperative banking system (including LDBs) provides funds to the government by way of investment in its securities. For SCBs and CCBs such investment is required by RBI under its SLR requirement. Hence, there is a net withdrawal of funds by the government from the co-operative banking system.

## 12.25 NON BANKING FINANCIAL INSTITUTION

There are four categories of non-banking financial institutions or investment institutions in India, viz.

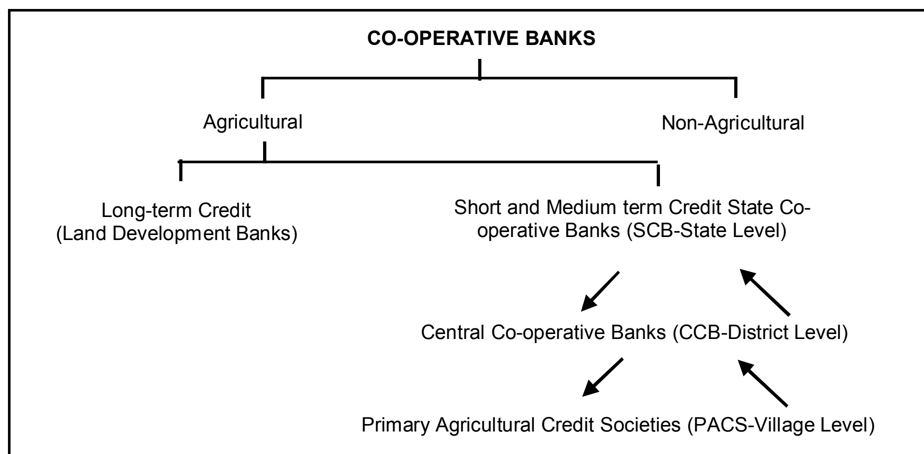
1. UTI (Unit Trust of India)
2. LIC (Life Insurance Corporation of India)
3. GIC (General Insurance Corporation of India)
4. Private Finance Companies.

The Reserve Bank of India (Amendment) Ordinance, 1997 confers wide-ranging powers on RBI for controlling the functioning of non-banking financial companies. The ordinance has defined an NBFC as a financial institution, which is a company, or a non-banking institution, and which has, as its principal business, the receiving of deposits under any scheme or arrangement or in any other manner, or lending in any manner. As per the ordinance, no NBFC can commence or carry on business (a) without obtaining from RBI a certificate of registration; and (b) having net owned funds of ₹ 50 lakhs or such other amount, not exceeding ₹ 200 lakhs, as RBI may specify. As the UTI, has now become a part of SEBI mutual fund discipline, its loan sanction and disbursement functions are being eliminated, as per SEBI guidelines relating to mutual funds.




*Commercial Banks*

NOTES




*Co-operative Banks*

## *12.26 SUMMARY OF THE UNIT*

Under the Ordinance of 1997 RBI provided powers to non-banking institutions such as UTT, LIC & GIC. Under the ordinance the business could not be carried out without certification from RBI.

## *12.27 GLOSSARY*

- **LDC:** Leas Developed Countries
- **Public Sector Units:** Units Controlled by Government
- **SEBI:** Securities and Exchange Board of India.

## *12.28 KEY TERMS*

- **Capital:** Funds required to start up business
- **Term Loans:** Finance required for Land, Buildings, Plant *etc*.
- **Modernisation:** Means upgradation of technology.

## *12.29 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill int the Blanks

1. RRB means__________Bank.
2. LAB means __________ Bank.

NOTES

3. Exim Bank regulates _______ and import.
4. NABARD is the development Bank for __________Sector.

### (B) True or False

1. RBI, the government banker provides credit only to the Central Government.
2. RBI gives credit to commercial banks without collateral.
3. RBI has no control over the deficit finance of the Government.

## *12.30 KEY TO CHECK YOUR ANSWER*

(a) 1. Regional Rural, 2. Local Area, 3. Export, 4. Agricultural.

(b) 1. False, 2. False, 3.True.

## *12.31 TERMINAL AND MODEL QUESTIONS*

1. Explain the funding by non-banking financial institutions. (Any one)
2. Explain briefly the four categories of investment institution in India.
3. What are the functions of RBI?

## *12.32 REFERENCE BOOKS*

1. Pramod Verna: 'Competitiveness of Indian Industry' - 'Wisdom', Delhi.
2. Ramgarajan: 'Indian Economy' - 'UBSPD', Delhi.

# UNIT 13 FOREIGN TRADE: THEORIES, ISSUES AND MODERN CONTEXT

**Structure:**

13.1 Introduction
13.2 India's Foreign Trade: Trends
13.3 India's Foreign Trade: Composition
13.4 India's Foreign Trade: Direction
13.5 Theory of International Trade
13.6 Some Implications of Traditional Trade Theory
13.7 Confrontation with Reality
13.8 Scale Economies
13.9 Product Differentiation
13.10 Oligopoly
13.11 Summary of the Unit
13.12 Glossary
13.13 Key Terms
13.14 Check Your Progress (Multiple Choice/Objective Type Questions)
13.15 Key to Check Your Answer
13.16 Terminal and Model Questions
13.17 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Know the components, trends and direction of foreign trade
- Know the theories of trading practices

NOTES

- Understand the product differentiation, scale of economics and their impact.

## *13.1 INTRODUCTION*

Our foreign trade dates back to the Indus Valley civilisation. Trade got impetus during British rule. To promote foreign trade, an organised effort was made after independence. As we know, international trade means trading of goods between countries. It helps in development of skills and entrepreneurship. This has profound impact on employment, technology and economy.

Foreign trade or international trade refers to the trading of goods between countries. Thus, international trade is an extension of internal trade *i.e.,* trade between two different regions within a country. Just like as single region within a country cannot produce everything it needs by itself, one single economy cannot produce every commodity all by itself. This could be due to differences in the availability of natural resources, skills of people, *etc*. Therefore, it would be advantageous for a country to indulge in trade with other countries, by exporting those commodities which it produces cheaper in exchange for what others can produce at a lower cost.

Foreign trade also facilitates the dissemination of technical knowledge, transmission of ideas, and import of know-how/skills, managerial talents and entrepreneurship. In addition, foreign trade encourages movement of foreign capital. In totality, foreign trade can have a profound impact on the growth of an economy in terms of production, employment, technology, resource utilisation and so on.

## *13.2 INDIA'S FOREIGN TRADE: TRENDS*

The origin of India's foreign trade can be traced back to the age of the Indus Valley civilisation. But the growth of foreign trade gained momentum during the British rule. During that period, India was a supplier of food stuffs and raw materials to England and an importer of manufactured goods. However, organised attempts to promote foreign trade were made only after Independence, particularly with the onset of economic planning. Indian economic planning completed five decades. During this period, the value, composition and direction of India's foreign trade have undergone significant changes.

NOTES

India's foreign trade has come a long way since 1950-51. The values of both exports and imports have increased several times over the period (Table). The value of exports rose from ₹ 606 crore in 1950-51 to ₹ 1,06,465 crore in 1995-96. The value of imports, during the same period, increased from ₹ 608 crore to ₹ 1,21,647 crore. With the exception pf 1971-72 and 1976-77, the value of India's imports has always been higher than that of exports.

| Year | Exports | Growth Rate | Imports | Growth Rate | Trade Balance |
|---|---|---|---|---|---|
| 1950-51 | 606 | | 608 | — | -2 |
| 1951-52 | 716 | 18.2 | 890 | 46.4 | -174 |
| 1952-53 | 578 | -19.3 | 702 | -21.1 | -124 |
| 1953-54 | 531 | -8.1 | 610 | -13.1 | -79 |
| 1954-55 | 593 | 11.7 | 700 | 14.8 | -107 |
| 1955-56 | 609 | 2.7 | 774 | 10.6 | -165 |
| 1956-57 | 605 | -0.7 | 841 | 8.7 | -236 |
| 1957-58 | 561 | -7.3 | 1035 | 23.1 | -474 |
| 1958-59 | 581 | 3.6 | 906 | -12.5 | -325 |
| 1959-60 | 640 | 10.2 | 961 | 6.1 | -321 |
| 1960-61 | 642 | 0.3 | 1122 | 16.8 | -4S0 |
| 1961-62 | 660 | 2.8 | 1090 | -2.9 | -430 |
| 1962-63 | 685 | 3.8 | 1131 | 3.8 | -446 |
| 1963-64 | 793 | 15.8 | 1223 | 8-.1 | -430 |
| 1964-65 | 816 | 2.9 | 1349 | 10.3 | -533 |
| 1965-66 | 810 | -0.7 | 1409 | 4.4 | -599 |
| 1966-67 | 1157 | 42.9 | 2078 | 47.5 | -921 |
| 1967-68 | 1199 | 3.6 | 2008 | -3.4 | -809 |
| 1968-69 | 135S | 13.3 | 1909 | -4.9 | -551 |
| 1969-70 | 1413 | 4.1 | 1582 | -17.1 | -169 |
| 1970-71 | 1535 | 8.6 | 1634 | 3.3 | -99 |
| 1971-72 | 1608 | 4.8 | 1825 | 11.7 | -217 |
| 1972-73 | 1971 | 22.6 | 1867 | 2.3 | 104 |
| 1973-74 | 2523. | 28.0 | 2955 | 58.3 | -432 |

NOTES

| | | | | | |
|---|---|---|---|---|---|
| 1974-75 | 3329 | 31.9 | 4519 | 52.9 | -1190 |
| 1975-76 | 4036 | 21.2 | 5265 | 16.5 | -1229 |
| 1976-77 | 5142 | 27.4 | 5074 | -3.6 | 68 |
| 1977-78 | 5408 | 5.2 | 6020 | 18.6 | -612 |
| 1978-79 | 5726 | 5.9 | 6811 | 13.1 | -1085 |
| 1979-80 | 6418 | 12.1 | 9143 | 34.2 | -2725 |
| 1980-81 | 6711 | 4.6 | 12549 | 37.3 | -5838 |
| 1981-82 | 7806 | 16.3 | 13608 | 8.4 | -5802 |
| 1982-83 | 8803 | 12.8 | 14293 | 5.0 | -5490 |
| 1983-84 | 9771 | 11.0 | 15831 | 10.8 | -6060 |
| 1984-85 | 11744 | 20.2 | 17134 | 8.2 | -5390 |
| 1985-86 | 10895 | -7.2 | 19658 | 14.7 | _ -8763 |
| 1986-87 | 12452 | 14.3 | 20096 | 2.2 | -7644 |
| 1987-88 | 15674 | 25.9 | 22244 | 10.7 | -6570 |
| 1988-89 | 20232 | 29.1 | 28235 | 26.9 | -8003 |
| 1989-90 | 27681 | 36.8 | 35416 | 25.4 | -7735 |
| 1990-91 | 32553 | 17.6 | 43193 | 22.0 | -10640 |
| 1991-92 | 44042 | 35.3 | 47851 | 10.8 | -3809 |
| 1992-93 | 53688 | 21.9 | 63375 | 32.4 | -9687 |
| 1993-94 | 69547 | 30.4 | 72806 | 15.7 | -3259 |
| 1994-95 | 82338 | 18.4 | 88705 | 21.8 | -6375 |
| 1995-96 | 106465 | 29.3 | 121647 | 37.1 | -15182 |
| 1996-97 | 118817 | 138920 | -20103 | 11.7 | 13.2 |
| 1997-98 | 130100 | 154176 | -24076 | 9.5 | 11.0 |
| 1998-99 | 139752 | 178332 | -38580 | 7.4 | 15.7 |
| 1999-2000 | 159561 | 215236 | -55675 | 14.2 | 20.7 |
| 2000-2001 | 203571 | 230873 | -27302 | 27.6 | 7.3 |
| 2001-2002 | 209018 | 245199 | -36181 | 2.7 | 6.2 |

***Source:*** Economic Survey, 1995-96 & 2002-03.

As a result, India has been a trade deficit country. Another aspect of India's foreign trade is the fluctuating growth rates of exports and imports. The growth rate for exports ranged from as low as - 19.3% in 1952-53 to

NOTES

42.9% in 1966-67. Similarly, the growth rate of imports varied from 21.1% in 1952-53 to 58.3% in 1973-74.

**Imports:** During 1950s, the value of trade increased only marginally. The value of exports, remained the same, more or less. But the value of imports, with certain fluctuations, increased by about 60% during the decade. The significant rise in imports was largely due to the increase in the quantum of imports of food grains, raw materials, capital equipments and machinery. The emphasis on heavy industries during the second Five Year Plan necessitated the imports of machinery and capital equipments which contributed to the increase in the value of imports.

The emphasis on heavy industries continued during the third Five Year Plan and the three Annual Plans. This resulted in increased imports of machinery and machine products. The bad weather conditions in the sixties led to more imports of food grains and agricultural raw materials. Added to these, the devaluation of the Indian rupee in 1966 further raised the value of imports. As a result, the value of imports rose by about 40% during 1960.

It was during the seventies that the value of imports went up sharply. This was largely due to the hike in the prices of petroleum and petroleum products effected by the Organisation of Petroleum Exporting Countries (OPEC) in 1973-74 and then in 19*79 and 1980. That is why the value of imports registered an increase of 58% in 1973-74, 53% in 1974-75, 34% in 1979-80, and 37% in 1980-81. During 1970-71 to 1979-80, the value of imports increased by more than 500%. In addition to the oil price hike, the general inflationary trends prevailing in the international market also contributed to the increase in the value of imports.

The increase in domestic production of crude oil in the eighties slowed down the increase in the value of imports, as the relative share of petroleum products in the country's import bill marked a decline. However, during the late eighties, partly due to an increase in the quantum of petroleum products imported and partly due to a rise in the international oil prices, the value of imports once again increased sharply. The 'Gulf crisis' in 1990 and the currency devaluation in 1991 further pushed up the country's import bill. On the whole, in the post Independence period, during the sixties and seventies, import of food items and capital goods contributed to the growth of imports. But since the eighties Petroleum products and capital goods determined the growth trends in the value of imports, to a large extent.

NOTES

However, the growth of imports in the nineties has been characteristically different from the earlier period, especially from the policy point of view. **In 1991, the Indian** Government initiated a major **import liberalisation programme as part of its what is now commonly known** as the **New Economic Policy. Import liberalisation consisted of gradual reduction** of import tariffs and **elimination of import** restrictions.

Major reductions in tarrifs have been introduced in the nineties. The import- weighted average tariff for the whole economy fell from 76.7% in 1990-91 to 40% in 1993-94, which further fell in 1994-95. The peak rate of tariff which was as high as 220% in 1991 has now been brought down to 65%.

Import licensing has been virtually scrapped for new materials, intermediate components and capital goods. These can now be freely imported subject to a "negative list" which is under constant review and has been substantially pruned in the nineties.

Due to these policy measures, the relative share of raw material, intermediate and capital goods imports went up particularly in 1993-94. However, due to slowdown in industrial growth, capital goods imports have declined in the first quarter of 1996-97. Another aspect of import growth during the current year is that due to (i) a fall in domestic crude oil production, (ii) a sharp rise in domestic demand and (iii) the recent spurt in world oil prices, imports of petroleum products are likely to push up the import bill in a big way.

**Exports:** Exports were more or less stagnant at around ₹ 600 crore during the fifties. The introduction of some export promotion measures led to the rise of exports in the sixties. Significant rise was seen in the exports of gems and jewellery, readymade garments and engineering goods. After the devaluation of 1966, exports of iron ore, leather and leather manufactures, chemical and allied products, *etc*. received a further boost. During 1960-61 to 1969-70, exports grew, on an average, by 10.2%.

It was in the 1970s, however, that exports grew significantly. On an average, exports grew by more than 19% during 1970-71 to 1979-80. A sizeable contribution, again came from gems and jewellery, readymade garments, engineering goods, chemicals, leather products, *etc*.

The high growth rate of India's exports in the 70s were mainly due the increase in the unit value index of exports o the increase in the quantum index of exports so new markets for India's exports in oil producing countries with the boom in oil prices increase in the price competitiveness

NOTES

of Indian exports as a result of a rise in the world prices of all commodities boom in the value of agro-based exports such as oil cakes, marine products and sugar; and increase in project exports to the Middle East countries.

During the 80s, particularly in the early 80s, the growth of exports slowed down. Exports grew by about 11% in the first half of eighties but the growth picked up later and exports grew by almost 27% in the second half of eighties. The sluggishness in export growth in the early eighties was mainly due to decline in demand for Indian exports abroad - adoption of protective measures by developed countries – fall in the value of the US dollar, among others.

The reorientation of the industrial and trade policy regime in the 1980s to release the supply side constraints was combined later in the decade with a more activist policy on the exchange rate so as to attain a steady depreciation in the real effective exchange rate. The improvement in productivity performance and the loosening of the tight import control regime created a better environment for exports. New incentives for exports, notably the exemption from tax of profits on export operations, also encouraged export growth. As a result, the growth of exports went up both in terms of value and volume.

In 1990-91, export growth once again declined but only marginally to about 18%. This deceleration in exports was attributed to:

1. A slow down in the expansion of world trade. The volume of world trade decelerated from 7.3% in 1989 to 4.2% in 1990 and further to 9% in 1991.
2. Loss of export markets in the Middle East due to the Gulf crisis.
3. Political and economic upheavals in Eastern Europe, which earlier provided a sheltered market to Indian exports.
4. Import curbs introduced during 1990-91 in response to foreign exchange shortage and intensified after the Gulf crisis, affecting export-related imports.
5. Movement in the exchange rate which was broadly supportive of exports since 1986-87 becoming adverse thus affecting competitiveness of exports; and
6. Internal law and order problems in some states.

The currency devaluation in 1991 and the subsequent liberalisation of export- import regime particularly full convertibility of rupee on current

NOTES

account have given a boost to the growth of exports. As a result, exports grew more significantly during the early '90s as compared to the earlier decades.

*Table13.1: Growth of Exports: 1960-61—2001-02*

| Year | Growth of Rate (%) |
|---|---|
| 1960-61 to 1969-70 | 10.2 |
| 1970-71 to 1979-80 | 19.3 |
| 1980-81 to 1989-90 | 14.9 |
| 1990-91 | 17.6 |
| 1991-92 | 35.3 |
| 1992-93 | 21.9 |
| 1993-94 | 30.4 |
| 1994-95 | 18.4 |
| 1995-96 | 29.3 |
| 1996-97 | 11.7 |
| 1997-98 | 9.5 |
| 1998-99 | 7.4 |
| 1999-00 | 14.2 |
| 2000-01 | 27.6 |
| 2001-02 | 2.7 |

***Source:*** 1. India: Towards Globalisation, UNIDO, 1995.
2. Economic & Political Weekly, September 28, 1996.
3. Economic Survey, 2002-03

However, the trends in foreign trade in April-August in 1996-97 have been discouraging as exports have only increased modestly. This was mainly due to a sharp fall in exports in July 1996 (2.66%) and in August 1996 (2.3%). During April-June 1996, exports grew at 26.7% which is quite comparable to the performances of the previous years. The rising cost of production, bottlenecks in ports and heavy rain in some regions are stated to be the factors responsible for the drop in export earnings in the months of July and August. With the easing of the latter two factors, export growth is likely to increase in the subsequent months.

NOTES

Thus, India's exports have grown considerably both in terms of value and volume, over a period of time. However, a significant indicator of India's export performance is India's share in world exports. Despite the significant growth, India's share in world exports was negligible and the relative share remained more or less at the same level. This is attributed to India's failure in improving its competitiveness in terms of price and quality in the international market.

*Table13.2: India's Share in World Exports*

| Year | Exports in World | US $ Million India | India's share in World Exports (%) |
|---|---|---|---|
| 1970 | 313706 | 2026 | 0.6 |
| 1975 | 875500 | 4355 | 0.5 |
| 1980 | 1989867 | 8378 | 0.4 |
| 1985 | 1932387 | 8750 | 0.5 |
| 1990 | 3137485 | 18178 | 0.6 |
| 1992 | 3218905 | 18145 | 0.6 |
| 1995 | 4946096 | 31117 | 0.6 |
| 1998 | 5091105 | 32700 | 0.6 |
| 1999 | 5522372 | 32639 | 0.6 |

**Source:** Economic Survey, 1995-96 & 2002-03.

## *13.3 INDIA'S FOREIGN TRADE: COMPOSITION*

The composition of foreign trade refers to the kinds of goods imported and exported by a country. It is essential to understand the composition of imports and exports as it reveals the economic status of a country. The changes that may occur in the composition of trade over a period of time reflect the economic transformation of a country.

In general, a developing country's imports comprise mainly heavy manufacturing goods like machinery, transport equipments, iron and steel, *etc*. whereas exports comprise mainly primary commodities like agricultural products, natural resources such as iron ore, and light manufactures consisting of textiles, leather products, processed foods *etc*. But in the process of industrialisation and economic development, the composition of trade undergoes a transformation. As a consequence, a

NOTES

developed country's imports would include mostly primary commodities and light manufactures and exports would consist mainly of heavy manufactured goods.

**Imports:** At the beginning of the 1950s, India's imports consisted mainly of food grains, machinery, transport equipment, iron and steel, petroleum and petroleum products, *etc*.

The announcement of the Industrial Policy Resolution, 1956 and the subsequent emphasis on the development of heavy and basic industries in the second five year plan had an impact on import composition. The policy of import substitution necessitated the setting up of a wide variety of industries to produce various manufactured goods such as machine-tools, sugar mill machinery, cement machinery, railway wagons, commercial vehicles, automobile tyres and tubes, *etc*. All these led to an increase in the import of capital goods and equipments in the late fifties.

The relatively underdeveloped agriculture and the demand-supply gap for good grains caused the import of food items, particularly cereals and cereal preparations. Food items accounted for about 15% of the Import bill in 1950-51. Since then food imports ranged between 15% and 17% for almost two decades. However, since the eighties, the relative share of food imports has declined considerably. This largely reflects the near self-sufficiency in food grains attained by India over the period.

A significant portion of India's imports comprised raw materials and intermediates. These accounted for ₹ 527 crore out of the total imports of ₹ 1,122 crore in 1960-61, thereby accounting for 47% of the value of imports. In 1970-71, raw materials and intermediates accounted for more than 50% of the value of imports. In 1980-81, their relative share peaked to about 78%. This was largely due to a rise in the quantum and prices of petroleum products. In 1985-86, the share of raw materials and intermediates relatively declined to 71%.

*Table13.3: Structure of India's Imports: 1960-61 — 2001-02 (% Share in value)*

| Major Items | | 1960-61 | 1970-71 | 1980-81 | 1990-91 | 1994-95 | 2000-01 | 2001-02 |
|---|---|---|---|---|---|---|---|---|
| I | Food and related items | 19.0 | 14.8 | 3.0 | N.A. | N.A. | 3.7 | 4.5 |
| II | Raw materials and Intermediate Manufactures of which: | 47.0 | 54.4 | 77.8 | N.A. | N.A. | N.A. | N.A. |
| (a) | Petroleum, oil and lubricants (POL) | 6.1 | 8.3 | 41.9 | 25.0 | 20.7 | 31.0 | 27.2 |

NOTES

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (b) | Fertilisers and chemical products | 7.8 | 13.2 | 11.9 | N.A. | N.A. | 8.2 | 8.9 |
| (c) | Pearls, precious and semi-precious stones | 0.1 | 1.5 | 3.3 | 8.7 | 5.7 | 9.6 | 9.0 |
| (d) | Iron and steel | 11.0 | 9.0 | 6.8 | 4.9 | 4.1 | 1.4 | 1.5 |
| (e) | Non-ferrous Metals | 4.2 | 7.3 | 3.8 | 2.6 | 3.3 | 1.1 | 1.3 |
| III | Capital Goods | 31.7 | 24.7 | 15.2 | 24.2 | 22.2 | 11.0 | 11.4 |
| IV | Other items (unclassified) | 2.3 | 6.1 | 4.0 | N.A. | N.A. | 20.1 | 22.2 |
| | Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

***Source:*** Economic Survey, 1995-96 & 2002-0-03

Of the raw materials and intermediates, (i) Petroleum, Oil and Lubricants (P.O.L) Fertilisers and chemical products (iii) Pearls, precious and semi-precious stones (iv) Iron and steel (v) Non-ferrous metals are the major items of imports. The very composition of raw material and intermediate imports has undergone a change since the fifties. In 1960-61, iron and steel and non-ferrous metals formed a significant part of the value of imports. However, their importance has declined steadily and gradually since then. POL formed about 1/8 of the value of imports in 1960-61. But their relative share has risen considerably both due to a consistent rise in the quantum imported and in the prices of petroleum products in the international market.

Since the late '80s, POL imports account for about quarter of the import bill of the country. The recent liberalisation measures introduced with respect to the automobile industry in the country will further push up the domestic demand for petroleum products. The scope for increased domestic production being limited, increased quantum of P.O.L. imports will become indispensable. As a result, the relative share of P.O.L. imports might go up further in the coming years.

The process of agricultural development necessitated a gradual increase in fertiliser imports. Chemical imports comprised mainly of chemical elements and compounds.

The import of pearls, precious and semi-precious stones is done mainly as a raw material for the gems and jewellery industry, which was/is a significant export item of India.

The capital goods imports comprise electrical and non-electrical machinery and transport equipments. The growing industrialisation has

NOTES

only led to increased demand for capital goods of various kinds. The policy of import substitution had little impact on the growth of capital goods imports. In fact, the industrial liberalisation of the nineties, has further pushed up these imports in the first half of nineties. However, there is a remarkable fall in the capital goods imports during April-June, 1996 which is attributed to a likely slow down in the industrial growth of the country'. On an average, capital goods have been accounting for about a quarter of the value of imports. Unless and until, India develops its own technology base, its capital goods import requirements will only go up in the future. Thus, P.O.L and capital goods, which together form about a half of the total imports would determine the future growth of India's imports.

Rise in non-POL imports in 2001-02 was contributed by higher imports of food and related items (mainly pulses, edible oil and spices), capital goods imports and imports of other intermediate goods. Imports under the fuel group, fertilizers and paper board, manufactures & newsprint, however, contracted in 2001-02. A significant feature of the performance in 2001-02 was the reversal in trend in imports of capital goods, which increased by 6.3% as against substantial declines in the preceding two years. Another highlight was the turnaround in export related imports that increased by 1.6% in 2001-02 as against a decline of 10.9% in 2000-01.

**Exports:** The structure of India's exports has undergone a considerable change since independence. Exports started growing considerably only since the sixties. India's exports are broadly classified under:

(i) agriculture and allied items which includes coffee, tea, oil cakes, tobacco, cashew kernels, spices, sugar, raw cotton, rice, fruits and vegetables, *etc*.

(ii) ores and minerals which include mica and iron ore, among others,

(iii) manufactured goods consisting of gems and jewellery, ready made garments, engineering goods, chemicals, leather products, jute manufactures, *etc*.

(iv) mineral fuels and lubricants (including coal); and

(v) others.

The major value of India's exports emanated from agricultural products on the one hand, and manufactured goods on the other. Among the agricultural items, tea was a prominent foreign exchange earner for the country. In 1960-61, tea exports earned about ₹ 124 crore out of the total

NOTES

exports revenue of ₹ 643 crore (thereby it accounted for about 20% of the total value of exports). However, the relative contribution of tea exports to total exports has come down gradually. In 1990-91, tea export contribution to total exports amounted to only 3.3%. Some of the major agricultural items whose exports have increased over the period, are cashew kernels, spices, rice, fish and fish preparation, tobacco, oil cakes and more recently, fruits and vegetables.

Though the export value of agriculture and allied products has consistently increased since the ’60s, their relative share in the total value of exports declined steadily. This could be broadly attributed to two factors:

Despite agricultural development (which has been confined to certain regions within the country) commercialisation of agriculture has not taken place on a significant scale. Subsistence farming, which largely, prevails in India constrains the scope for export growth.

Exports from the manufacturing sector have grown more significantly.

However, in the ’90s agricultural development has been gaining increased attention from the policy markers:

1. The Government of India has brought out an Agricultural Policy which lays more thrust on agricultural development and exports.
2. The food processing industry has been accorded a ‘sun rise industry’ status for its promotion, in order to prevent the wastage of fruits and vegetables due to lack of processing facilities and to promote exports of processed foods.
3. The export obligation of Export Oriented Units (EOUs) related to agriculture and allied products has been brought down to 50%. This enables these EOUs to sell the remaining 50% of the production in the domestic market thereby enabling them to settle down quickly.
4. Some of the state governments have taken policy decisions to enable food processing units to acquire agricultural land for cultivating the required raw materials for in house consumption.
5. Even ‘contract farming’ is encouraged to promote agriculture industry linkages.

All these are aimed at giving a new turn to agriculture development and exports in the nineties. However, the relative share of agriculture and allied items in total exports has declined further in the nineties. If the

NOTES

potential of Indian agriculture is harnessed appropriately, agriculture and allied items exports could be stepped up more significantly in the future.

The exports of manufactured goods have grown at a much faster rate than that of agriculture. As a result, the relative share of manufactured goods in the total value of exports has gone up steadily from 45% in 1960-61 to 78% in 1994-95. This reflects a positive outcome of India's industrial development.

Even within manufacturing exports, the composition has changed over the period. In 1960-61, jute manufactures was the most prominent manufactured item of exports (by contributing more than 46% of the total value of manufactured exports which amounted to 21% of the total value of exports). However, with the emergence of substitutes for jute goods in the international market and the decline of jute industry domestically, the share of jute goods in the total value of exports decreased continuously, In 1990-91, jute manufactures' exports accounted for hardly 1% of the total value of exports and in 1994-95 it declined further to 0.6%.

*Table 13.4: Structure of India's Imports : 1960-61 - 2001-02 (% Share in value)*

| Major Items | | 1960-61 | 1970-71 | 1980-81 | 1990-91 | 1994-95 | 2000-01 | 2001-02 |
|---|---|---|---|---|---|---|---|---|
| I | Agriculture and allied products | 44.2 | 31.7 | 30.7 | 19.4 | 16.6 | 13.5 | 13.4 |
| II | Ores and Minerals | 8.0 | 10.7 | 6.2 | 4.6 | 3.1 | 2.6 | 2.9 |
| III | Manufactured Goods | 45.3 | 50.3 | 55.8 | 72.9 | 78.2 | 78.0 | 76.1 |
| | - Gems & Jewellery | 0.1 | 2.8 | 9.6 - | 16.1 | 17.1 | 16.6 | 16.7 |
| | - Readymades | 0.1 | 1.9 | 8.4 | 12.3 | 12.5 | 12.5 | 11.4 |
| | - Engineering Goods | 2.0 | 12.0 | 13.0 | 11.9 | 13.2 | — | — |
| | - Chemicals | 1.1 | 2.3 | 3.5 | 6.5 | 9.2 | — | — |
| | - Leather Products | 3.0 | 4.7 | 5.0 | 8.0 | 6.1 | 3.8 | 3.7 |
| | - Jute manufactures | 21.0 | 12.3 | 4.9 | 0.9 | 0.6 | — | — |
| | - Other manufactures | 21.0 | 14.2 | 11.3 | 17.2 | — | — | — |
| IV | Minerals/Fuels and Lubricants | 1.1 | 0.8 | 0.4 | 2.9 | 2.0 | 2.6 | 2.9 |
| V | Others | 1.4 | 6.5 | 6.9 | 0.2 | 0.1 | 1.7 | 2.8 |
| | **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

***Source:*** Economic Survey, 1995-96 & 2002-03.

NOTES

The export of (1) readymade garments, (2) leather and leather products (3) gems and jewellery (4) engineering goods and (5) chemicals has increased gradually. In 1994-95, these five items together had a share of more than 58% of the total value of exports. In 1960-61, these same items contributed hardly 8% of the total value of exports.

The decline in value of exports in 2001-02 was spread across both the agricultural and manufactured commodity groups. Under manufactured goods, major exports like gems & jewellery, engineering goods, textiles including ready made garments, chemical and related products, leather and manufactures recorded sharp decelerations or even decline in exports. The decline in agricultural and allied exports (including plantation) in 2001-02 was mainly on account of lower exports of tobacco, marine products, spices and cashew nuts. While the decline in exports of tobacco and cashew nuts was due to lower volume of these exports, decline in unit value contributed to lower exports of spices and marine products.

The share, in total exports, of manufactured goods and agriculture and allied products declined from 78.0% and 13.5% respectively in 2000-01 to percent and 13.4% respectively in 2001-02. Correspondingly, share of exports of petroleum products and ores and minerals, in total exports, increased to 4.8% and 2.9% respectively during the year.

This brings out the fact that the export composition of India has grown more in terms of non-traditional items than traditional items. But non-traditional items are largely confined to light manufactures. The share of only light manufactures went up from year to year.' Thus, though the export composition got diversified in terms of faster growth of non-traditional items, these are largely confined to light manufactures. The near absence of heavy India's Foreign Trade manufactures in India's exports reflects the inadequate indigenous technology base for the development of heavy manufactured goods. Unlike industrialising countries like South Korea and Singapore, India's export composition has not yet started diversifying in the form of significant emergence of heavy manufactured goods and consumer durables.

## *13.4 INDIA'S FOREIGN TRADE: DIRECTION*

India's foreign trade relations cover the countries all around the world. To understand the regional direction of India's foreign trade and its progress, countries of the world are classified under five broad groups :

NOTES

1. Organisation for Economic Co-operation & Development (OECD) Countries which, in turn, comprise:
   (a) The European Economic Community (EEC):
   United Kingdom, Germany, France, Belgium, *etc*.
   (b) North America : Canada, USA
   (c) Asia and Oceania : Japan and Australia
2. Organisation of Petroleum Exporting Countries (OPEC)
3. Eastern Europe
4. Developing Countries
5. Others

**Imports:** Most of India's imports originate from the industrialised (OECD) countries (Table 13.5). In 1960-61, about four-fifths of the imports were from the OECD countries. Of these, the UK and the USA together accounted for as much as 50% of the total value of India's imports. However, since then, the relative importance of OECD countries in India's imports has declined to some extent (thought it has increased marginally in the 90s). This is reflected in the gradual fall in the share of UK and USA in the value of India imports.

In 1993-94, UK and USA together accounted for hardly 19% of the total value of imports. But countries like Belgium and Japan have become more important trading partners as far as India's imports are concerned. By and large, India imports capital goods, raw materials and intermediates from OECD countries.

India imports mainly Petroleum, Oil and Lubricants (P.O.L) from the OPEC. Both in terms of value and volume, POL had a minor presence in India's import structure in the 60s and 70s. OPEC accounted for hardly 5% of the value of imports in 1960-61 and hardly 8% in 1970-71. But thereafter, due to the sharp rise in oil prices as well as increase in the quantity of India's imports, the share of OPEC in the value of India's imports went up steeply. As a result, imports in 1980-81 from OPEC accounted for almost 28% of the import bill. The subsequent fall in international oil prices resulted in a relative fall but went up again as a result for the Gulf crisis in 1991.

*Table 13.5: Direction of India's Imports 1960-61 - 2001-02 (% Share in value)*

NOTES

| Countries | | 1960-61 | 1970-71 | 1980-SI | 1990-91 | 1995-96 | 1999-00 | 2000-01 | 2001-02 |
|---|---|---|---|---|---|---|---|---|---|
| I | OECD: | 78.0 | 63.7 | 45.7 | 54.0 | 52.4 | 43.0 | 39.9 | 40.1 |
| 1. | EEC: | 37.1 | 19.6 | 21.0 | 29.4 | 26.7 | 21.2 | 19.8 | 19.1 |
| | - Belgium | 1.4 | 0.7 | 2.4 | 6.3 | 4.6 | 7.4 | 5.7 | 5.4 |
| | - East Germany | 10.9 | 6.6 | 5.5 | 8.0 | 8.6 | 3.7 | 3.5 | 3.9 |
| | - UK | 19.4 | 7.8 | 5.8 | 6.7 | 5.2 | 5.5 | 6.3 | 5.0 |
| 2. | North America | 31.0 | 34.9 | 14.7 | 13.4 | 11.6 | 7.9 | 6.8 | 7.2 |
| | - USA | 29.2 | 27.7 | 12.9 | 12.1 | 10.5 | 7.2 | 6.0 | 6.1 |
| 3. | Asia & Oceania | 7.1 | 7.4 | 7.4 | 11.2 | 9.7 | 7.5 | 5.9 | 6.9 |
| | - Japan | 5.4 | 5.1 | 6.0 | 7.5 | 6.7 | 5.1 | 3.6 | 4.2 |
| II | OPEC: | 4.6 | 7.7 | 27.8 . | 16.3 | 20.9 | 22.5 | 5.4 | 5.8 |
| III | Eastern Europe | 3.4 | 13.5 | 10.3 | 7.S | 3.4 | 1.6 | 1.3 | 1.4 |
| | - USSR | 1.4 | 6.5 | 8.1 | 5.9 | 2.3 | 1.3 | 1.0 | 1.0 |
| IV | Developin g Countries | 11.7 | 14.6 | 15.7 | 18.4 | 18.3 | 20.7 | 17.5 | 19.1 |
| | - Asia | 5.7 | 3.3 | 11.4 | 14.0 | 14.4 | 15.7 | 14.4 | 15.3 |
| V | Others | 2.2 | 0.5 | 0.5 | 3.5 | 5.0 | 12.2 | 35.9 | 33.6 |
| | Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

***Source:*** 1. India: Towards Globalisation, IINIDO, 1995. 2. Economic Survey, 2002-03.

The growing domestic demand for P.O.L and increasing oil prices in the international market will make OPEC all the more important in terms of India's imports in the future.

Eastern Europe, particularly, the former USSR was a significant source of India's imports for nearly two decades: mid-sixties to mid-eighties. The main items of imports from these countries were iron and steel, non-ferrous metals, chemicals, capital equipment, pharmaceuticals and petroleum products. However, with the transformation of the economic system of East-European countries and the disintegration of the USSR, imports from Eastern Europe declined drastically.

The regional shares in sourcing of imports in 2001-02 reveal enhanced shares from all the major regions, with a corresponding reduction in share of residual category. This was contributed by an increase in imports from OECD, OPEC Eastern Europe and from other developing countries.

NOTES

A significant development in the direction of India's imports is with reference to developing countries, particularly Asia. The imports generated from Asian countries have increased significantly since the '80s. This could be attributed to (i) rapid economic development of many Asian countries, specially South East Asian-countries and (ii) greater trade co-operation among the members of SAARC (South Asian Association for Regional Co-operation).

On the whole, India has experienced increasing regional diversification in the process of the growth of imports.

**Exports:** A major share of India's exports goes to industrialised (OECD) countries. In 1960-61, more than 66% of the value of exports were absorbed by OECD countries. But the relative share of OECD countries in India's exports declined in 1970-71 and again in 1980-81.

Thereafter, the share has increased again. In the '90s, the exports to OECD countries stood at around 57%. Within the OECD countries, UK and USA were the major destinations for India's exports, which accounted for as much as 43% of the value of exports in 1960-61. However, the pre-eminent position of these two countries, particularly the UK has declined considerably since then. Of course, in the nineties, the USA is emerging as a major trade partner in terms of India's export destination. In 1990-91, exports to the USA accounted for almost 15% of the value of exports.

*Table 13.6: Direction of India's Exports 1960-61 - 2001-02 (% Share in value)*

| | Countries | 1960-61 | 1970-71 | 1980-81 | 1990-91 | 1995-96 | 1999-00 | 2000-01 | 2001-02 |
|---|---|---|---|---|---|---|---|---|---|
| I | OECD: | 66.2 | 50.1 | 46.6 | 53.5 | 55.7 | 57.3 | 52.7 | 49.3 |
| 1. | EEC: | 36.2 | 18.4 | 21.6 | 27.5 | 26.5 | 24.7 | 22.7 | 21.8 |
| | - Belgium | 0.8 | 1.3 | 2.2 | 3.9 | 3.5 | 3.7 | 3.3 | 3.2 |
| | - East Germany | 3.1 | 2.1 | 5.7 | 7.8 | 6.2 | 4.7 | 4.3 | 4.1 |
| | - UK | 26.9 | 11.1 | 5.9 | 6.5 | 6.3 | 5.5 | 5.2 | 4.9 |
| 2. | North America | 18.7 | 15.2 | 12.0 | 15.6 | 18.3 | 24.4 | 22.4 | 20.8 |
| | - USA | 16.0 | 13.5 | 11.1 | 14.7 | 17.4 | 22.8 | 20.9 | 19.4 |
| 3. | Asia & Oceania | 10.1 | 15.2 | 10.6 | 10.4 | 8.3 | 5.8 | 5.1 | 4.5 |
| | - Japan | 5.5 | 13.3 | 8.9 | 9.3 | 7.0 | 4.6 | 4.0 | 3.4 |
| II | OPEC: | 4.0 | 6.4 | 11.1 | 5.6 | 9.7 | 10.6 | 10.9 | 12.0 |
| III | Eastern Europe | 7.0 | 21.0 | 22.1 | 17.9 | 3.8 | 3.1 | 2.4 | 2.3 |

NOTES

| | - USSR | 4.5 | 13.7 | 18.3 | 16.1 | 3.3 | 2.6 | 2.0 | 1.8 |
|---|---|---|---|---|---|---|---|---|---|
| IV | Developin g Countries | 14.8 | 19.9 | 19.2 | 16.8 | 25.7 | 25.6 | 26.7 | 28.0 |
| | - Asia | 7.0 | 10.8 | 13.4 | 14.3 | 21.3 | 20.9 | 21.4 | 22.4 |
| V | Others | 8.0 | 2.6 | 1.0 | 6.2 | 5.1 | 3.4 | 7.3 | 8.4 |
| | Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

***Source:*** 1. India: Towards Globalisation, IINIDO, 1995. 2. Economic Survey, 2002-03.

Today, India's exports within OECD are not confined to only UK and USA but more evenly spread among other countries such as Belgium, France, Germany, Japan, the Netherlands, *etc*. This implies that India's export penetration has been diversified among the OECD countries over the period.

The share of OPEC in India's exports has always been minimum and showed no definite trends over time.

India's export trade with Eastern Europe like that of imports peaked during the '70s and '80s. But since then, due to the factors described earlier, exports to the region have declined rapidly.

Direction of exports over the 1990s show greater consistency in our exports to Organisation for Economic Cooperation and Development (OECD) countries, including the European Union (EU) region and larger fluctuations/dispersal to areas like the Organisation of Petroleum Exporting Countries (OPEC), Eastern Europe and other developing countries. In 2001-02, exports to OECD countries declined due mainly to lower exports to major countries like USA, Japan, Canada, UK., Germany, France and Belgium. Decline in exports to Eastern Europe was due to lower exports to Russia. The rise in exports to OPEC region was mostly contributed by higher exports to Nigeria, Indonesia and Iraq. Overall, while the OECD countries' and Eastern Europe region share in total exports declined to 49.3% and 2.3% respectively, the shares, in total exports, increased to 12.0% for OPEC region and 28.0% for other developing countries in 2001-02.

A significant development in the direction of India's exports, is the emergence of Asian Countries as the major buyers. Since 1960-61, the share of Asian Countries in India's exports has steadily gone up. The growing economic prosperity in South East Asia and greater trade Co-operation among Asian Countries, particularly South Asian countries, may have contributed largely to this development.

The destination of India's exports and imports has some important implications:

- Despite relative decline in importance, OECD countries are the major destination for Indian exports and major source of imports.
- Among the OECD countries, the USA has emerged as the leading trade partner of India.
- The importance of developing countries, particularly Asian countries as trade partners is growing gradually.

NOTES

- The trade relations with East European countries including Russia have declined drastically since 1990-91.
- Due to P.O.L. imports, the OPEC is an indispensable trade partner but its importance in terms of trade exports is not too significant.
- India's trade relations with South American and African countries are negligible.

## *13.5 THEORY OF INTERNATIONAL TRADE*

Traditional trade theory was well settled and accepted.

However the implications of traditional trade theory were found to be at odds with data.

A lot of data did not seem to fit traditional trade theories gave rise to the new trade theory.

### Fundamental Ideas of Traditional Trade Theory

### Comparative Advantage and Gains from Trade

Comparative advantage is one of the most fundamental ideas in trade theory.

A country has comparative advantage in a good if has a lower opportunity cost of producing the good than another country.

Countries are expected to export goods for which their autarky (no trade) relative prices are lower than other countries.

Countries gain from trade when they have different autarky relative prices of goods.

### Hecksher-Ohlin Theory(H.O)

One of the reasons why a country might have comparative advantage in a good is that countries differ in their factor endowments.

There are two factors capital and labor.

The home country is the capital abundant one, the one with more capital per unit of labor.

One of the goods is more capital intensive than the other: it uses more capital per unit of labor than the other good.

NOTES

Countries have access to same technologies–factor endowments only difference between countries.

Under free trade, the capital abundant country (home) is expected to produce relatively more of the capital intensive good than the other country.

Capital abundant country (home) therefore, is expected to export the capital intensive good if no strong bias in consumption.

Owners of capital in the capital abundant country (home) benefit due to seeing their rents rise relative to prices of goods, while owners of labour (home workers) suffer due to seeing their wage fall relative to prices of goods.

As long as capital endowments in the two countries are not too different and which good is capital intensive is the same in both countries, the wage and rent will be the same across countries under free trade with no transport costs.

## 13.6 SOME IMPLICATIONS OF TRADITIONAL TRADE THEORY

1. Trade should be greatest between countries with the greatest differences between them.
2. Gains from trade should be greatest between countries with the greatest differences.
3. Trade should cause countries to specialise more in production and to export goods distinctly different from what they import.
4. Countries should export goods that make relatively intensive use of their relatively abundant factors.
5. Factor prices should be more similar between countries with more liberal trade policies between them.
6. Free trade should equalise factor prices being countries with similar enough relative factor endowments but not between countries with very different factor endowments. Countries with similar enough factor endowments to have equal factor prices under free trade should use similar techniques and produce similar goods.

NOTES

7. Domestic interest groups should be identified by factors rather than industries.
8. International investment should be stimulated by differences in factor endowments.
9. International trade and international investment should be negatively correlated.
10. Trade policy should take the form of trade restrictions rather than trade stimulants.

## 13.7 CONFRONTATION WITH REALITY

According to traditional trade theory, one might think that United States should trade more with Mexico than with Canada because we have greater factor endowment and technology differences with Mexico than Canada. But most trade is between countries at similar stages of development countries with similar factor endowments and similar technologies.

These developed countries also are the ones who seem to gain the most from international trade. Average tariffs are highest in developing countries.

What developed countries trade with each other look very similar, there are not substantial differences in the factor composition of a developed country's imports and exports with another developed country. There is a cleares factor endowment basis for trade between developed and developing countries.

While factor prices are not equalised across countries, do not observe free trade yet in the world. Factor prices do become closer to being equalised as trade is liberalised. The convergence of factor prices appears to be greatest for countries with the most similar factor endowments. Predictions regarding factor price equalisation fairly well supported by the data.

Objections to trade liberalization appear to be aligned according to industry affiliation and not according to factor identities (capital vs labor).

Traditional trade theory suggests international investments should flow from capital abundant countries to capital scarce countries. While there is some foreign direct investment (FDI) from developed countries to developing countries and that share is growing, the bulk of FDI still occurs from one developed country to another and back again. Similar to trade in goods, international investment occurs primarily between similar

NOTES

developed countries and among similar goods such that factor endowments do not appear to be major motive for FDI among developed countries.

## *13.8 SCALE ECONOMIES*

HO Theory would predict little gains from trade between similar countries, yet these countries seem to have prospered due to their openness.

Need other models of gains from specialisation, where countries are able to produce more at lower cost through international trade.

Scale economies provide a basis for trade logically independent of (pre-existing) comparative advantage.

## *13.9 PRODUCT DIFFERENTIATION*

Each variety of a good is produced by a single firm operating under monopolistic competition.

Vertically differentiated products (quality) have all consumers agree on what brand is best; horizontally differentiated products (variety) have consumers disagree on what brand is best.

Ideal variety approach equivalent to having consumers love variety for its own sake.

Even if national IRS, product differentiation is sufficient to ensure that no country loses from international trade (and so Graham case requires homogeneous goods).

## *13.10 OLIGOPOLY*

Suppose each country has a single monopolist in autarky economically independent and countries identical. Duopoly two suppliers when trade opened.

In Cournot-Nash, firms choose quantity and total quantity increases with increased competition. Free trade price below both autarky prices.

Can have gains from trade even though no trade actually occurs; gains are from potential competition.

If firms choose quantity for each market get two-way trade.

If impose transport costs, get wasteful two-way trade of identical products.

NOTES

Interesting welfare conclusions because oligopoly profits contribute to national income. Assume all output sold to a third country to eliminate consumer surplus effects in welfare.

If government can credibly commit to subsidising, exports can increase profits.

Explains why trade policy might take form of promotion rather than restriction.

Uncertainty over correct policy limits usefulness in practice.

As number of domestic firms increases, optimal policy shifts from subsidy to tax; also if firms choose price instead of quantity, optimal policy becomes a tax.

A common resource available in fixed supply limits profit shifting ability of export subsidies for symmetric firms.

## *13.11 SUMMARY OF THE UNIT*

India's foreign trade has grown remarkably, both in terms of value and quantity, since the beginning of economic planning. The policy of industrial and trade liberalisation introduced in 1991 has given a new turn to the growth of both imports and exports. However, imports have always exceeded exports which means that India has become a perennially trade deficit country.

India's imports mainly comprise capital goods like machinery and equipments, raw materials and intermediates like P.O.L., iron and steel, non-ferrous metals, precious stones, *etc*. Thus, India's imports are crucial in nature for the functioning of the economy. India's export composition has transformed with the faster growth of manufactured goods and the relative decline of agricultural and allied products. But, manufactured exports are largely confined to light manufactures. India's imports as well as exports have also undergone diversification in terms of destination.

As a result of all these, the share of foreign trade in India's Gross National Product (GNP) has been increasing steadily. But it is still lower than that of East Asian and Latin American countries. The share of foreign trade in GNP in India accounted for 17% in 1992 whereas it was 54% in South Korea, 36% in China and 23% in Mexico. Further, the share of India's exports in world exports has been negligible which is the outcome of the lack of competitiveness of Indian goods in the international market.

NOTES

All these show clearly that, despite remarkable growth, India has to go a long way in:

- attaining economic self-sufficiency in the form of paying for imports through exports
- improving the competitiveness of its goods in terms of price and quality to increasingly penetrate the world market
- diversification of exports, specially in terms of heavy manufactures orealising foreign trade as a major sector of the economy in terms of GNP.

Every country has its trade policy to protect their own products. It also restricts imports. Indian Trade development had to face stiff competition and it was difficult to protect domestic trade, consequently our import increased. With the economic reforms of 1991 our trade has grown and the Gross National Product (G.N.P) has increased.

## *13.12 GLOSSARY*

- **OECD:** Organisation of Economic Cooperation and Development.
- **Foreign Collaboration:** It is an agreement between two or more companies from different countries.
- **Free Trade Area:** Countries come together and remove duties among themselves while maintaining them with outsiders.

## *13.13 KEY TERMS*

**(i) Balance of Trade** (or trade balance) Refers to the difference between the values of exports and imports. If the value of exports is more than the value of imports, the trade balance is said to be positive or favourable. If the value of imports is more than the value of exports, the trade balance is said to be unfavourable or negative.

**(ii) Negative List** Refers to list of items whose imports are totally banned.

**(iii) Trade Deficit:** When a country imports more than it exports, the resulting negative number is called a trade deficit.

NOTES

**(vi) Import substitution:** It means replacing foreign imports with domestic production.

## 13.14 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)

### (A) Fill in the Blanks

1. __________sector contributes more than 50% of India's national Income.
2. EPCG means Export Promotion Capital _________.

### (B) True or False

1. Removal of Q.R's means duty free imports.
2. W.T.O stands for World Trade Officer.
3. Export can be direct or indirect.
4. There are no new technologies in Globalisation.

## 13.15 KEY TO CHECK YOUR ANSWER

(A) 1. Service, 2. Goods

(B) 1. False, 2. False, 3. True, 4. False

## 13.16 TERMINAL AND MODEL QUESTIONS

1. Explain the salient features of trade policy 1991.
2. What do you understand by QR's?(Quantitative Restrictions)
3. What were the impediments for the trade growth in India?

## 13.17 REFERENCE BOOKS

1. Frances Cherunilam: International Trade, H.P.H. Mumbai.
2. Singh R.K: Economic Reforms - Abhijeet, Delhi.

# UNIT 14 FOREIGN DIRECT INVESTMENT AND FOREIGN INSTITUTIONAL INVESTORS

## Structure:

14.1 FDI – Introduction

14.2 Foreign Direct Investment (FDI) in Multi-brand Retail Sector

14.3 Foreign Direct Investment

14.4 FDI Policy

14.5 Industrial Credit

14.6 Industrial Relations

14.7 The Securities and Exchange Board of India Act of 1992

14.8 Foreign Institutional Investors (FII)

14.9 Summary of the Unit

14.10 Glossary

14.11 Key Terms

14.12 Check Your Progress (Multiple Choice/Objective Type Questions)

14.13 Key to Check Your Answer

14.14 Terminal and Model Questions

14.15 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Understand policies, objectives, and procedures of F.D.I.
- Understand the impact of FDI on development and growth.

NOTES

## *14.1 FDI – INTRODUCTION*

FDI is Foreign Direct Investment and it refers to investment in real assets by foreign enterprises. After independence we decided on an economic model that was required at that time with the New Economic Policy it was possible for the foreign institutional Investors to invest. There were no restrictions on the volume of investment and there was no lock-in period.

Foreign Direct Investment refers to investment in real assets like factories, sales offices, distribution channels *etc.* by foreign enterprises. Equity investment exceeding 10% of stake in a company by a foreign investor with long-lasting interest is also known as FDI. [As per US Dept, of Commerce definition]

The economic model followed by India after independence relied on import substitution and selective foreign capital inflow, both through portfolio investment and the Foreign Direct Investment (FDI) route. This changed radically with the liberalisation measures announced in 1991.

Both portfolio and FDI were not only allowed but also actively encouraged. The Foreign Investment Promotion Board (FIPB) was created to approve FDI proposals. Similarly, the Reserve Bank of India gives automatic approvals for foreign direct investment in industries, particularly in the infrastructure sector.

During the 1990s, the ‘ceilings’ on FDI in different sectors were progressively raised and presently, 100% foreign investments is allowed in several industrial sectors.

### Modes of Foreign Direct Investment

FDI can enter India through two channels:

- The automatic route under which companies receiving Foreign Direct Investment need to inform the Reserve Bank of India within 30 days of receipt of funds and issuance of shares to the foreign investor.
- For sectors that are not covered under the automatic route, prior approval is needed from the Foreign Investment Promotion Board (FIPB).

NOTES

**FDI Ceiling** on Various Sectors According to the FIPB Regulations (per cent)

| | |
|---|---|
| Automobiles | 100 |
| Telecom | 72 |
| Electricity generation, transmission and distribution (except nuclear power) | 100 |
| Roads and Highways | 100 |
| Ports and Harbors | 100 |
| Civil Aviation (in Greenfield airport ventures) | 100 |

Multilateral agencies such as the World Bank, the Department for International Development (DFID), Japan Bank for International Cooperation (JBIC) and Asian Development Bank (ADB) have financed projects in India across infrastructure sectors such as power, roads and highways, telecom and irrigation.

***Source:*** Compiled from the Economic Survey, Ministry of Finance, Government of India, 2004, 2005 & 2007 issues.

## China and India–What Explains their Different FDI Performance?

It is important to understand the reasons why China has been so successful in obtaining FDI.

Even today, FDI is estimated to account for less than 10% of India's manufacturing exports. For China, the lion's share of FDI inflows are to a broad range of manufacturing industries. Meanwhile, for India, services, electronics and electrical equipment and engineering and computer industries get a major share of the FDI.

China's total and per capita GDP are higher, making it more attractive for market seeking FDI. Reasons for high FDI in China:

- Higher literacy and education rates suggest that its labour is more skilled, making it more attractive to efficiency-seeking investors.
- China also has large natural resource endowments.
- China's physical infrastructure is more competitive, particularly in the coastal areas.
- China has more "business-oriented" and FDI-friendly policies than India.

NOTES

- China's FDI procedures are easier, and decisions can be taken rapidly.
- China has more flexible labour laws, a better labour climate and better entry and exit procedures for business. China opened its doors to FDI in 1979 and has been progressively liberalising its investment regime. India allowed FDI in 1980s in some sectors, but did not take comprehensive steps towards liberalisation till 1991.

However, India may have an advantage over China in technical manpower, particularly in information technology. It also has better English language skills.

The two countries focused on different types of FDI and pursued different strategies for industrial development. For long, India followed an import-substitution policy and relied on domestic resource mobilisation and domestic firms encouraging FDI only in higher technology activities.

Some of the differences in competitive advantages of the two countries are illustrated by the composition of their inward FDI flows.

| Country | FDI flows in following (Major areas): |
|---|---|
| China | Information & communication technology, hardware design and manufacturing by such companies as Acer, Ericsson, General Electric, Hitachi Semiconductors, Hyundai Electronics, Intel, LG Electronics, Microsoft, Mitac International Corporation, Motorola, NEC, Nokia, Philips, Samsung Electronics, Sony, Taiwan Semiconductor Manufacturing, Toshiba and other major electronics TNCs India IT services, call centres, business back-office operations and R&D |

***Source:*** Compiled from the annual reports of Reserve Bank of India and People Bank of China.

China's accession to the WTO in 2001 has led to the introduction of more favourable FDI measures. With further liberalisation in the services sector, China's investment environment may be further enhanced. For instance, China has allowed 100% foreign equity ownership in such industries as leasing, storage and warehousing and wholesale and retail trade, advertising and multi model transport services.

Is is important to note that the heavy FDI inflows to China are not 100% true. China's ability to attract phenomenal amount of foreign investment is

NOTES

a puzzle for many. "About 40% of China's FDI represents its domestic savings, recycled as foreign investment, via Hong Kong, to take advantage of economic incentives, popularly called 'round trapping'. Another 25% or so seems to represent investment in real estate by overseas Chinese. This is potentially problematic, as such investment could easily give rise to property bubbles. Thus, the quantum of foreign investment from advanced economies, that could improve domestic production capability, is perhaps not very different from that in India, in relation to its domestic output". [Nagraj R, 2006—'Foreign Direct Investment in India—Trends & Issues' (Eds, Raj Kapila & Raj Uma, Economic Developments in India, Vol 100, Page 326)].

### Future Outlook

India's rising growth process requires rapidly expanding infrastructure facilities to support it.

The government realises the fact that domestic resources alone may not be adequate to sustain the required expansion in infrastructure. Thus, it has followed a strategy to create incentives for Foreign Direct Investment. India, today, has an extremely liberal regime for FDI in terms of entry norms. International experience shows that there can be a number of other barriers for those willing to invest in infrastructure projects. The government has taken systematic initiatives to address these problems largely through comprehensive reforms in sectors like power and telecommunications. The combination of domestic private foreign investment and multilateral investments is likely to propel India's economic growth momentum in future.

## *14.2 FOREIGN DIRECT INVESTMENT (FDI) IN MULTI-BRAND RETAIL SECTOR*

### Introduction

In a significant, decision on Nov. 24, 2011, the Central Government gave approval to the proposal to allow 51% foreign direct investment FDI in multibrand retail as well as 100% FDI in single brand retail. The decision was hailed as a big reform measure adopted by the Government which will benefit both consumers and farmers. It was pointed out that this would lead to the creation of supply chains, logistic support, storage facilities, and cut middlemen to ensure better prices for farmers' products and cheaper goods for the consumers and generate for employment for 10

NOTES

million persons in three years. It will bring not only foreign capital so badly needed for the growth of the Indian economy but also superior technology and better managerial techniques.

At present 100% FDI is permitted under the automatic route for wholesale trade subject to certain end-sale limitations and restrictions while in single brand retail it is permitted up to 51% with government approval. But due to stiff opposition by the opposition parties FDI is multi-brand retail was not permitted for it is feared that it would hit small shopkeepers and neighbour stores. In March 2010, the Central Government came out with a blue print for discussion describing the merits of throwing open the multi-brand retail trading to foreign direct investment (FDI). The policy of allowing FDI in multi-brand retail trade will permit global giants such as Wall-Mart, Tesco and Carrefour to set up huge market stores in India with back-end infrastructure. It is contended that FDI in multi-brand retail trading will help both farmers and consumers. Government proposal provides for safety clauses and appointment of a regulator to protect various interests.

The government decision regarding entry of FDI in retail comes with certain conditions to address the fears of small traders that the global giants setting up big stores selling multi-brand products would drive them out of business and render them unemployed. These conditions are stated below:

1. Minimum investment by the big global retailers setting up stores in India should be $ 100 million.
2. 50% of the investment by multibrand retail giants must be in back-end infrastructure such as cold chains, storage facilities (*i.e.* ware housing), logistic support and transportation.
3. At least 30% of goods purchased for sale in these multi-brand stores must be sourced from small-scale and medium enterprises (SME).
4. These giant multi-brand retail stores can only be opened in cities with at least 10 lakh population. India has about 43 such cities. The Government will have the first right of procurement of agricultural produce.
5. Since retail trade is a state subject, the different states are free to allow or not for the opening up retail shops by these international retail giants.

NOTES

Against the opening up of multi-brand to foreign investment (FDI) it is pointed out that it would adversely affect the large unorganised sector which will not stand up to the competition of FDI in this sector.

The government proposal contains enacting a law called Multi Regulation Act to protect small retailers and setting up a centrally administered agency to monitor compliance with the rules. It is mentioned that despite without any restrictions at present only 5% of the nearly $ 500 billion or about ₹ 23 lakh crore of retail trade is in the organised sector.

## Case for FDI in Multi-brand Retail

The inter-ministerial committee headed by chief economic advisor favoured the opening up of multi-brand retail trade on the ground that it will help to fight inflation, especially food inflation. Today it is estimated that about 40% of all farm products get rotten by the time they reach the final point of sale. Apart from the enormous waste that this generates, it creates upward pressure on food prices, hitting consumers hard with no benefit to the farmers. The lack of organised storage and transport chains is the main culprit behind these losses. To quote the DIPP paper "there is the need to address issues relating to the farmers through removal of structural inefficiencies, as also to improve post-harvest management that requires investment in back end logistics and storage infrastructure. A week supply chain result in large-scale wastage and more often than not, the ultimate consumer pays a lot more than what reaches the farmer. It is important to provide for steadier incomes to farmers either through direct marketing or contract farming programmes. Further, allowing FDI on this multi-brand retail sector will not only bring financial capital into the Indian economy, it will also bring in new technologies for storage and transport".

The DIPP paper further mentioned that to ensure the advantages of opening up of the multi-brand retail trade to FDI, the government could make 50% total FDI for multi-brand retail mandatory to be invested in creation of back-end infrastructure and reserve half of all in the retail sector for rural youth. Besides, this will help in boosting investment in warehouses and cold chains to cut wastes of agricultural products. Foreign investment in multi-brand retail will eliminate high margins of middlemen that will not only benefit farmers but ensure lower prices to the consumers. Thus from the perspective of consumers there is urgent need to check food inflation and control the demand -supply imbalances.

NOTES

The retail sector needs large-scale investments. A substantial portion of these investments are expected from private enterprises, hence, it is imperative to make it financially worthwhile for them. It has long been argued that the entry of foreign retailers through joint ventures would help develop backward linkages to sources of supply and thus develop a domestic supply chain of international standards. Eventually, this would improve productivity benefiting the farmer, and the competition may eventually help bring down prices for consumers. The government believes that permitting FDI in the sector will also help bring in technical and management know how which is in India's long-term interest.

Addressing people's concern about opening up the multi-brand retail sector to foreign direct investment the department of Industrial Policy and promotion or DIPP moved its amended proposals for approval by the cabinet in this regard. In its 24 November 2011 decision the cabinet approved these proposals. According to these proposals 51% of foreign direct investment (FDI) in multi-brand retail shall be permitted subject to a minimum investment of $100 million. It is also proposed that state governments will have the final say in whether they have front-end retail stores in their states. Further the Government claims that draft framework for FDI in multi-brand retail has been prepared keeping adequate safeguards to protect small shopkeepers and to ensure that FDI in multi-brand retail actually helps in development of back-end infrastructure. According to the Government framework, at least 50% of FDI in multi-brand retail projects should be in infrastructure. Multinational retailers will have to file a statement of account with the RBI and Foreign Investment Promotion Board showing the investment in back-end functions.

The government is very clear that FDI in multi-brand retail should create large scale employment and bring quality investment into the country leading to development of back-end infrastructure. According to industry estimates, lack of cold chains leads to a loss of about 40% of the country's farm produce or ₹ 50,000 crore, every year. Because of this, Dr. Kaushik Basu, Economic Adviser, Ministry of Finance, asserts that FDI in multi-brand retail will serve as an important measure to fight food inflation which arises due to supply-side bottlenecks, one of them being lack of back-end infrastructure such as cold chain and warehouses to store food grains.

For easier monitoring, the government will also allow back-end infrastructure to be executed through a dedicated entity. Multi-brand retail stores would be required to source at least 30% of their products, including

food items, from small and medium enterprises, according to the draft framework. These stores will be allowed only in cities with a population of more than 1 million.

NOTES

At least 30% of the turnover of these ventures will have to come from small traders through wholesale cash-and-carry stores set up for the purpose. In order to address concerns of some States that multi-brand FDI will drive out local shops, the draft framework proposes powers to State governments to impose additional conditions on MNC retailers, such as measures to integrate 'kirana' or local retailers into the value chain.

## Case Against FDI in Multi-brand Retail

But the Government's decision to allow global retail giants to open their shops in India has met with a stiff opposition. The reasons for which the decision have been opposed are stated below:

First, the crucial disadvantage of opening up to multi-brand retail sector to foreign direct investment (FDI) by global retail giants is that it will badly hurt small traders and shopkeepers who would be competed out by these giant retailers. It is because of the economies of scale and procuring goods from cheaper sources, even from abroad, they will be able to sell goods at cheaper prices. It is pointed out that retail sector in India employs over 40 million people, next only to agriculture. Being unable to compete with the giant retailers, they would be forced out of business and thus deprived of their livelihood. As a result there will massive loss of jobs. This has been the experience of most countries which have permitted the entry of FDI in retail.

Besides, not only will the small traders and shopkeepers who are engaged in self-employment in retail business will lose their jobs but also other workers who are employed in these relatively small shops and retail outlets will be rendered unemployed as due to deficient in skills, the majority of them are unlikely to be absorbed in the global giant retail stores. As a result, unemployment in the country will increase.

The government and the supporters of its decision to allow entry of global giants in retail business point out that 10 million jobs will be created by them in three years. This is quite a tall claim without any evidence. Of course, they will employ people in retail shops, in cold chain, warehousing etc. but they will displace more than they employ. It may be noted that many workers who do not find employment in agriculture find jobs in the unorganised service sector (i.e. retail business) to make meagre earnings as

NOTES

they fail to get employment in the organised sector at higher wages. A majority of them are unskilled and are therefore unlikely to get jobs in the supermarket shops set up by the global giants. The entry of big giants in the organised retail sector will add to their miseries and send them below the poverty line.Former Prime Minister Manmohan Singh was of the view that there was no reason why the small traders will not be able to compete with retail giants. This is only a wishful thinking without any facts and evidence.

Another outcome of the entry of FDI multiband retail giants is that the supermarket stores set up by them will source most of their manufactured goods from abroad to sell in their stores in India. Already crazy of foreign goods, a major chunk of middle class in India will bring foreign goods which are supposed to be of better quality. This will lead to more imports of manufactured goods which will hurt the Indian manufacturing industries, especially small-scale and medium enterprises. The Government has stipulated that for their big retail stores, foreign global giants must source 30% of the goods from local small and medium enterprises. However, this will be difficult to enforce.

Thus, with FDI retail giants setting up shops in India will not only displace small traders they will also cause loss of jobs in their manufacturing sector as these supermarkets opened with FDI by global giants will source their goods internationally and not from domestic sources. This will hurt small Indian investors and producers who cannot compete will these global giants. This will lead to greater loss of jobs. This has been the actual experience of most countries which have allowed the entry of FDI in retail.

Country and the largest supplier of manufactured goods to Wall-Mart and other international retail giants. It obviously cannot say no to these international chains opening stores in China when it is global supplier to them. India, in contrast, will lose both retail services and manufacturing jobs.

The claim that opening up of multi-brand retail trade spur competition and improve farm productivity has been contested. The obstacle to growth of agricultural productivity are tiny farm holdings and that too are fragmented. Agricultural productivity per hectare in India is one of the lowest in the world, Besides small and fragmented land holdings, there is a lack of irrigation facilities.

Even after sixty years of planning and rural development only 40% of arable land is irrigated, the remaining 60% of the arable land is still rained.

NOTES

Increasing fluctuations in rainfall, depleting ground water level and lower and improper fertilizer usage are also issues of great concern. So, who is going to benefit from efficient back-end operations and improved infrastructure of business? Certainly not the common Indian farmers.

There would be further land consolidation in favour of the already rich and resourceful farmers, creating conditions for further widening of the gap between the well-to-do and poor farmers.

Rural infrastructure is another area of worry. One cannot drive high speed, air-conditioned trucks carrying fresh perishable fruits or milk products on roads unsuitable even for bullock-carts. During the monsoon, when a considerable amount of agriculture inputs is expected to be moved to villages, more than 30% of the villages in flood prone states become unapproachable by road. How FDI in multi-brand retail trade will help in building rural infrastructure is open to question?

Lastly 'farming is the riskiest profession' observes Dr. M.S. Swaminathan, eminent agriculture scientist. In spite of being an agricultural country, our farmers are not insulated from risk. The existing insurance system is either beyond their reach or too complicated to be relied upon. The arrival of retail in a big way will certainly make farming riskier. Meeting customers' (mostly urban) demands and quality specifications require more resource-intensive farming. We need to learn lessons from the innumerable incidents of farmers' suicides being reported across the country. Only time will tell how much risk these big retail players will be willing to shoulder.

Finally the argument advanced by the Government in favour of its decision permitting FDI in retail giants that it will create the supply chain, back-end infrastructure such as storage facilities, refrigeration, transportation for farm's produce is quite misleading. Foreign multinational giants cannot be expected to make large investment in rural infrastructure including power generation and transportation. Why plan after plan in the 60 years of planning (1951-2011) which has been allocating quite a good chunk of resources to them has failed to accomplish this task. Further, why to rely on foreign multinationals for building up cold chain infrastructure and warehousing.

To conclude, the Government argument that FDI in retail will solve all problems like back-end infrastructure, generate employment on a large scale and check inflation, especially food inflation is making a tall claim. In fact, FDI in retail is no solution for these fundamental problems of supply-side bottlenecks and of rising inflation and unemployment. They

NOTES

have to be solved through prudent resource allocation in development planning for India.

There is a fear that opening up multi-brand retail trade to FDI is not a panacea for the problems of Indian agriculture. It will create more distress not only for our retail shopkeepers and create large-scale unemployment but will also not benefit farmers.

## *14.3 FOREIGN DIRECT INVESTMENT*

During April-November 2007, foreign direct investment (FDI) equity inflows stood at ₹ 45,098 crore (US$11.14 bn) against ₹ 33,030 crore (US$7.23 bn) during April-September 2006, signifying a growth of 36% in terms of rupee and 54% in terms of US dollar.

From April 2000 to November 2007, Mauritius remained the predominant source country for FDI to India, accounting for 44.24% share of the cumulative total, followed by the United States (9.37%), the United Kingdom (7.98%), and the Netherlands (5.81%).

During April-November 2007, the position of Mauritius remained still prominent (42.77%). While the shares of the United States (5.45%), the United Kingdom (2.19%), and the Netherlands (4.51%) were lower, those of Japan (5.72%) and Singapore (8.73%) were higher. In the sectoral distribution of FDI inflows, financial and non-financial services secured a growth of more than seven times during 2006-07, to secure the first spot in cumulative inflows, displacing computer software and hardware. Along with services, the shares of sectors like telecommunications, construction, housing, and real estate have buoyed during April-November 2007.

Of the total FDI received, about 53.57% came through the automatic route of the RBI, while 20.15% came through the government-approval route, and the rest in the form of acquisition of existing shares. Among the destinations of FDI inflows, Mumbai, New Delhi, Bengaluru and Chennai maintained the first four positions in that order. During the period of August 1991-November 2007, India received about 7,898 approvals for foreign technology transfer, of which 81 were obtained during 2006-07 and 52 during April-November 2007.

NOTES

## 14.4 FDI POLICY

As a result of the comprehensive review of the FDI policy, wide-ranging policy changes were notified in 2006, like extending automatic routes, increasing equity caps, removing restrictions, simplifying procedures, and extending the horizon of FDI to vistas like single-brand product retailing and agriculture. Of late, several steps have been initiated to facilitate FDI inflows which, among other things, include: raising the equity cap in civil aviation, organising Destination India events in association with CII (Confederation of Indian Industry) and FICCI (Federation of Indian Chambers of Commerce & Industry), with a view to attract investments, activating the Foreign Investment Implementation Authority (FIIA) towards a speedy resolution of investment-related problems; setting up of National Manufacturing Competitiveness Council (NMCC) to provide a continuing forum for policy dialogue, to energize the growth of manufacturing; regular inter-actions with foreign investors through bilateral/regional/international meets and meetings with individual investors; and making the website of The Department of Industrial Policy & Promotion (www.dipp.nic.in) more user-friendly with an online chat facility. About 4,500 investment-related queries have been replied during 2007-08.

## 14.5 INDUSTRIAL CREDIT

The overall industrial credit, which slackened in the first half of 2007-08, is now showing signs of recovery. During April-August 2007, the outstanding gross deployment of bank credit increased only by 2.8% from end-March 2007, while the corresponding increase stood at 8.5% during 2006. However, the gap between the rates of credit growth between April-November 2006 and April-November 2007 has substantially narrowed.

The Data further shows that there is a strong sectoral pattern to the growth of industrial credit Among the sectors that experienced high rates of production growth during April-November 2007, credit growth also has been robust for jute textiles, leather and leather products, basic metals, and engineering goods. The slackening of the credit growth in mining and quarrying, and wood products has occurred over a high base achieved by the end-March 2007. Encouragingly, the outstanding credit to "transport equipment" group, which has witnessed a slowdown in production, has grown significantly from the end-March 2007. Besides, the near-doubling

NOTES

of the rate of credit growth to infrastructure augurs well for many infrastructure-dependent industrial groups and for the economy as a whole.

## *14.6 INDUSTRIAL RELATIONS*

The continued decline in the number of strikes and lockouts indicates improved industrial relations. The number of strikes and lockouts, taken together, was down by 5.7% in 2006. As per the available information, during the current year till November 2007, West Bengal experienced the maximum instances of strikes and lockouts followed by Tamil Nadu and Gujarat. Industrial disturbances were concentrated mainly in textiles, financial intermediaries (excluding insurance and pension fund), engineering, and chemical industries.

## *14.7 THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT OF 1992*

The Securities and Exchange Board of India Act, 1992 (hereinafter referred as "The SEBI Act is having retrospective effect, and is deemed to have come into force on January 30, 1992. Relatively, a brief Act containing only 35 sections, the SEBI Act governs all the stock exchanges and securities transactions in India.

A Board by the name of the Securities and Exchange Board of India (SEBI) consisting of one Chairman and five members, one each from the Department of Finance and of the Central Government, one from the RBI, and two other persons; and having its head office in Mumbai and regional offices in Delhi, Kolkata, and Chennai, has been constitute under the SEBI Act to administer its provisions. The Central government has the right to terminate the services of the Chairman or any member of the Board. The Board decides all questions in its meeting by a majority vote, with the Chairman having a second or a casting vote.

Section 11 of the SEBI Act provides that it shall be the duty of the Board to protect the interest of investors in securities, to promote the development of, and to regulate, the securities market by such measures, as it thinks fit. It empowers the Board to regulate the business in stock exchanges, to register and regulate the working of stockbrokers, sub-brokers, share-transfer agents, bankers ; to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors, and so on, to register and regulate the working of

NOTES

collective investment schemes, including mutual funds, to prohibit fraudulent and unfair trade practice sf and insider trading, to regulate takeovers, to conduct enquiries and audits of the stock exchanges, and so on.

As all stock exchanges are required to be registered with SEBI under the provisions of the Act under Section 12 of the SEBI Act, all the stockbrokers, sub-brokers, share-transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors, and such other intermediary, who may be associated with the securities markets, are obliged to register with the Board, and the Board has the power to suspender cancel such registration. The Board is bound by the directions given by the Central government, from time to time, on questions of policy, and the Central government has the right to supersede! the Board. The Board is also obliged to submit a report to the Central government every year giving true and full account of its activities, policies, and programmes. Any one aggrieved by the Boards decision is entitled to appeal to the Central government.

## *14.8 FOREIGN INSTITUTIONAL INVESTORS (FII)*

Foreign Institutional Investors (FIIs) including institutions such as pension funds, mutual ; funds, investment trusts, asset management, or their power of attorney holders (providing discretionary and non-discretionary portfolio management services), are invited to invest in the securities traded on the primary and secondary markets, including the equity and other securities/instruments of companies, which are listed/to be listed on the stock exchanges in India—including the OTC(Over The Counter) Exchange of India. These would include shares, debentures, war-rants, and the schemes floated by domestic mutual funds. To be eligible to do so, the FIIs would be required to obtain registration with Securities and Exchange Board of India (SEBI). FIIs are also required to file with SEBI and another application addressed to RBI, for seeking various permissions under FERA.

SEBI shall be granting registration to the FII, taking into account the track record of the FII, its professional competence, financial soundness, experience, and such other relevant criteria. FIIs seeking registration with SEBI should hold a registration from the Securities Commission, or the regulatory organisation for the stock market, in its own country of domicile incorporation.

NOTES

SEBI's registration and RBI's general permission under FERA to an FII will be for five years, renewable for similar five-year periods later on. RBI's general permission under FERA enable the registered FII to buy, sell, and realise capital gains on investments, made through initial corpus remitted to India, subscribe/renounce rights offerings of shares, invest on all recognised stock exchanges through a designated bank branch, and to appoint a domestic custodian for the custody of investments held.

The general permission from RBI shall also enable the FII to

1. Open foreign currency denominated account(s) in a designated bank. (These can even be more than one account in the same bank branch, each designated in different foreign currencies, if it is required so by FII for its operational purposes.)
2. Open a special non-resident rupee account to which could be credited all receipts from the capital inflows, sale proceeds of shares, dividends, and interests.
3. Transfer sums from the foreign currency accounts to the rupee account and *vice versa*, at the market rates of exchange.
4. Make investments in the securities in India out of the balances in the rupee account.
5. Transfer repatriable (after tax) proceeds from the rupee account to the foreign currency accounts.
6. Repatriate the capital, capital gains, dividends, incomes received by way of interest, and so on, and any compensation received towards sale/renouncement of rights offerings of shares, subject to the designated branch of a bank/the custodian being authorised to deduct withholding tax on capital gains, and arranging to pay such tax and remitting the net proceeds at market rates of exchange.
7. Register FII's holdings without any further clearance under FERA.

There is no restriction on the volume of investment, either minimum or maximum, for the purpose of entry of FIIs, in the primary/secondary market. Also, there is no lock-in period for the purpose of such investments made by FIIs.

The portfolio investments in primary or secondary markets will be subject to a ceiling of 24% of issued share capital, for the total holdings of all

NOTES

registered FIIs, in any one company. The ceiling would apply to all holdings, taking into account the conversions, out of the fully and partly convertible debentures issued by the company. The holding of a single FII in any company would also be subject to a ceiling of 5% of the total issued capital. For this purpose, the holdings of a FII ground will be counted as holdings of a single FII.

The maximum holding of 24% for all non-resident portfolio investments, including those of the registered FIIs, will also include NRI corporate and non-corporate investments, but will not include the following:

1. Foreign investments under financial collaborations (direct foreign investments), which are permitted up to 51% in all priority areas and
2. Investments by FIIs through the following alternative routes:
    (i) Offshore single/regional funds,
    (ii) Global depository receipts, and
    (iii) Euroconvertibles.

The disinvestment will be allowed only through stock exchanges in India, including the OTC Exchange. In exceptional cases, SEBI may permit-sales, other than through stock exchanges, provided the sale price is not significantly different from the stock market quotations, where available. All secondary market operations would be only through the recognised intermediaries on the Indian Stock Exchange, including the OTC Exchange of India. A registered FII will not engage in any short-selling in securities but will take a delivery of the purchased and give a delivery of the sold securities.

A registered FII can appoint an agency approved by SEBI, to act as a custodian of securities and for confirmation of transactions in securities, settlement of purchase and sale, and for reporting information. Such custodian shall establish separate accounts for detailing on a daily basis the investment capital utilisation and securities held by each FII for which it is acting as a custodian. The custodian will report to the RBI and SEBI, semi-annually, as part of its disclosure and reporting guidelines.

The RBI shall make available to the designated bank branches, a list of companies where no investment will be allowed on the basis of the upper-prescribed ceiling of 24%, having been reached under the portfolio investment scheme. The RBI may, at any time, request by an order a registered FII, to submit information regarding the records of utilisation of

NOTES

the inward remittances of investment capital and the statement of securities transactions. RBI and/or SEBI may also, at any time, conduct a direct inspection of the records and accounting books of a registered FII. FIIs investing under this scheme will benefit from a concessional tax regime of a flat rate tax of 20% on dividend and interest income and a tax rate of 10% on long term (one year of more) capital gains.

## 14.9 SUMMARY OF THE UNIT

In the early phase of independence we had open policy towards foreign investment in India, however, there was growing apprehension that the controls may go in the hand of foreign players therefore the 'License Raj' was introduced. However, the New Economic Policy of 1991 did away with the License Raj and the economy was once again opened to Flls.

## 14.10 GLOSSARY

- **TNC:** Trans National Corporations
- **Trade Policy**: Policy Regarding Export and Import
- **TRIMs:** Trade Related Investment Measures
- **QR**: Quantitative Restrictions

## 14.11 KEY TERMS

- **F.D.I:** Foreign Direct Investment.
- **Flls:** Foreign Institutional Investors.
- **SMEs:** Small and Medium-sized Enterprises
- **DIPP:** Department of Industrial Policy and Promotion.

## 14.12 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)

### (A) Fill in the blanks

1. Government carries out monetary policy through __________.
2. Minimum investment by foreign multinational company is _________dollars.

NOTES

### (B) True or False

1. Government policy has no impact on quality of development.
2. Foreign companies in India enjoy less profit as compared to local enterprise.
3. FIIs were invited to improve transport and power sector.

## *14.13 KEY TO CHECK YOUR ANSWER*

(A) 1. RBI, 2. 100 Million

(B) 1. False, 2. False, 3. True.

## *14.14 TERMINAL AND MODEL QUESTIONS*

1. Write a short note on growth of FDI in India.
2. Explain the modes of FDI inflows in India.
3. Compare the development of China and India *vis-a-vis* FDI.

## *14.15 REFERENCE BOOKS*

1. Kuman Sanjeev: FDI in India, B.R.P.C, Delhi.
2. Guha Ashok: Economic Liberalisation, Oxford, Delhi.
3. Khan A: Strategy of foreign investment, Kitab, Allahabad.

# UNIT 15 FOREIGN EXCHANGE RATES AND FOREIGN EXCHANGE MARKETS

**Structure:**

15.1 Introduction
15.2 Foreign Exchange Markets in India – a Brief Background
15.3 Features of the Forward Premium on the Indian Rupee
15.4 Intervention in Foreign Exchange Markets
15.5 The Foreign Exchange Market
15.6 The Market for Foreign Exchange
15.7 The Demand for Currency
15.8 The Supply of Currency
15.9 Exchange Rates
15.10 Changes in Exchange Rates
15.11 Exchange Rates and Interest Rates
15.12 Summary of the Unit
15.13 Glossary
15.14 Key Terms
15.15 Check Your Progress (Multiple Choice/Objective Type Questions)
15.16 Key to Check Your Answer
15.17 Terminal and Model Questions
15.18 Reference Books

**NOTES**

## Objectives

After reading this Unit, you will be able to:

- Know about trade theory
- Understand demand and supply of currency *vis-a-vis* exchange rates.
- Understand the speculative flow of funds from one country to another and its importance of short term on exchange.

# *15.1 INTRODUCTION*

During 2003-04 the average monthly turnover in the Indian foreign exchange market touched about 175 billion US dollars. Compare this with the monthly trading volume of about 120 billion US dollars for all cash, derivatives and debt instruments put together in the country, and the sheer size of the foreign exchange market becomes evident. Since then, the foreign exchange market activity has more than doubled with the average monthly turnover reaching 359 billion USD in 2005-2006, over ten times the daily turnover of the Bombay Stock Exchange. As in the rest of the world, in India too, foreign exchange constitutes the largest financial market by far.

Liberalisation has radically changed India's foreign exchange sector. Indeed the liberalisation process itself was sparked by a severe balance of Payments and foreign exchange crisis. Since 1991, the rigid, four-decade-old, fixed exchange rate system replete with severe import and foreign exchange controls and a thriving black market is being replaced with a less regulated, market driven arrangement.

While the rupee is still far from being "fully floating" (many studies indicate that the effective pegging is no less marked after the reforms than before), the nature of intervention and range of independence tolerated have both undergone significant changes. With an over-abundance of foreign exchange reserves, imports are no longer viewed with tear and skepticism. The Reserve Bank of India and its allies now intervene occasionally in the foreign exchange markets not always to support the rupee but often to avoid an appreciation in its value. Full convertibility of the rupee is clearly visible in the horizon. The effects of these developments are palpable in the explosive growth in the foreign exchange market in India.

NOTES

Exchanging currency means trading one currency for another. The value at which an exchange takes place is called exchange rate. The two main functions of a foreign exchange markets are (1) to determine the price of different currencies in terms of one another and (2) to transfer the currency risk to the one who is willing to bear it. The growth of foreign exchange market in the last few years has been phenomenal. Trading is regulated by Foreign Exchange Dealers Association of India (FEDAI).

## *15.2 FOREIGN EXCHANGE MARKETS IN INDIA – A BRIEF BACKGROUND*

The foreign exchange market in India started in earnest less than three decades ago when in 1978 the government allowed banks to trade foreign exchange with one another. Today over 70% of the trading in foreign exchange continues to take place in the inter-bank market. The market consists of over 90 Authorized Dealers (mostly banks) who transact currency among themselves and come out “square” or without exposure at the end of the trading day. Trading is regulated by the Foreign Exchange Dealers Association of India (FEDAI), a self regulatory association of dealers. Since 2001, clearing and settlement functions in the foreign excliange market are largely carried out by the Clearing Corporation of India Limited (CCIL) that handles transactions of approximately 3.5 billion US dollars a day, about 80% of the total transactions.

The liberalisation process has significantly boosted the foreign exchange market in the country by allowing both banks and corporations greater flexibility in holding and trading foreign currencies. The Sodhani Committee set up in 1994 recommended greater freedom to participating banks, allowing them to fix their own trading limits, interest rates on FCNR deposits and the use of derivative products.

The growth of the foreign exchange market in the last few years has been nothing less than momentous. In the last 5 years, from 2000-01 to 2005-06, trading volume in the foreign exchange market (including swaps, forwards and forward cancellations) has more than tripled, growing at a compounded annual rate exceeding 25%. The inter-bank forex trading volume has continued to account for the dominant share (over 77%) of total trading over this period, though there is an unmistakable downward trend in that proportion (Part of this dominance, though, results from double-counting since purchase and sales are added separately, and a

NOTES

single inter-bank transaction leads to a purchase as well as a sales entry.) This is in keeping with global patterns.

In March 2006, about half (48%) of the transactions were spot trades, while swap transactions (essentially repurchase agreements with a one-way transaction – spot or forward – combined with a longer-horizon forward transaction in the reverse direction) accounted for 34% and forwards and forward cancellations made up 11% and 7% respectively. About two-thirds of all transactions had the rupee on one side. In 2004, according to the triennial central bank survey of foreign exchange and derivative markets conducted by the Bank for International Settlements (BIS (2005a)) the Indian Rupee featured in the 20 position among all currencies in terms of being on one side of all foreign transactions around the globe and its share had tripled since 1998. As a host of foreign exchange trading activity, India ranked 23,d among all countries covered by the BIS survey in 2004 accounting for 0.3% of the world turnover. Trading is relatively moderately concentrated in India with 11 banks accounting for over 75% of the trades covered by the BIS 2004 survey.

## *15.3 FEATURES OF THE FORWARD PREMIUM ON THE INDIAN RUPEE*

The Indian rupee has had an active forward market for some time now. The forward premium or discount on the rupee (*vis-a-vis* the US dollar, for instance) reflects die market's beliefs about future changes in its value. The strength of die relationship of this forward premium with the interest rate differential between India and the US - the Covered Interest Parity (CIP) condition - gives us a measure of India's integration with global markets. The CIP is a no-arbitrage relationship that ensures that one cannot borrow in a country, convert to and lend in another currency, insure the returns in the original currency by selling his anticipated proceeds in die forward market and make profits without risk through this process.

Chakrabarti (2006) reports that between late 1997 and mid-2004 the average discount on the rupee was about 4% per annum. During the period the average difference between 90-180 days bank deposit rates in India and the inter-bank USD offer rate was about 4.5% for 3 months and 3.5% for the 6 months period. With these two figures in the same ballpark (particularly given that bank deposit rates and inter-bank rates are not strictly comparable), annual averages of interest rate differences and the

NOTES

forward exchange premium also indicate a moderate degree of co-movement between the two variables.

The interest rate differential explains about 20% of the total variation in the forward discount. The deviation of the Indian rupee-US dollar from the covered interest parity, however, exhibits long-lived swings on both sides of the zero line, This would indicate arbitrage opportunities and market imperfections provided we could be sure of die comparability of the interest rates considered. Therefore, while the behaviour of the forward premium on the Indian rupee is broadly in lines with the CIP, more careful empirical analysis involving directly comparable interest rates is necessary to measure the strength of the covered interest parity condition and the efficiency of the foreign exchange market.

Under market efficiency, the forward exchange rate is considered to be an unbiased predictor of the future spot rate, with random prediction errors. While the prediction errors of forward rates on the rupee appear to show some degree of persistence, any conclusion in this matter too must await more rigorous analysis.

## *15.4 INTERVENTION IN FOREIGN EXCHANGE MARKETS*

The two main functions of the foreign exchange market are to determine the price of the different currencies in terms of one another and to transfer currency risk from more risk-averse participants to those more willing to bear it. As in any market essentially the demand and supply for a particular currency at any specific point in time determines its price (exchange rate) at that point. However, since the value of a country's currency has significant bearing on its economy, foreign exchange markets frequently witness government intervention in one form or another, to maintain the value of a currency at or near its “desired” level. Interventions can range from quantitative restrictions on trade and cross-border transfer of capital to periodic trades by the central bank of the country or its allies and agents so as to move the exchange rate in the desired direction. In recent years India lias witnessed both kinds of intervention though liberalisation has implied a long-term policy push to reduce and ultimately remove the former kind. It is safe to say that over the years since liberalisation, India has allowed restricted capital mobility and followed a “managed float” type exchange rate policy.

NOTES

During the early years of liberalisation, the Rangarajan Committee recommended that India's exchange rate be flexible. Officially speaking, India moved from a fixed exchange rate regime to "market determined" exchange rate system in 1993. The overt objective of India's exchange rate policy, according to various policy pronouncements, has been to manage "volatility" in exchange rates without targeting any specific levels. This has been hard to do in practice.

The Indian rupee has had a remarkably stable relationship with the US dollar. Meanwhile the dollar appreciated against major currencies in the late 90s and then went into an extended decline particularly during 2003 and 2004. The lock-step pattern of the US dollar and the Rupee is best reflected in the movements in the two currencies against a third currency like the Euro. The correlation of the exchange rates of the two currencies against the Euro during 1999-2004 was 0.94. Several studies have established the pegged nature of the rupee in recent years (see Chakrabarti (2006) for a more detailed discussion). Based on volatility, India had a de facto crawling peg to the US dollar between 1979 and 1991 which changed to a de facto peg from mid-1991 to mid-1995, with a major devaluation in March 1993. From mid-1995 to end-2001, the rupee reverted to a crawling peg arrangement in practice. An analysis of the ratio of the variance of the exchange rate to the sum of the variances of the interest rate and the foreign exchange reserves reveals a move even closer to the fixed exchange rate system. A comparison of the sensitivity (beta) of the Dollar-rupee rate with the Euro-rupee rate for a three-year period (1999 through 2001), indicates that India had a dollar beta of 1.01 — tenth highest among the 53 countries considered. More importantly, the US dollar-Euro exchange rate explained about 97% of all movements in the Indian rupee-Euro exchange rate — highest among all the 53 countries considered. Clearly the Indian rupee has been an excellent "tracker" of the US dollar.

It is instructive to consider the Rupee-Dollar exchange rate in the light of the Purchasing Power Parity (PPP) holding that the exchange rate between two currencies should equal the ratio of price levels in two countries. In its dynamic form PPP holds that that the rate of depreciation of a currency should equal the excess of its inflation rate to that in the other country. Over a reasonably long period of time, die devaluation in the Indian Rupee, *vis-a-vis* the US dollar does seem to have an association with the difference in the inflation rates in the two countries. Between 1991 and 2003, the two variables have had visible co-movements with a correlation of about 0.57 (Chakabarti (2006)). This may be a result of Indo-US trade

NOTES

flows dominating the exchange rate markets but it is perhaps more likely that it reflects the exchange rate management principles of the monetary authorities.

The Reserve Bank of India lias used a varied mix of techniques in intervening in the foreign exchange market — indirect measures such as press statements (sometimes called "open mouth operations" in central bank speak) and, in more extreme situations, monetary measures to affect the value of the rupee as well as direct purchase and sale in the foreign exchange market using spot, forward and swap transactions. Till around 2002, die measures were mostly in the nature of crisis management of saving-the-rupee kind and sometimes the direct deals would be repeated over several days till the desired outcome was accomplished. Other public sector banks, particularly the SBI often aided or veiled the intervention process.

## *15.5 THE FOREIGN EXCHANGE MARKET*

Exchanging currency means trading one currency for another. The value at which an exchange takes place is called the exchange rate, which can be regarded as the price of one currency expressed in terms of another one, such as £1 (GBP) exchanging for US$1.50 cents.

When nations are formed, they commonly introduce their own currency as a mark of independence, rather than share the currency of another country. For example in 1792, shortly after independence from Britain, the USA introduced the dollar as its official currency in preference to the British pound. The word dollar is derived from 'thaler' a European word for the silver coinage which was commonly used across Europe between the 15th and 18$^{th}$ century. The British pound itself is at least 1300 years old and is the world's longest surviving currency. However, it is the Chinese who can claim the world's first coins, some 3000 years ago, and its first paper money, used about 1200 years ago, although paper money disappeared in China in the 15th Century. The most recent currency to be added to the stock of world currencies is the European euro, which came into existence in 1999.

Today, currencies are issued and controlled by central banks, such as the European Central Bank (ECB), the US Federal Reserve, and the Bank of England. The two main global currencies are the US Dollar ($) and the European Euro (€). The Euro is shared by sixteen European countries as part of European integration that dates back to the 1950s.

NOTES

## 15.6 THE MARKET FOR FOREIGN EXCHANGE

Currencies are bought and sold, just like other commodities, in markets called Foreign Exchange Markets. The world's three most common transactions are exchanges between the dollar and the euro (30%) the dollar and the yen (20%) and the dollar and the Pound Sterling (12%).

How currency values are established depends upon whether they are determined solely in free markets, called freely floating, or determined by agreements between governments, called fixed or pegged. Like most currencies, the pound has at times been both fixed, and floating. Between 1944 and 1971, most of the world's currencies were fixed to the US Dollar, which in turn was fixed to gold. After a period of floating, the pound joined the European Exchange Rate Mechanism (ERM) in 1990, but quickly left in 1992, and has floated freely ever since. This has meant that its value is largely determined by the interaction of demand and supply.

## 15.7 THE DEMAND FOR CURRENCY

The demand for currencies is derived from the demand for a country's exports, and from speculators looking to make a profit on changes in currency values.

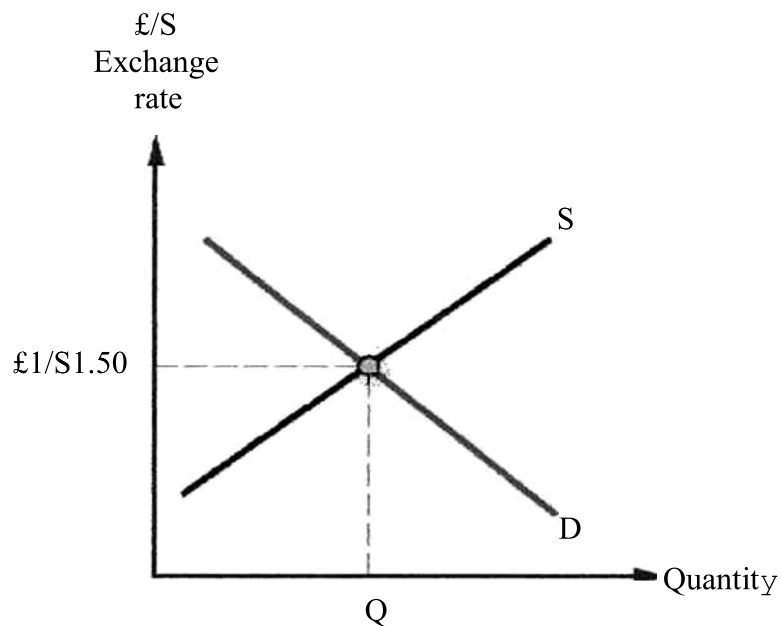
## 15.8 THE SUPPLY OF CURRENCY

The supply of a currency is determined by the domestic demand for imports from abroad. For example, when the UK imports cars from Japan it must pay in yen (¥), and to buy yen it must sell (supply) pounds. The more it imports the greater the supply of pounds onto the foreign exchange market. A large proportion of short-term trade in currencies is by dealers who work for financial institutions. The London foreign exchange market is the World's single largest international exchange market.

## 15.9 EXCHANGE RATES

The equilibrium exchange rate is the rate which equates demand and supply for a particular currency against another currency.

NOTES




## Example-1

If we assume the UK and France both produce goods that the other wants, they will wish to trade with each other. However, French producers require payment in Euros and the British producers require payments in pounds Sterling. Both need payment in their own local currency so that they can pay their own production costs in their local currency. The foreign exchange market enables both French and British producers to exchange currencies so that trades can take place.

The market will create an equilibrium exchange rate for each currency, which will exist where demand and supply of currencies equates.

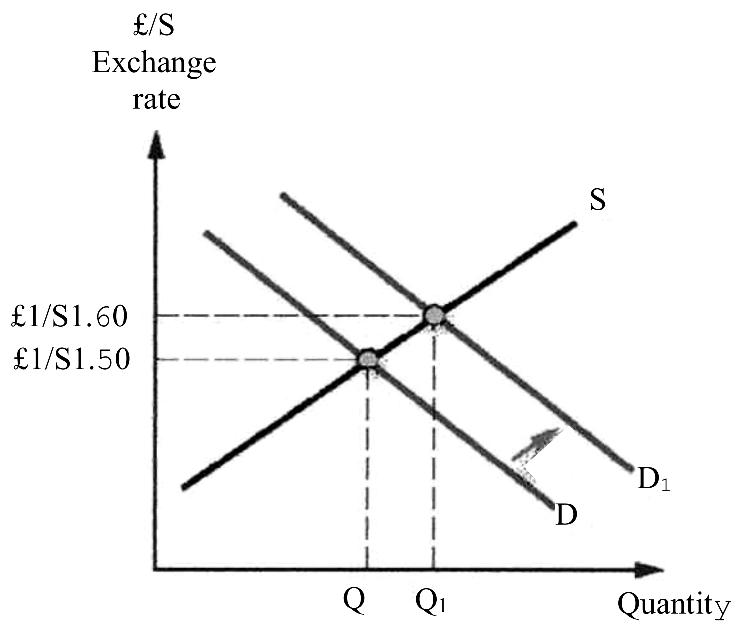
## *15.10 CHANGES IN EXCHANGE RATES*

Changes in the value of a currency like Sterling reflect changes in demand and supply. On a demand and supply graph, the price of Sterling is expressed in terms of the other currency, such as the US$.

An increase in the exchange rate

For example, an increase in exports would shift the demand curve for Sterling to the right and push up the exchange rate. Originally, one pound bought $1.50, but now buys $1.60, hence its value has risen.

NOTES




## *15.11 EXCHANGE RATES AND INTEREST RATES*

Changes in a country's interest rates also affect its currency, through its impact on the demand and supply of financial assets in the UK and abroad. For example, higher interest rates relative to other countries, makes the UK attractive the investors, and leads to an increase in the demand for the UK's financial assets, and an increase in the demand for Sterling.

Conversely, lower interest rates in one country relative to other countries leads to an increase in supply, as speculators sell a currency in order to buy currencies associated with rising interest rates. These speculative flows are called hot money, and have an important short-term effect on exchange rates.

## *15.12 SUMMARY OF THE UNIT*

Exchanging currency means trading one currency for another. The value at which the exchange takes place is the exchange rate, this means the price of one currency expressed in terms of another. Foreign exchange constitutes the largest financial market in India.

NOTES

## *15.13 GLOSSARY*

- **FEMA:** Foreign Exchange Management Act.
- **Foreign Affiliate:** A foreign enterprise which invests in a host country in cash or kind.
- **FEDAI:** Foreign Exchange Dealers Association of India.
- **ECB:** European Central Bank

## *15.14 KEY TERMS*

- **B.O.T:** Board of Trade
- **SEZ:** Special Economic Zones
- **OGL:** Open General License
- **EPZ:** Export Processing Zones

## *15.15 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. Major source of industrial finance, apart from capital market includes ___________.
2. S.S.I considers a 'Sick' unit when it is net in production for at least _________years.

### (B) True and False

1. R.B.I uses varied mix techniques in intervening in Foreign Exchange Markets.
2. The demand for currencies is derived from the demand for a country's imports.

## *15.16 KEY TO CHECK YOUR ANSWER*

(A) 1. FDI, 2. three,

(B) 1. True, 2. False.

NOTES

## *15.17 TERMINAL AND MODEL QUESTIONS*

1. Write a short note on foreign exchange market.
2. What do you understand by exchange rate Explain?
3. Liberalisation has boosted foreign exchange. Discuss.

## *15.18 REFERENCE BOOKS*

1. Raltod J.S.- ‘Export Marketing’ H.P.H. Mumbai.
2. Sury Niti - ‘FDI’, NCP, Delhi.

# UNIT 16 GLOBALISATION, LIBERALISATION AND PRIVATISATION

## Structure:

16.1 Introduction to Economics Policy – Reforms
16.2 Globalisation
16.3 Liberalisation
16.4 Privatisation
16.5 Conclusion
16.6 Summary of the Unit
16.7 Glossary
16.8 Key Terms
16.9 Check Your Progress (Multiple Choice/Objective Type Questions)
16.10 Key to Check Your Answer
16.11 Terminal and Model Questions
16.12 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Develop a clear understanding about the concepts of liberalisation, globalisation and privatisation.
- Understand and appreciate the interrelationship between liberalisation, globalisation and privatisation.
- Understand the merits and demerits of the economic reforms undertaken in relation to liberalisation, globalisation and privatisation.
- Know about the reforms in the new economic policy.

NOTES

- Understand how reforms lead to industrial development and growth.
- Understand the important of opening the economy to private sector.

## *16.1 INTRODUCTION TO ECONOMIC POLICY – REFORMS*

Economic Reforms in India commenced during the year 1985 after Rajiv Gandhi took over as Prime Minister. The Prime Minister in his first national broadcast said: “The public sector has entered into too many areas where it should not be. We shall open the economy to the private sector in several areas hither to restricted to it.” Consequently, a number of measures were taken to remove controls, open areas to private sector players. This may be described as the first phase of liberalisation. Some of the measures initiated by his government were:

- Cement was decontrolled and a number of licenses were issued to private sector units to produce cement.
- The share of free sale sugar was increased to help the sugar industry.
- The ceiling on asset limit of big business houses was raised from ₹ 20 crores to ₹ 100 crores.
- 94 drugs were delicensed and brought out of the purview of the MRTP Act.
- Electronics industry was freed from the restrictions of the MRTP Act.
- Foreign firms were welcomed in this area.
- A Scheme of broad banding was introduced. This implies that within the overall capacity, firms were free to produce a range of commodities.

For instance, in lieu of the license to produce up to 350 c.c. engines capacity, firms were allowed to produce two- wheelers of any type - scooter; motor-cycles, mopeds *etc*. The process of broad banding was extended to 25 categories of industries. These industries included four-wheelers, chemicals, pharmaceuticals, petro-chemicals, and typewriter of all types- manual and electronic. The industrialists were not required to

NOTES

take a license of each and every item in a group, but were entitled to the production of a range of products within a group. However, Rajiv Gandhi did not take a very strong and categorical position on the issue of privatisation and globalisation, though some liberalisation of the economy did take place. It was only when P.V. Narasimha Rao took over as Prime Minister in 1991 that a new industrial policy was announced which marked a sharp departure from the earlier policy of 1956.

An unprecedented balance of payments crisis emerged in early 1991. The current account deficit doubled from an annual average of $2.3 billion or 1.3% of GDP during the first half of the 1990s, to an annual average of $5.5 billion or 2.2% of GDP during the second half of the 1990s. For the first time in modem history, India was faced with the prospect of defaulting on external commitments since the foreign currency reserves had fallen to a mere $1 billion by mid-1991. The balance of payments came under severe strain from one liquidity crisis experienced in mid-January 1991 and another in late June 1991.

There were three aims of Economic policy:

- Globalisation,
- Liberalisation, and
- Privatisation.

In 1990 for the first time there was a crisis of payment default to International institutions. There was a severe strain on liquidity crisis. Hence there were reforms on economic policy in terms of globalisation, liberalisation and palatalisation. It means dismantling the regine of industrial licensing and controls. This benefited the foreign exchange market in India.

## *16.2 GLOBALISATION*

Globalisation is primarily economic phenomenon, involving the increasing interaction, or integration of national economic systems through the growth in international trade, investment and capital flows. A rapid increase in cross- border social, cultural and technological exchange is part of the phenomenon of globalisation.

It has four parameters :

- Reduction of trade barriers so as to permit free flow of capital and services across national frontiers;

NOTES

- Creation of an environment in which free flow of capital can take place;
- Creation of an environment permitting free flow of technology among nation-states; and
- Creation of an environment in which free movement of labour can take place in different countries of the world.

The advocates of globalisation, especially from the developed countries, limit the definition of globalisation to only three components *viz*., unhindered trade flows, capital flows and technology flows. They insist that the developing countries accept their definition of globalisation and conduct the debate on globalisation within the boundaries set by them. But several economists and social thinkers in developing countries believe that this definition is incomplete. If the ultimate aim of the globalisation movement is to integrate the world into one global village, then the fourth component of unrestricted movement of labour cannot be left out. But whether the debate about globalisation is earned out at the World Trade Organisation (WTO) or at any other international forum, there is a deliberate effort to black out 'labour flows' as an essential component of globalisation.

To pursue the objective of globalisation, the following measures, have been taken.

**(i) Reduction of import duties:** There has been a considerable reduction in import duties. A reduction in import duties and the extension of MODVAT credit on taxes paid on inputs have been important measures for improving efficiency of the tax system. By 1990 import duties were 300% or more for several items and above 200% for many items. Peak rates were progressively reduced during the 1990s to reach 35% in 2001.

The median tariff rate was brought down to 25% in the 2003-04 budget. It has come down to 15% during 2004-05.

Besides this, the government has attempted to rapidly dismantle quantitative restriction on imports and exports. It has also undertaken adjustment of exchange rate so as to remove over-valuation of currency. This has helped in stepping up exports.

On the 8th February, 1997 the Commerce Ministry removed restrictions on 162 items for imports. Out of them, 69 items were moved from Special Import License (SIL) to free imports. Among these items are escalators and moving walkways, cable cars, burglar and fire alarms, cameras of all

NOTES

kinds, auto-bank note dispensers, industrial vacuum cleaners and various kinds of glassware. Besides this, 93 items were moved from industrial to SIL (Special Import License) list which included photographic films rubber stoppers, aluminium beverage cans, car air-conditioning machines, cosmetic perfumes, picture tubes below 14 inches and a wide range of office machines. By April 2001, all the quantitative restrictions on imports were removed. Only a few items have been retained for exports through State Trading enterprises.

**(ii) Encouragement of foreign investment:** The government has taken a number of measures to encourage foreign investment. The main measures taken in this regard are:

(a) Approval would be given for direct investment up to 51% foreign equity in high priority industries as per Industrial Policy of 1991. There shall be no bottlenecks of any kind in this process. Such clearances will be given if foreign equity covers the foreign exchange requirements for imported capital goods.

On the 31st of December, 1996 the Cabinet gave its assent to a new list of industries whereby joint ventures with up to 74% foreign equity would be cleared automatically. Among the industries listed for the purpose are: Mining services such as oil and gas fields services., basic metals and alloy industries, other manufacturing industries related to the items based on solar energy like solar cells, cookers, air and water heating systems, small hydro-equipment, construction and maintenance of roads, bridges, tunnels, pipelines, ropeways, ports, harbours and runways, electric generation and transmission and other infrastructure. The basic purpose of this move is to facilitate direct foreign investment in India.

(b) To provide access to international markets, majority foreign equity holding up to 51% equity would be allowed for trading companies primarily engaged in export activities.

**(iii) Encouragement to foreign technology agreement:** The Industrial Policy of 1991 undertook the following measures:

(a) Automatic permission will be given for foreign technology agreements in high priority industries up to a lump sum payment of ₹ 1 crore, 5% royalty for domestic sales and 8% for exports, subject to total payments of 8% sales over a 10-year period from

NOTES

the date of the agreement or 7 years from commencement of production.

(b) In respect of other industries, automatic permission would be given if no free foreign exchange were required for any payments. No permission will be necessary for hiring of foreign technicians and foreign testing of indigenously developed technologies.

(c) No permission will be necessary for hiring of foreign technicians and foreign testing of indigenously developed technologies.

## *16.3 LIBERALISATION*

The main aim of the liberalisation was to dismantle the excessive regulatory framework that curtailed the freedom of enterprise. Over the years, the country had developed a system of "licence-permit raj'. The aim of the new economic policy was to save the entrepreneurs from unnecessary harassment of seeking permission from Babudom (the bureaucracy of the country) to start an undertaking.

Similarly, the big business houses were unable to start new enterprises because the Monopolies and Restrictive Trade Practices (MRTP) Act had prescribed a ceiling on asset ownership to the extent of ₹ 100 crores. In case a business house had assets of more than ₹ 100 crores, its application after scrutiny by the MRTP Commission was rejected. It was believed that on account of the rise in prices this limit had become outdated and needed a review. The second objection by the private sector lobby was that it prevented big industrial houses from investing in heavy industry and infrastructure, which required lump sum investment. In order that the big business could be enthused to enter the core sectors–heavy industry, infrastructure, petrochemicals, electronics *etc*., with big projects, the irrelevance of MRTP limit was recognised and hence scrapped.

The major purpose of liberalisation was to free the large private corporate sector from bureaucratic controls. It, therefore, started dismantling the regime of industrial licensing and controls. In pursuance of this policy, the industrial policy of 1991 abolished industrial licensing for all projects except for a short set of 18 industries.

On April 14, 1993, the Cabinet Committee on Economic Affairs decided to remove three more items from the list of 18 industries reserved for compulsory licensing. The three items were; motor cars, white goods (which include refrigerators, washing machines, air-conditioners,

NOTES

microwave ovens *etc*) and raw hides and skins and patent leather. In the case of cars and white goods, the basic puipose of dereservation was to increase investment in industries in procuring cars and white goods so that the demand of the large middle class ranging from 250 to 300 million can be satisfied. These commodities are no longer considered as luxury goods, but are considered domestic gadgets to reduce the drudgery of domestic work. Liberalising the automotive sector led to better designs in two wheelers, unleashing the urge to compete in global markets and widening the domestic markets through better quality and standards. It should be of interest to know that a car has 20000 components— all manufactured in the small industry sector. The automotive component manufacturing in the small-scale sector suddenly started looking up and by the turn of the decade of reforms, the component manufacturing captured global markets. The government, in response to the market demand, liberalised the industries producing these goods and freed them from industrial licensing. Therefore, liberalisation led to globalisation.

The abolition of licensing for raw hides and skins and patent leather is motivated by the desire to push up exports. Since the potential for leather and good quality shoe exports is very large, the government decided to abolish licensing so that large-scale units could realise this potential by the use of modem technology.

The List of Industries in which Industrial Licensing is Compulsory:

1. Coal and Lignite,
2. Petroleum (other than crude) and its distillation products,
3. Distillation and brewing of alcoholic drinks,
4. Sugar,
5. Animal fats and oils,
6. Cigars and Cigarettes of tobacco and manufactured tobacco substitutes,
7. Asbestos and asbestos-based products,
8. Plywood, decorative veneers and other wood-based products,
9. Raw hides and skins, leather, chamois leather and patent leather,
10. Tanned or dressed furskins,
11. Paper and newsprint except bagasse-based units,
12. Aerospace and defence equipment:all types,

NOTES

13. Industrial explosives,
14. Hazardous chemicals,
15. Drugs and pharmaceuticals.

This long list also got truncated to six by 1999.

## 16.4 PRIVATISATION

Privatisation deals with the transfer of businesses from the state to the private sector. This commonly involves complex contractual structures to be put in place, and the industries concerned are usually closely regulated.

Privatisation in narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But in another sense, it implies the opening up of the private sector to areas, which were hitherto reserved for public sector. Such deliberate encouragement of investment to the private sector in the economy, will over a period of time increase the overall share of the private sector in the economy. This is the broader view in which privatisation of the economy can be effected. The basic purpose is to limit the areas of the public sector and to extend the areas of private sector operation including heavy industries and infrastructure.

Privatisation is, therefore, a process of involving the private sector in the ownership or operation of a state owned or public sector undertaking. It can take three forms: (i) Ownership measures; (ii) Organisational measures; and (iii) Operational measures.

**(i) Ownership measures:** The degree of privatisation is judged by the extent of ownership transferred from the public enterprises to the private sector. Ownership may be transferred to an individual, co-operative or corporate sector. This can have three forms:

**(a)** **Total decentralisation** implies 100% transfer of ownership of a public enterprise to private sector.

**(b)** **Joint Venture** implies partial transfer of a public enterprise to the private sector. It can have several variants – 25% transfer to private sector in a joint venture implies that majority ownership and control remains with the public sector. 51% transfer of ownership to the private sector shifts the balance in favour of the private sector, though the public sector retains a substantial stake in the undertaking. 74% transfer of ownership to the private

NOTES

sector implies a dominant share being transferred to private sector. In such a situation, the private sector is in a better position to change the character of an enterprise.

**(c)** **Liquidation** implies the sale of assets to a person who may use them for the same purpose or some other purpose. This solely depends on the preference of the buyer.

**(d)** **Workers' co-operative** is a special form of decentralisation. In this form, ownership of the enterprise is transferred to workers who may form a co-operative to run the enterprise. In such a situation, appropriate provision of bank loans is made to enable workers to buy the shares of the enterprise. The burden of running the enterprise rests on the workers in a workers' Co-operative. The workers become entitled to ownership dividend besides getting wages for their sendees.

**(ii) Organisational measures** include a variety of measures to a limited state control. They include:

**(a)** A **holding company** may be designed to taking top-level major decisions with sufficient degree of autonomy for the operating companies in its hold in their day-to-day operations. A big company like the Oil & Natural Gas Commission (ONGC), Steel Authority of India (SAIL) or Bharat Heavy Electricals Limited (BHEL) may acquire a holding status, thereby transferring a number of functions to its smaller units. In this way, a decentralised pattern of management emerges.

**(b)** **Leasing:** In this arrangement, the government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period, say of 5 years. While entering into a lease, the bidder is required to give an assurance of the quantum of profits that would be made available to the state. This is a kind of tenure ownership. The government reserves the right to review the lease to the same person or to grant the lease to another bidder depending upon the circumstances of the case.

**(c)** **Restructuring** is of two types: financial restructuring and basic restructuring.

— Financial restructuring implies the writing off of accumulated losses and rationalisation of capital composition in respect of

NOTES

debt-equity ratio. The main purpose of this restructuring is to improve the financial health of the enterprise.

— Basic restructuring is said to occur when the public enterprise decides to shed some of its activities to be taken up by ancillaries or small-scale units.

## 16.5 CONCLUSION

Liberalisation has transformed India's external and a direct beneficiary of this has been the foreign exchange market in India. From a foreign exchange- starved, control-ridden economy, India has moved on to position of $150 billion plus in international reserves with a confident rupee and drastically reduced foreign exchange control. As foreign trade and cross-border capital flows continue to grow, and the country moves towards capital account convertibility, the foreign exchange market is poised to play an even greater role in the economy.

## 16.6 SUMMARY OF THE UNIT

globalisation is a process that increases interactions with foreign countries, this leads to better opportunities and influx of new technologies. However, there can be adverse impart on society, culture and growth. The country had great expectations with liberalisation for improved economy which has not materialised.

## 16.7 GLOSSARY

- **Globalisation:** A process of global integration of products, technology labour *etc*.
- **Foreign Investment:** Investment from foreign corporate bodies, NRIs .
- **Privatisation:** A process by which major economic decisions are taken by a large ho of individuals and private units.

## 16.8 KEY TERMS

- **Globalisation**: The process involving increase interaction with foreign countries.

NOTES

- **Privatisation:** The transfer of business from state to private sector.
- **liberalisation:** Means removal of excess regulations and freedom for business.

## *16.9 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the blanks

1. Economic Liberalisation means ________ of economy.
2. Important source of foreign investment in India is _________.
3. Generally _______and democracy are widely believed to help globalisation.

### (B) True or False

1. Unemployment increases due to increased industrialisation.
2. With Liberalisation there are no threats to the economy.
3. The performance of public sector was noteworthy after independence.

## *16.10 KEY TO CHECK YOUR ANSWER*

(A). 1. Opening, 2. NRI, 3. free trade

(B). 1. True, 2. False, 3. False.

## *16.11 TERMINAL AND MODEL QUESTIONS*

1. Write a brief account on globalisation.
2. Explain the meaning of privatisation.
3. Explain the impact of foreign trade on growth and development.

## *16.12 REFERENCE BOOKS*

1. Patel I.G. Economic Reforms and Global Change, Macmillan, Delhi.
2. Michael: Globalisation, HPH, Mumbai

# UNIT 17 REGIONAL TRADING BLOCKS

**Structure:**

17.1 Introduction
17.2 Regional Trade Blocks
17.3 Trading Blocks
17.4 The Main Advantages for Members of Trading Blocks
17.5 The Main Disadvantages of Trading Blocks
17.6 Development
17.7 Summary of the Unit
17.8 Glossary
17.9 Key Terms
17.10 Check Your Progress (Multiple Choice/Objective Type Questions)
17.11 Key to Check Your Answer
17.12 Terminal and Model Questions
17.13 Reference Books

**Objectives**

After reading this Unit, you will be able to understand:

- Know about the meaning and necessity of trading blocks.
- Understand the advantages of free trade market access and protection.

## *17.1 INTRODUCTION*

Trade Blocks are Free Trade Zones designed to encourage trade activities. This provides their members with mechanism for competing in an aggressive global market. There are advantages for the members such as

NOTES

free trade, market access, protection and job opportunities. The disadvantages in terms of loss of benefits and distortion of trade.

The Internet and technological advances in telecommunications link trade partners across the globe. Yet, this does not mean that trade barriers are non-existent. While the **World Trade Organisation (WTO)** promotes global multilateral free trade, regional trade blocks provide their members with the mechanisms for competing in an aggressive global market.

Regardless of the size of your business, it is essential to know the international trade regulations that govern your import and/or export operations.

## *17.2 REGIONAL TRADE BLOCKS*

In general terms, regional trade blocks are associations of nations at a governmental level to promote trade within the block and defend its members against global competition. Defense against global competition is obtained through established tariffs on goods produced by member states, import quotas, government subsidies, onerous bureaucratic import processes, and technical and other non-tariff barriers.

Since trade is not an isolated activity, member states within regional blocks also cooperate in economic, political, security, climatic, and other issues affecting the region.

In terms of their size and trade value, there are four major trade blocks and a larger number of blocks of regional importance.

**The four major regional trade blocks are, as follows:**

As discussed earlier -

1. **E.U:** European Union.
2. **NAFTA:** North American Free Trade Agreement.
3. **SCM:** Southern Common Markets.
4. **ASEAN:** Association of southeast Asian Nations.

Regardless of the size of your business, it is essential to know the international trade regulations that govern your import and/or export operations.

The concept of trade blocks is crucial in the context of international trade. Trade blocks are free trade zones designed to encourage trade activities

across nations. The formation of trade blocks involves a number of agreements on tariff, trade and tax. The activities of trade blocks have huge importance in the economic and political scenarios of the contemporary world. Over the years trading blocks have played a major role in regulating the trend and pattern of international trade.

NOTES

### Regional Trade Blocks at a Glance

Regional trade blocks protect the interests of the member countries. The primary aim of trade block activities is to create a favourable economic framework for promotion of cross border trade among the member countries.

Different regional blocks have come up in the period of economic liberalisation in various parts of the world.

### Activities of Trade Blocks

It is true that the principal objective of all trade blocks is promotion of trade; however, the difference lies in their modes of operation. The activities of trade blocks can be evaluated by using three basic measures.

The number of latest agreements, meetings and other activities undertaken by the regional trade blocks. The pattern of future planning regarding trade promotion and focus on intergovernmental associations and quicker time frame for policy implementation. Number of practical achievements attained by the member countries. In practice, the success of trading blocks crucially depends on the performance of the member countries. To ensure effective trade promotion the trading blocks need to be more flexible and accommodation. Besides trade promotion, the regional blocks are also expected to take part in other domains of the member countries. Effective management of trade block activities ensures all-round development of the member nations.

## *17.3 TRADING BLOCKS*

A regional trading Blocks is a group of countries within a geographical region that protect themselves from imports from non-members. Trading Blocks are a form of economic integration, and increasingly shape the pattern of world trade. There are several types of trading Blocks:

NOTES

### Preferential Trade Area

Preferential Trade Areas (PTAs) exist when countries within a geographical region agree to reduce or eliminate tariff barriers on selected goods imported from other members of the area. This is often the first small step towards the creation of a trading blocks.

### Free Trade Area

Free Trade Areas (FTAs) are created when two or more countries in a region agree to reduce or eliminate barriers to trade on all goods coming from other members.

### Customs Union

A customs union involves the removal of tariff barriers between members, plus the acceptance of a common (unified) external tariff against non-members. This means that members may negotiate as a single block with 3rd parties, such as with other trading blocks, or with WTO.

### Common Market

A ‘common market’ is the first significant step towards full economic integration, and occurs when member countries trade freely in all economic resources – not just tangible goods. This means that all barriers to trade in goods, services, capital, and labour are removed. In addition, as well as removing tariffs, non-tariff barriers are also reduced and eliminated. For a common market to be successful there must also be a significant level of harmonisation of micro-economic policies, and common rules regarding monopoly power and other anti-competitive practices. There may also be common policies affecting key industries, such as the Common Agricultural Policy (CAP) and Common Fisheries Policy (CFP) of the European Single Market (ESM).

## *17.4 THE MAIN ADVANTAGES FOR MEMBERS OF TRADING BLOCKS*

### Free Trade within the Block

Knowing that they have free access to each others markets, members are encouraged to specialise. This means that, at the regional level, there is a wider application of the principle of comparative advantage.

NOTES

### Market Access and Trade Creation

Easier access to each others markets means that trade between members is likely to increase. Trade creation exists when free trade enables high cost domestic producers to be replaced by lower cost, and more efficient imports. Because low cost imports lead to lower priced imports, there is a 'consumption effect', with increased demand resulting from lower prices.

### Economies of Scale

Producers can benefit from the application of scale *economies*, which will lead to lower costs and lower prices for consumers.

### Jobs

Jobs may be created as a consequence of increased trade between member economies.

### Protection

Firms inside the block are protected from cheaper imports from outside, such as the protection of the *EU shoe industry* from cheap imports from China and Vietnam.

## *17.5 THE MAIN DISADVANTAGES OF TRADING BLOCKS*

### Loss of Benefits

The benefits of free trade between countries in different blocks is lost.

### Distortion of Trade

Trading blocks are likely to distort world trade, and reduce the beneficial effects of specialisation and the exploitation *to eomparative advantage*.

### Inefficiencies and Trade Diversion

Inefficient producers within the bloc can be protected from more-efficient ones outside the block. For example, inefficient European farmers may be protected from low-cost imports from developing countries. *Trade diversion* arises when trade is diverted away from efficient producers who are based outside the trading area.

NOTES

### Retaliation

The development of one regional trading block is likely to stimulate the development of others. This can lead to trade disputes, such as those between the EU and NAFTA, including the recent Boeing (US)/Airbus (EU) dispute. The EU and US have a long history of trade disputes, including the dispute over US steel tariffs, which were declared illegal by the WTO in 2005. In addition, there are the so-called beef wars with the US applying £60m tariffs on EU beef in response to the EU's ban on US beef treated with hormones; and complaints to the WTO of each others generous agricultural support.

During the 1970s many former UK colonies formed their own trading blocks in reaction to the UK joining the European common market.

## *17.6 DEVELOPMENTS*

### Agricultural Sector

The agricultural sector has remained relatively untouched by the reform programmes except the thrust given in the Export-Import Policy 2002-2007. Some progress has also been made in terms of the removal of: (i) controls on the inter-state movement of certain grains and (ii) administered prices. However, controls on the export and import of certain products remain. The government of India has identified potential commodities in various states and Agricultural Export Zones (AEZ) have been set up in order to promote exports.

### Food Processing Sector

In the food processing sector, tariff reforms have resulted in the average duties being halved since 1993 (currently, ranging between 15 and 25%). Import licensing restrictions have also been removed. The food processing sector has witnessed increased foreign investment, wherein up to 51 and 100% of participation is allowed automatically for foreigners and non-resident Indians respectively.

### Mining and Petroleum Sector

India heavily depends on the import of petroleum. Prices, until recently, were administered but the government has recently placed an emphasis on increased oil exploration domestically to reduce import dependence and is

NOTES

encouraging new explorations by offering investment incentives like tax holidays to companies.

Major policy changes since 1991 include automatic permission for foreign equity participation in the mining activity of 13 minerals. However, the Foreign Investment Promotion Board (FIPB) must approve foreign equity participation in case of over 50% share of participation. Trade reforms include a reduction in tariff rates to around 10% (from 46% in 1993-94) for non-ferrous and iron ores and 13% (from 65% in 1993-94) for coal.

## Manufacturing Sector

Reforms have been implemented in the manufacturing sector, including (i) reductions in average tariff rates, (ii) removal of import licensing restrictions, (iii) relaxations in compulsory industrial licensing, and (iv) liberalisation of foreign investment policies. The rules governing foreign investment have also been considerably simplified with an enlarged list of industries, including the automobile sector. (Refer to the website of Engineering Export Promotion Council for more details).

## Services Sector

Services sector contributes more than 50% of India's national income. Its overall growth has been fueled by rapid expansion of activities in the area of finance, information technology, commerce and tourism. The software, BPO and KPO sectors have contributed to the growth of the Indian economy in the recent past. Global outsourcing of services has been an important segment of the service sector for many years. Steps have been taken in liberalising telecommunications sector. Many value-added services-including cellular mobile telephone are now open to foreign equity participation. In the area of financial services, the insurance sector that had been monopolised by the government till, now has been made open to domestic private investors and foreign tie-ups. Under the Financial Services Agreement, the government has offered to remove restrictions on foreign firms in the banking sector.

India has a large pool of well-qualified professionals capable of providing services abroad. GATS (General Agreement on Trade in Services) recognises "movement of natural persons" as one of the modes for supply of services. However, the commitments shown by the developed countries have very little to offer to the developing countries. The present commitments are largely restricted to business visitors and intra-corporate transferees.

NOTES

## *17.7 SUMMARY OF THE UNIT*

The association of nations have created areas for regional trade Blocks, to promote trade. It also acts as buffer against competition Common market have been created by four major trade blocks.

1. E.U- European Union
2. NAFTA - North American Free Trade Agreement
3. SCCM - Southern Common Markets
4. ASEAN - Association of Southeast Asian Nations

## *17.8 GLOSSARY*

- **Trade Policy:** Policy regarding Import/Export
- **Tariffs:** Duties on import of goods and service
- **PTA:** Preferential Trade Area.

## *17.9 KEY TERMS*

- **Anti dumping:** Action against dumping
- **Trade Blocks:** Inter governmental agreement where regional barriers to trade are reduced or eliminated.
- **Custom Valuation:** Set of rules for valuation that ensures trade objectives.

## *17.10 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. Customs union involves ________ of tariff barriers between members.
2. In Custom market the members trade freely in all ________.
3. ‘Scale economies lead to lower _______for consumers.

NOTES

## (B) True or False

1. Regional Trading Block is group of nations within the region.
2. In a common market member countries are not allowed to trade freely.
3. Trade Blocks do not create jobs.

## *17.11 KEY TO CHECK YOUR ANSWER*

(A) 1. Removal, 2. Resources or Goods, 3. Prices

(B) 1. True, 2. False, 3. False

## *17.12 TERMINAL AND MODEL QUESTIONS*

1. Explain the purpose of creating blocks.
2. Write a note on advantages of trading blocks.

## *17.13 REFERENCE BOOKS*

1. Das K - Trade & Development, 'Deep', Delhi.
2. Balagopal - Export Management, HPH, Mumbai.

# UNIT 18 WORLD TRADE AND EMERGING ENVIRONMENT

## Structure:

18.1 Introduction
18.2 Foreign Trade Policy of India
18.3 Salient Features of EXIM Policy
18.4 Emerging Environment
18.5 Foreign Exchange Reserves (QR – Quantitative Restrictions)
18.6 Phased Removal of QRs
18.7 Removal of QRs: Implications
18.8 Special Provisions of WTO Agreement
18.9 Conclusion
18.10 Summary of the Unit
18.11 Glossary
18.12 Key Terms
18.13 Check Your Progress (Multiple Choice/Objective Type Questions)
18.14 Key to Check Your Answer
18.15 Terminal and Model Questions
18.16 Reference Books

## Objectives

After reading this Unit, you will be able to:

- Understand the importance of World Trade and trading environment.
- Explain The importance of GATT and WTO.
- Discuss the Importance of export promotion initiatives.

NOTES

## 18.1 INTRODUCTION

The most important initiatives of the EXIM policy were (1) the removal of restrictions on agricultural export (2) setting up of twenty export zones in twelve states. The policy also made Special Economic Zones (SEZ), there were attractive because of benefits of income tax. However, there were quantitative restriction, such as import and export. Eventually the quantitative restrictions were phased out. This had an impact on prices in the free trade environment.

## 18.2 FOREIGN TRADE POLICY OF INDIA

The focus of trade policy reforms in India have been on liberalisation, openness and globalisation with a basic thrust on export promotion activity, removal of Quantitative Restrictions and making Indian industry more competitive to meet global requirements. Although the EXIM Policy of India is primarily a five-year policy, commerce ministry announces appropriate amendments every year, keeping in mind the latest national and international developments. This is usually done on 31st March every year. The last five-year EXIM policy was effective till 2002.

Although the 2002 EXIM policy was supposed to last for 5 years, the UPA government announced new five-year 'Foreign Trade' Policy from 2004 by changing the name 'EXIM' policy. There is a special emphasis on certain areas like the industrial clusters, Agri-Export Zones, gems and jewellery and hardware in 2004-09 policy. It attempts to build on what has already been announced earlier.

Taking into account the important sectors, an attempt has been made to highlight the salient features of EXIM policy 2002 in comparison with the 1997-2002 policy and the changes introduced in 1999, 2000 and 2001.

| **Export-Import (EXIM) Policy—Comparative Perspectives** | | | |
|---|---|---|---|
| Features | 2002 EXIM | 1997-2002 Export Import Policy | |
| | Policy | Amended on Amended on Amended in March 31, 2001 March 31, 2000, 1999 | Presented in 1997 |

NOTES

## *18.3 SALIENT FEATURES OF EXIM POLICY*

The EXIM Policy 2002 was described as pro-growth and positive with certain concrete measures. The most important initiatives of the policy were: (i) removal of Quantitative Restrictions on agricultural exports and (ii) setting up of 20 Agri-export Zones in 12 states. The policy also made the Special Economic Zones (SEZs) more attractive by extending income tax benefits to the units in SEZs.

Commendable steps announced in the 2002 policy were:

(a) The setting up of OBUs (Overseas Banking Units) in the Special Economic Zones. It would lead the SEZs to have access to money at internationally competitive rates thereby reducing the cost of capital;

(b) Continuation of all the existing exports promotion schemes. For example, continuation of Duty Entitlement Pass Book (DEPB) scheme with further simplification;

(c) Relaxation of minute verification of technical characteristics;

(d) Reduction in interest rate from 24% to 15% in case of non-fulfilment of export obligation by exporters under the various schemes. This measure is likely to tap immense export potential;

(e) Sectoral focus on leather, textiles, electronics, and gems and jewellery and this is expected to tap the immense untapped export potential that would get a boost;

(f) Focus on Latin American, African and new Soviet republic countries;

(g) More freedom to bring in foreign exchanges remittances within 360 days instead of the earlier limit of 180 days, and

(h) Permission to exporters to keep 100% export proceeds in Exchange Earner's Foreign Currency (EEFC) account.

### Focal Issues

Some of the issues pertaining to the EXIM policy 2002 were:

(a) No scheme was announced for remission of indirect taxes for the exporters.

(b) The funds allocated for the states could have been much more to meaningfully address the needs of infrastructure development.

NOTES

(c) The Cluster Development issue needs to be looked at in a greater detail as most of the clusters lack basic infrastructure facilities necessary for exports.

## *18.4 EMERGING ENVIRONMENT*

The NDA government in India was replaced by the UPA government in 2004. The UPA government changed the name of EXIM Policy, to Foreign Trade Policy and the new five year 'Foreign Trade Policy' was announced in 2004 by the Commerce Minister. With a view to doubling percentage share of global trade within 5 years and expanding employment opportunities, especially in semi urban and rural areas, certain special focus initiatives have been identified for the agriculture, hand looms, handicraft, gems & jewellery and leather sectors (given below).

(a) A new scheme called the Vishesh Krishi Upaj Yojana (Special Agricultural Produce Scheme) for promoting the export of fruits, vegetables, flowers, minor forest produce, and their value-added products has been introduced.

(b) Funds shall be earmarked for the development of Agri Export Zones (AEZ).

(c) Units in AEZ shall be exempt from bank guarantee under the EPCG scheme.

(d) Capital goods imported under EPCG shall be permitted to be installed anywhere in the AEZ.

(e) Import of capital goods shall be permitted duty free under the EPCG scheme.

(f) New towns of export excellence with a threshold limit of ₹ 250 crore have been notified.

(g) Specific funds earmarked under Market Access Initiative Scheme for promoting hand loom and handicraft exports.

(h) New handicraft SEZs shall be established which would procure products from the cottage sector and do the finishing for exports.

(i) The Handicraft Export Promotion Council has been authorised to import trimmings, embellishments and consumables on behalf of those exporters for whom direct importing may not be viable.

NOTES

(j) Import of gold of 18 carat and above shall be allowed under the replenishment scheme.

## *18.5 FOREIGN EXCHANGE RESERVES (QR – QUANTITATIVE RESTRICTIONS)*

Quantitative Restrictions (QRs) refer to limits set by countries to restrict imports (or exports). These are generally in the form of quotas, licensing requirements or in the form of canalising of imports — *i.e.*, allowing only a few players or entities to import specific things. QRs are thus measures, other than tariffs or duties, imposed to restrict imports (or exports). Under the GATT, imports have to be controlled only through tariffs or customs duties. There are, however, some exceptions to the rule. One exception is that a country can take recourse to QRs on grounds of Balance of Payments (BoP) difficulties. It was under this exception that India had maintained QRs. Till 1993, India's BoP situation had been quite unhealthy. Since 1994-95, there has been steady improvement in the BoP status as indicated by foreign exchange reserves position of the country.

*Table 18.1: Foreign Exchange Reserves and Total Imports in India*

| Year ending on | Total Foreign Exchange Reserves (Billion US $) | Total imports during the year (Billion US $) |
|---|---|---|
| 31st March 1993 | 9.8 | 21.88 |
| 31st March 1994 | 19.3 | 23.31 |
| 31st March 1995 | 25.2 | 28.65 |
| 31st March 1996 | 21.7 | 36.68 |
| 31st March 1997 | 26.4 | 31.13 |
| 31st March 1998 | 29.4 | 41.48 |
| 31st March 1999 | 32.5 | 42.39 |
| 31st March 2000 | 38.0 | 42.20 |
| 31st March 2001 | 47.4 | 46.5 |
| 31st March 2002 | 54.1 | 51.4 |
| 31st March 2003 | 75.4 | 59.4 |
| 31st March 2004 | 112 | 75.3 |

***Source:*** Compiled from Handbook of Statistics on Indian Economy, RBI, Mumbai, 2002 & RBI Annual Report 2004-2005.

NOTES

The Table 18.1 presents the data on India's foreign exchange reserves and total imports for the period 1993 to 2004. From the table, it can be noted that foreign exchange reserves became quite healthy over the years as compared to the trends in India's total imports. With the improvement in the balance of payments position in the mid 1990s, in general, members of the WTO raised question about India's need to continue Quantitative Restrictions.

By 1997, India had negotiated with most of the trading partners, to arrive at a mutually agreeable solution for phasing out the QRs. Under the Agreements, the QRs were to be withdrawn over a six- year period ending 31st March 2003. USA, however, felt that the period was too long and filed a dispute against India with the WTO. The Dispute Settlement Body of WTO, which was constituted in November 1997, gave its adjudication against India. Although India filed an appeal before the Appellate Body of WTO against the verdict of the panel, they upheld the findings of the dispute settlement body. Accordingly, QRs on the 1429 tariff lines were removed by 1st April 2001 under the agreement (of which QRs on 714 were removed with effect from 1st April 2000).

## *18.6 PHASED REMOVAL OF QRS*

India had been following consistent policy for gradual removal of restrictions on imports ever since the economic reforms were initiated. There used to be a fresh list of items allowed for importing under OGL (Open General License) every year. The process gathered momentum during the second half of 1990s. Year-wise details on type of non- tariff barriers and progress towards their removal is given in Table 18.2. As given in the table, on 31 March 1997 import of 6649 tariff lines (as per Harmonised System of India Trade Classification) out of total number of 10,202 was already free. It can be further seen from the table that consequent to improvement in Balance of Payment (BoP), import restrictions on 488 tariff lines were removed in 1996-97, 132 in 1997-98 and 1274 in 1998-99. The process of removal of import restrictions on BoP grounds completed on 31.3.2001.

NOTES

*Table 18.2: Different Types of Non Tariff Barriers (NTB) imposed on India's Imports (1996-97 to 2001-02*)*

| NTV/Year | 1.4.1997 | 1.4.1998 | 1.4.1999 | 1.4.2000 | 1.4.2001 |
|---|---|---|---|---|---|
| Prohibited | 59 | 59 | 59 | 59 | 59 |
| Restricted | 2322 | 2314 | 1183 | 968 | 479 |
| Canalised | 129 | 129 | 37 | 34 | – |
| SIL | 1043 | 919 | 886 | 226 | – |
| Free | 6649 | 6781 | 8055 | 8854 | 9611** |
| Total | 10202 | 10202 | 10220 | 10141 | 10149 |

***Source:*** Indian Economic Survey 2001-02, Government of India, Page 142.

*As per Harmonised System of India Trade Classification, HS-ITC classification of export and import.

** Including 29 tariff lines, which are shifted to state trading.

India's imports have been progressively liberalised. The level of tariff lines, which were made 'free import' category, as on 1.4.1996, was 61%. This percentage has increased to around 95% as on 1.4.2001. Action has been completed on removal of restrictions on tariff lines (2714 items), and has been notified to WTO under the BoP cover. Table 18.2 shows that the number of freely importable tariff lines had increased from 6649 to 9611 as on 01.04.2001 over a period of five years from 1996.

There were 2,984 tariff lines under the restricted list on 01.04.1996, which got reduced to 1183 on 01.04.1999, 968 on 01.04.2000, and finally 479 on 01.04.2001. Further, Special Import License (SIL) has become part of history with effect from 01.04.2001. QRs are, however, still being maintained on about 5% of tariff lines (538 items) as permissible under Article XX and XXI of GATT on grounds of health, safety and moral conduct.

## 18.7 REMOVAL OF QRS : IMPLICATIONS

With the removal of QRs on imports into India, consumers benefit as they get a wider choice of goods and services at a lower cost. Secondly, freer trade brings down prices and helps in keeping the level of inflation low as an advantage to the society. Thirdly, the government gets revenue from customs duties on imports—*e.g.* things, which were being bought in the markets abroad and brought into the country through undisclosed channels, can be brought through legal channels, thus generating revenue for the

**NOTES**

country. (A case in point could be that of freeing of gold imports, which has resulted in gold now being imported through legal channels, resulting in substantial revenue earning through customs duty for the government). Fourthly, it would lead to easier access to imported raw materials and capital goods for the domestic manufacturers leading to faster industrial growth. Finally, competition from imports can lead to upgradation in the quality of even domestic products and increased productivity.

As mentioned above, removal of quantitative restrictions will have an impact on prices. When the movement is from regulated regime to free trade environment, imports increase and the market share of domestic producers tend to decline. With the increase in imports, there is a possibility of the domestic prices being depressed to the advantage of consumers. Competition from imports can lead to an increase in the quality of even the domestic products. However, it is widely suggested that Indian industry has to be on a sound footing to face the competition from the rest of the world, especially from the MNCs. A large number of companies may sink and others, who are quality-conscious and competent, may emerge as leaders.

The reservation of items for the Small Scale Industry sector has become meaningless after the lifting of quantitative restrictions on imports. On this ground, many people have generally expressed the concern for the small enterprise development in India. However, government's decision to reduce customs duties on a host of inputs used in the manufacture of final products by the small-scale sector is expected to improve its price competitiveness. It may, thus, help the industry to compete against cheaper imports, particularly from countries like China.

As a matter of fact, in order to offset the adverse implications of removal of QRs, duties on some items have been revised upwards to safeguard the interests of the domestic industry.

The applied rates of duties have also been raised to the bound levels for most of the items. India has generally bound its tariffs on primary agricultural commodities at 100%; on processed items at 150% and on edible oils at 300% and can raise its applied rates in case of any surge in imports. But import duties have to be fixed keeping in mind domestic availability of the goods under consideration and also the interests of the consumers.

NOTES

## *18.8 SPECIAL PROVISIONS OF WTO AGREEMENT*

There is need for balance between the interests of the consumers and that of the domestic producers, which has to be maintained by government. For this purpose, WTO has made special provisions based on which the member countries will have to take action.

## *18.9 CONCLUSION*

The salient observations emerging from the different discussion points, covered in the chapter, are listed below:

1. Though the negotiations conducted under the aegis of GATT and WTO have helped in reducing tariff rates, many countries use Non-tariff barriers such as standards and countervailing duties to restrict the flow of trade. This aspect continues to hamper the prospects of India's export performance.
2. Quantitative Restrictions on imports of 95% tariff lines have been removed as part of trade liberalisation in India. Also, the customs duties on most of the items have been brought down. At the same time, there is special emphasis on export promotion activity, according to the EXIM policy. These policy measures have been expected to have significant impact on the industrial sector in the country.
3. While trade liberalisation measures have gained significant momentum over the recent years, there is also a need for maintaining balance between the interests of consumers and domestic producers. Taking this aspect into account, the government has to monitor the price and quantity of commodities being imported. This necessitates that the government resorts to appropriate action, on the basis of special provisions and permitted actions in the WTO agreement.

## *18.10 SUMMARY OF THE UNIT*

WTO is an international organisation of 153 member countries, It was created in 1995. WTO unlike GATT is empowered to enforce rules with economic sanctions. The nature of trade environment is changing. The

NOTES

primary factors that will shape future world trade and global trading systems are, technological innovations, shifts in production and consumption patterns and finally demographic change.

## *18.11 GLOSSARY*

- **EEFC:** Exchange Earner's Foreign Currency Account.
- **OBUs:** Overseas Banking Units.
- **SEZ:** Special Economic Zones.

## *18.12 KEY TERMS*

- **W.T.O:** World Trade Organistion.
- **GATT:** General Agreement on Tariffs and Trade.
- **TRIPS:** Trade Related Intellectual Property Rights.

## *18.13 CHECK YOUR PROGRESS (MULTIPLE CHOICE/OBJECTIVE TYPE QUESTIONS)*

### (A) Fill in the Blanks

1. As per WTO requirements patents are for________years.
2. Quantitative restrictions can be set on the grounds of balance of _______difficulties.
3. TRIM—Trade related investment measures do not apply to restrictions in_________.

### (B) True or False

1. WTO helps to promote Trade.
2. Free trade decreases cost of living.
3. Primacy objective of GATT was to expand international trade.
4. W.T.O. is not the only body dealing with trade among nations.

NOTES

## *18.14 KEY TO CHECK YOUR ANSWER*

(A) 1. 20, 2. Payment, 3. Quantity

(B) 1. True, 2. True, 3.True, 4. True

## *18.15 TERMINAL AND MODEL QUESTIONS*

1. Explain the role of WTO in dispute settlement.
2. Write a short note on Administrative procedures of WTO.
3. What are the salient features of W.T.O agreement.

## *18.16 REFERENCE BOOKS*

1. Bhandani: WTO - Deep, Delhi.
2. Gupta K.R -WTO - Atlantic, Delhi.
3. Suryakant B - WTO - Palak, Mumbai.

NOTES

## *18.14 KEY TO CHECK YOUR ANSWER*

(A) 1. 20, 2. Payment, 3. Quantity

(B) 1. True, 2. True, 3.True, 4. True

## *18.15 TERMINAL AND MODEL QUESTIONS*

1. Explain the role of WTO in dispute settlement.
2. Write a short note on Administrative procedures of WTO.
3. What are the salient features of W.T.O agreement.

## *18.16 REFERENCE BOOKS*


1. Bhandani: WTO - Deep, Delhi.
2. Gupta K.R -WTO - Atlantic, Delhi.
3. Suryakant B - WTO - Palak, Mumbai.