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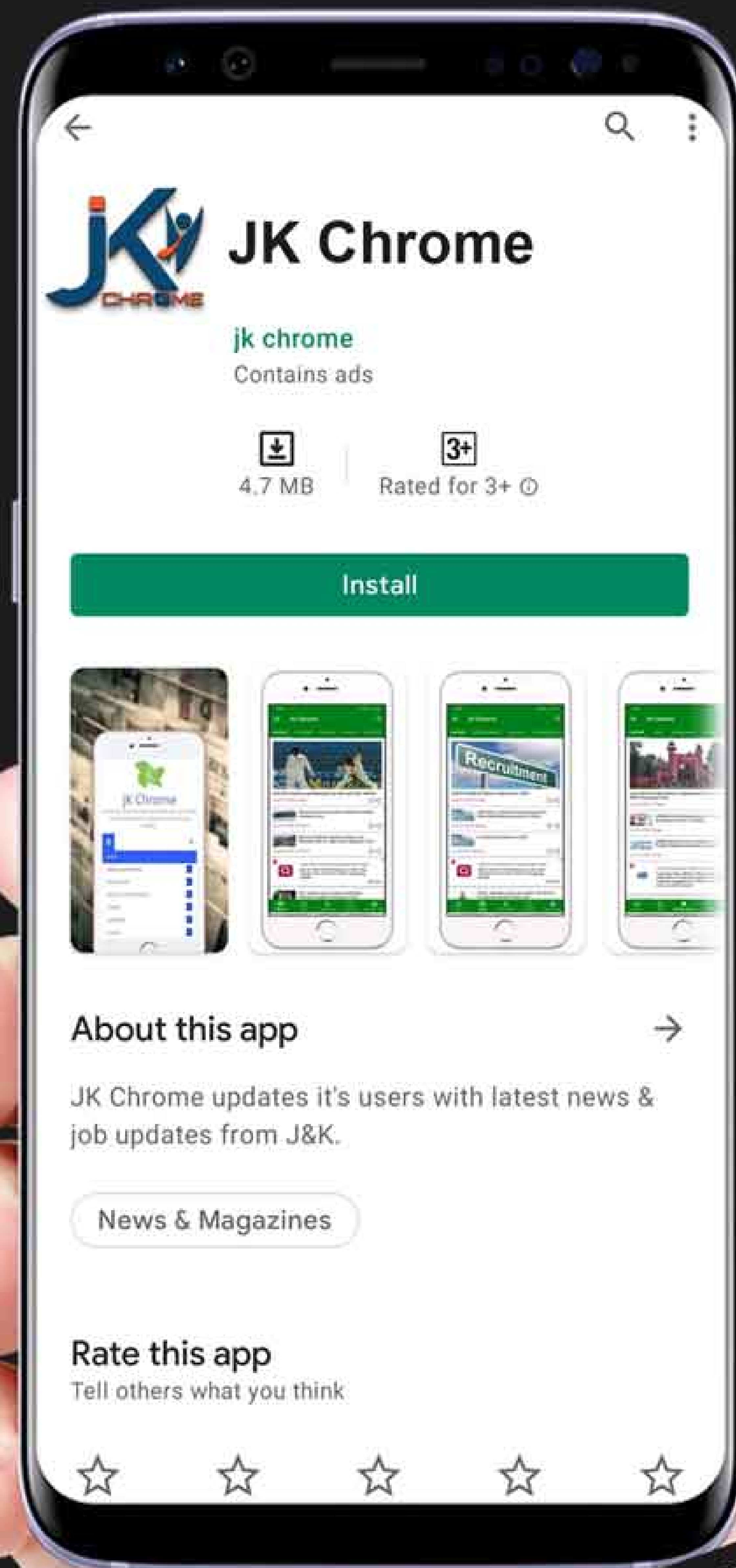

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INDIAN ECONOMY

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Introduction to Economics

1.1. INTRODUCTION TO ECONOMICS

The term or word 'Economics' comes from the Ancient Greek **oikonomikos** (Oikos means "households"; and, nomos means "management", "custom" or "law"). Thus, the term 'Economics' literally means 'management of households'. Different scholars have defined economics differently. We can simply define economics as a **scientific discipline** that '**studies the production, distribution, and consumption of goods and services**'. Earlier economics was seen as science of wealth creation. However, now human well-being has come to the center of economics. Along with creation of wealth, distribution and utilization of wealth for human wellbeing has also become important domain of economics.

The study of Economics analyses the behaviour and interactions among economic agents, individuals and groups belonging to an economic system. It deals with the activities such as the consumption and production of goods and services and the distribution of income among the factors of production. It is concerned with human activities related to wealth. The subject Economics is classified into two branches, namely, Micro Economics and Macro Economics.

1.2. MICROECONOMICS AND MACROECONOMICS

Microeconomics may be defined as that branch of economic analysis which studies the economic **behaviour of the individual unit**, may be a person, a particular household, or a particular firm in

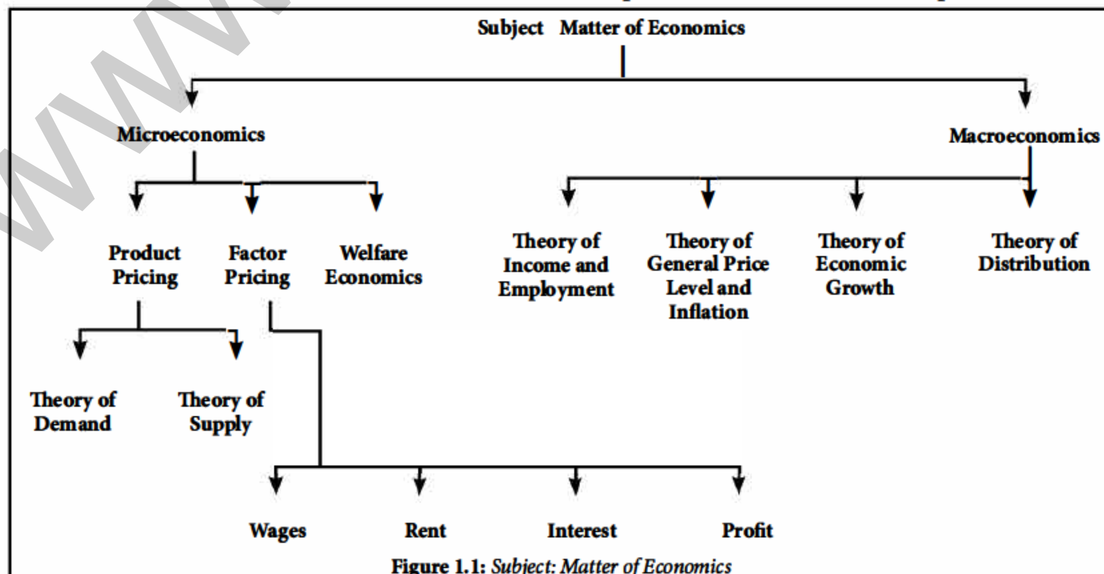

Figure 1.1: *Subject: Matter of Economics*

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making decisions on the allocation of limited resources.

It is concerned with the behaviour of individual unit in an economy. For example: determining price of a single product or behaviour of a single consumer or a business firm. It focuses on how individual economic units or agents operate or function or make decisions, as well as how they interact with each other. For example: whether price rises in the automobile or oil industries are driven by supply or demand changes.

Macroeconomics may be defined as that branch of economic analysis which studies the **behaviour of all the units combined together**, not of one particular unit. It deals with broad aggregates like national income, employment and output and so on.

The **subject matters** covered in **Macro Economics** are the areas such as employment, national income, inflation, business cycle, poverty, inequality, disparity, investment and saving, capital formation, infrastructure development, international trade, balance of trade and balance of payments, exchange rate and economic growth.

Micro Economics	Macro Economics
It is that branch of economics which deals with the economic decision making of **individual economic agents** such as the producer, the consumer etc.	It is that branch of economics which deals with **aggregates and averages** of the entire economy. E.g., aggregate output, national income, aggregate savings and investment, etc.
It takes into account small components of the whole economy	It takes into consideration the economy of the country as a whole
It deals with the process of price determination in case of individual products and factors of production	It deals with general price-level in any Economy.
It is known as price theory	It is also known as the income theory
It is concerned with the optimization goals of individual consumers and producers	It is concerned with the optimization of the growth process of the entire economy

General Price level: It is a weighted average of price of all goods and services in an economy during a given time interval normalized relative to some base year. It is represented by different indices like CPI or WPI.

1.2.1. Interdependence of Microeconomics and Macroeconomics

Microeconomics and Macroeconomics are complementary to each other. In fact, they are so interdependent that neither approach is complete without the other. In the words of Prof. Samuelson, "There is really no opposition between microeconomics and macroeconomics. Both are absolutely vital. You are less than half educated if you understand the one while being ignorant of the other.

The conjunction of all micro decisions has consequence at the macro level. The functioning of the economy at the macro level will have bearings for decision-making at the micro level. **For Example**: rise in inflation (**macro effect**) will cause rise in the cost of production leading to rise in prices which consumers will pay (micro effect).

1.3. UNDERSTANDING MICROECONOMICS

1.3.1. Consumer Behaviour and Costs (Demand side of the Economy)

Demand in economics is the **desire to possess** something and the **willingness** and the **ability to pay** a certain price in order to possess it. As per economic theories, goods and services are supplied only when they are demanded. Demand for any good or service is mainly determined by consumer behaviour which is based mostly on cost-benefit

analysis (minimizing cost and maximizing the benefits). The **Law of Demand** explains the **relationship between the price** of a commodity and the **quantity demanded** of it. The law of demand states that there is an **inverse relationship between the price and the quantity demanded** of a commodity. It means that people will buy more at lower prices than at higher prices if all other factors are constant.

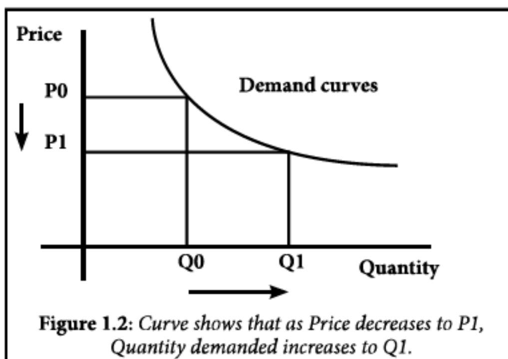

Figure 1.2: *Curve shows that as Price decreases to P1, Quantity demanded increases to Q1.*

Normally, the demand curve slopes downwards from left to right. But there are some **unusual demand curves which do not obey the law/usual demand curve**. For them, a fall in price brings about a contraction of demand and a rise in price results in an extension of demand. Therefore, the demand curve slopes upwards from left to right. It is known as **exceptional demand curve**.

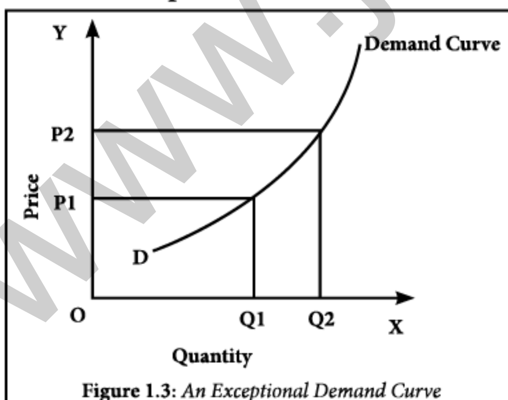

Figure 1.3: *An Exceptional Demand Curve*

Veblen Effect (Conspicuous Consumption / Luxury Goods) means spending of money on luxury goods and services to display financial power. **Demand for Veblen goods increases with rise in their price**. For example – A Rolex watch or Rolls Royce car is desirable because of their high price and associated status symbol.

Giffen Goods are goods with the unique characteristic that an **increase in prices actually increases** the **quantity** of the good that is **demanded**. The generally accepted explanation is that Giffen goods are a type of **inferior good** without a substitute. For example, when the price of rice increases, people cannot shift out of rice but rather eat only rice (more rice) instead of other vegetables.

Speculative effect reverses the demand curve due to expectation of certain future events. If the price of the commodity is increasing then the consumers will buy more of it because of the expectation that it will increase still further. For example: stock markets.

1.3.1.1. Determinants of Demand

Determinants of demand include: **Price** of the good, **Income** of the buyer, **Taste** or level of **preference** for the product, the **prices of related products**, future **expectations**. Consumers are expected to purchase more of a product at lower prices than at higher prices. When income of consumers rises, demand of the product rises and the converse is also true. The demand for some goods and services is very susceptible to changes in tastes and fashions. For Example: the growing awareness in respect of noise and environmental pollution has resulted in a decline in the demand for crackers during Diwali celebrations. Demand is also affected by presence of **substitute goods** (those that directly competes with the good in the opinion of the buyer, for example, if tea is costly, buyer may drink coffee) and **complementary goods** (used with the good in the opinion of the Buyer; e.g., if I buy bread, I have to buy jam also). Expectations also bring about a change in demand. Expectation of rise in price in future results in increase in demand.

Substitute goods are pair of competing goods which, in the opinion of buyers, can replace each other. For example, if tea is costly, buyer may drink coffee

Complementary goods are pair of goods that are interdependent or compatible. For example: bread and jam, tea and sugar etc.

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13.1.2. Elasticity of Demand

Elasticity: It refers to the responsiveness of one economic variable to a change in another variable. If a small change in one variable brings a huge change in other, then it is highly elastic. However, if change in one variable has little or no effect on other, then it is said to be highly inelastic.

The Law of Demand explains the direction of change in demand due to change in the price. It fails to explain the rate of change in demand due to a given change in price. The impact of the price change is always not the same. Sometimes, the demand for a good change considerably, even for small price changes. On the other hand, there are some goods for which the demand is not affected much by price changes.

Demand for a commodity is said to be "Elastic" when the quantity demanded increases by a large amount due to a little fall in the price and decreases by a large amount due a little rise in the price.

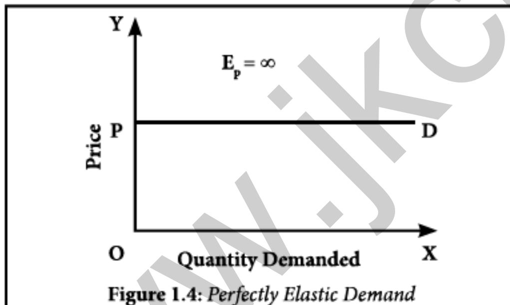

Figure 1.4: *Perfectly Elastic Demand*

Perfectly Elastic Demand - The demand is said to be **perfectly elastic** when a slight change in the price of a commodity causes an **infinite change in its quantity demanded.** Such as, even a small rise in the price of a commodity can result in greater fall in demand even to zero. In some cases, a little fall in the price can result in the increase in demand to infinity. In perfectly elastic demand the demand curve is a horizontal straight line parallel to x axis. For example- those objects having substitutes, when the price rises, the Demand will fall considerably.

For Example: When the price of coffee increases, consumers might decide to buy tea instead of coffee. Coffee is an elastic product because a small increase in the price dropped the quantity demanded.

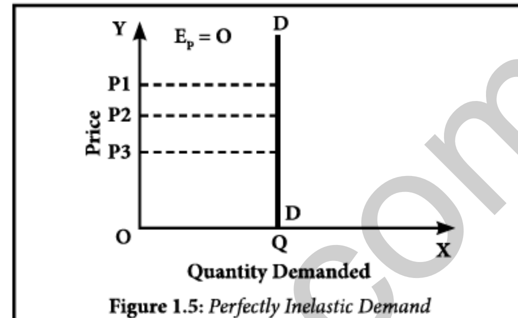

Figure 1.5: *Perfectly Inelastic Demand*

Perfectly Inelastic Demand - When there is **no change in the demand** for a product due to the change in the price, then the demand is said to be perfectly inelastic. Here, the demand curve is a vertical straight line which shows that the demand remains unchanged irrespective of change in the price.

For example, whatever be the price, the staple food of wheat and rice will have similar Demand as it is essential (so Demand is inelastic)

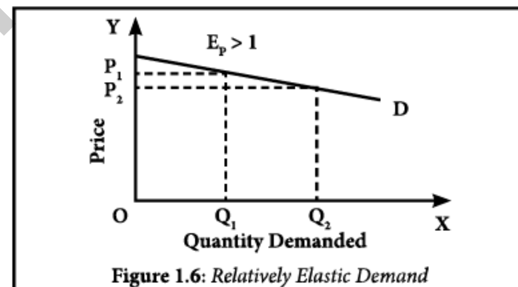

Figure 1.6: *Relatively Elastic Demand*

Relatively Elastic Demand - The demand is relatively elastic when the proportionate change in the demand for a commodity is greater than the proportionate change in its price.

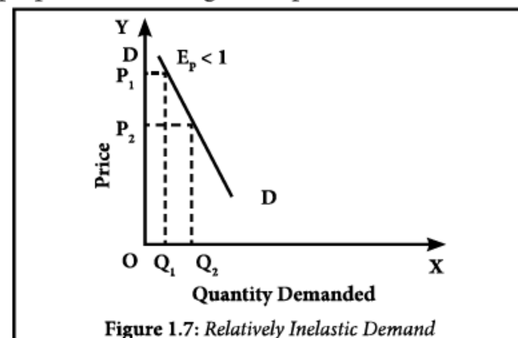

Figure 1.7: *Relatively Inelastic Demand*

Relatively Inelastic Demand - When the proportionate change in the demand for a product is less than the proportionate change in the price, the demand is said to be relatively inelastic. It is

also called as the elasticity less than unity. Here the demand curve is steeply sloping.

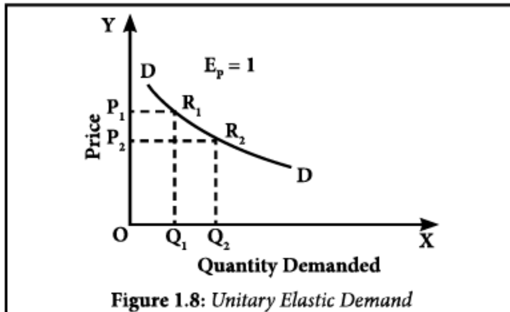

Figure 1.8: *Unitary Elastic Demand*

Unitary Elastic Demand – The demand is unitary elastic when the proportionate change in the price of a product results in the same proportionate change in the quantity demanded. Here the shape of the demand curve is a rectangular hyperbola.

1.3.1.3. Opportunity Cost and Demand

Opportunity costs represent the potential benefits an individual, investor or business misses out on while choosing one alternative over another. In simple words, you lose something by choosing one over the other. **For Example**: I can sleep extra or I can exercise in that time. If I choose to sleep, I will lose my exercise (opportunity cost). In cost-benefit analysis, any economic being will try to minimize the opportunity cost as far as possible. E.g., When person X has the money only to buy either food or a car, X will choose food because the opportunity cost of choosing a car is very high as the cost involved is hunger and death.

1.3.2. Production and Costs (Supply side of Economics)

Supply is the **quantity** of a commodity that an **individual/firm is willing to sell at a particular price**. The supply of a commodity is always with reference to the price at which the desired quantity is supplied. **Law of Supply** is associated with production analysis. It explains the **relationship** between the **price** of a commodity and the **supply** of that commodity. The Law of Supply can be stated as: if the **price of a commodity increases its quantity supplied increases** and if the price of a commodity decreases, quantity supplied also decreases provided that other variables remain same. In other words, when the price is higher, the greater will be the incentive for the firm to sell.

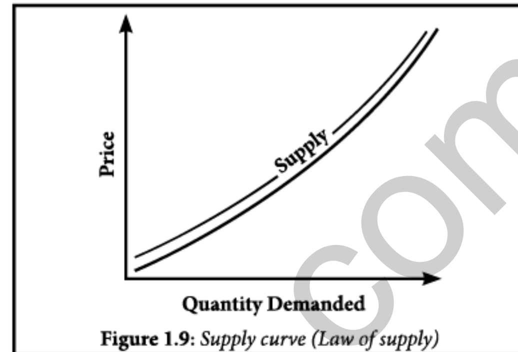

Figure 1.9: *Supply curve (Law of supply)*

1.3.2.1. Determinants of Supply

There are a number of factors which influence the supply of a commodity. Some of the important factors influencing supply or quantity supplied of a commodity are: **Price** of the commodity supplied, **Production cost** (including labour and material cost), **Taxes, Objectives** of the firms. When price of the commodity increases, its supply also increases (Law of Supply). It means that when the price of the commodity is higher, the more profitable will it be to produce or supply that commodity, other things remaining unchanged. If production cost increases, then supply would decrease because of shrinkage in profit margins. Higher the taxation, lesser will be the incentive for production. And finally, there may be firms whose primary objective may not be profits. So even if the prices decrease, they may still continue to maintain supply levels for social welfare. Further, if objective of a company is to establish itself in market or to eliminate competition, it may continue to supply products at a very low-price level, sometimes even bearing a loss.

1.3.2.2. Elasticity of Supply

The Law of Supply tells us that there is a direct relation between the price of a commodity and its amount supplied, other things remaining unchanged. **Elasticity of supply measures** the degree to which the quantity supplied responds to price changes.

Relatively elastic supply: One percent change in the price of a commodity causes **more than one per cent change in the quantity supplied of the commodity**. **(Es >1)**

Unitary elastic supply: The coefficient of elastic supply is equal to 1 **(Es = 1)**. One percent change

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Movement and Shifts in Demand-Supply Curve

Movement refers to changes along the demand/supply curve. Movement results in change in both price level and quantity supplied or demanded.

Shift refers to change in position of curve i.e., change in quantity supplied/demanded while the price level remains the same.

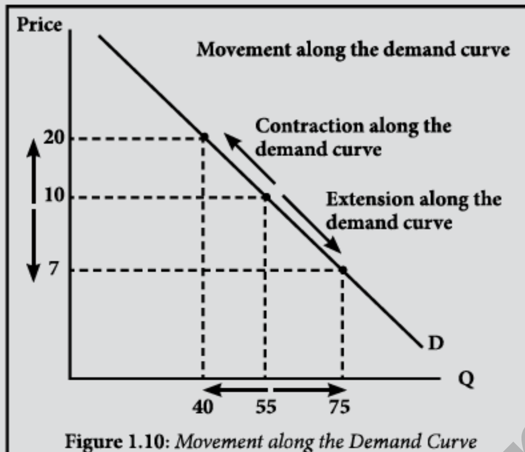

Figure 1.10: *Movement along the Demand Curve*

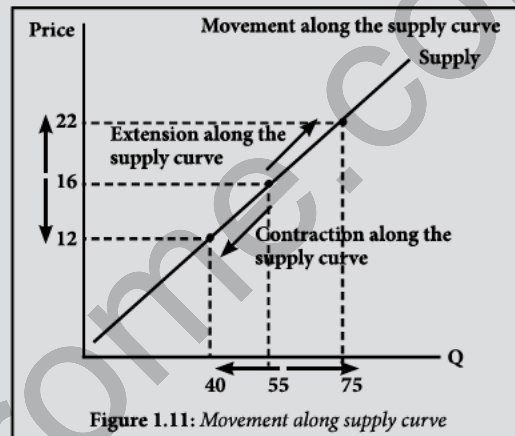

Figure 1.11: *Movement along supply curve*

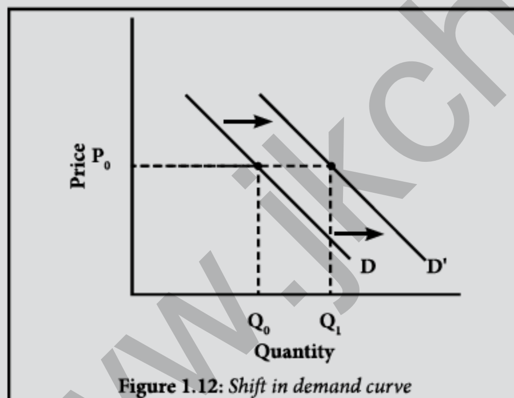

Figure 1.12: *Shift in demand curve*

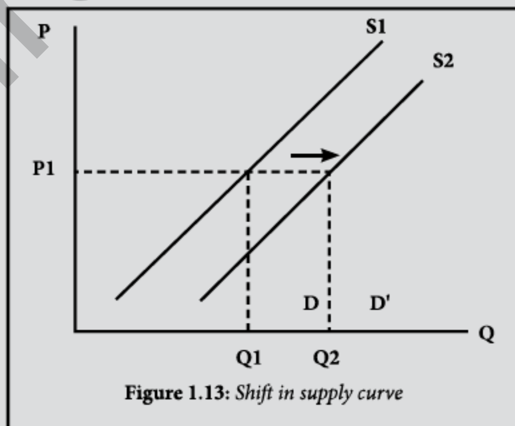

Figure 1.13: *Shift in supply curve*

in the price of a commodity causes an **equal (one per cent) change in the quantity supplied of the commodity**.

Relatively inelastic supply: One percent change in the price of a commodity causes a less than one per cent change in the quantity supplied of the commodity. **(Es <1)**

Perfectly inelastic supply: One percent change in the price of a commodity causes no change in the quantity supplied of the commodity.

Perfectly elastic supply: One percent change in the price of a commodity causes an infinite change in the quantity supplied of the commodity.

For example, During the COVID-19 pandemic, there was an increased cost for masks which were immediately met by the market by supplying more masks (elastic supply of masks), but the number of doctors cannot be immediately increased in a country (inelastic supply of doctors).

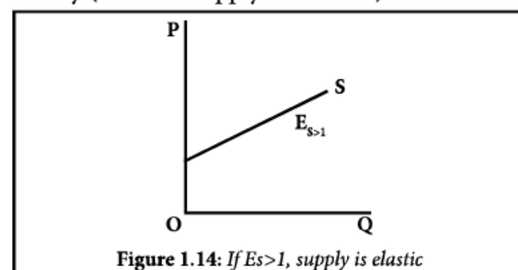

Figure 1.14: *If Es>1, supply is elastic*

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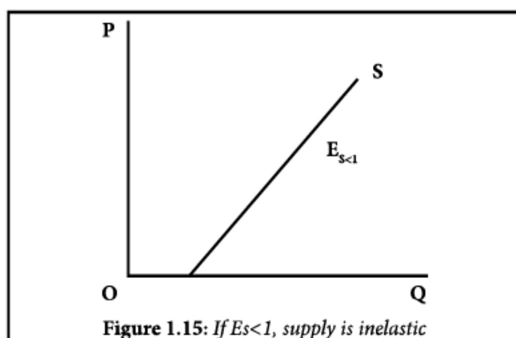

Figure 1.15: *If Es<1, supply is inelastic*

1.3.3. Market Equilibrium and Competition

Market is a place where buyers and sellers meet (physically or virtually) to facilitate the exchange or transaction of goods and services. **Market Equilibrium** is an ideal situation where **quantity demanded is equal to Quantity supplied.** At equilibrium, the market price is sufficient to induce suppliers to bring to market the same quantity of goods that consumers will be willing to pay for at that price. The equilibrium price is the price at which the producer can sell all the units he wants to produce, and the buyer can buy all the units he wants.

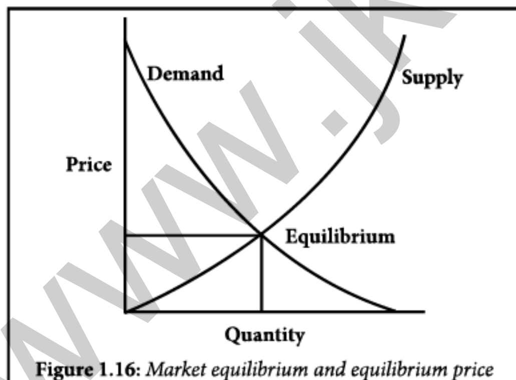

Figure 1.16: *Market equilibrium and equilibrium price*

Competition is a feature of market where sellers of the same commodity compete with each other for the same buyers. Based on the competition present, the markets can be divided into

1. Perfectly competitive markets
2. Monopoly
3. Imperfect markets
   a. Monopolistic competition
   b. Oligopoly
   c. Monopsony

In a **perfectly competitive markets,** participants are high (both buyers and sellers) and so products have many substitutes. Seller is a price taker, not a price maker, as consumers have various options. All buyers are willing to buy at a certain price but none at a higher price. For example, competitive pricing in the telecom industry causing low data prices to customers due to several players like Jio, Airtel, Vodafone, etc.

In **monopoly,** buyers are many, but the Seller is one and so the product has no substitutes or no close substitutes. In this case, the seller is a price maker and usually, seller tries to maximize his profit. For example, a patented drug or specific type of crop seeds.

Monopolistic competition is characterized by an industry in which many firms offer products or services that are similar but not perfect substitutes. So, such firms are still price setters in spite of many other players, and buyers are just price takers. For example, in spite of several mobile phone manufacturers, Apple iPhone still enjoys a monopolistic competition and hence the seller has the freedom of its pricing.

In **oligopoly**, buyers are many, but sellers are few with intense competition. In spite of the product having close substitutes and due to higher demand from many customers, the seller is a price maker and buyers are price takers. **For example**, in India, domestic civil aviation has very few players like Air India, Indigo, Vistara, GoAir, SpiceJet, and AirAsia. Hence, the price of these air travels is decided by these very few companies as the buyers don't have alternatives.

Monopsony is a market where there is only one Buyer even though there are many sellers. Since there is no competition in buying, the buyer is the price maker while sellers are price takers. For example, in the defense industry, the Indian government is the only buyer.

1.4. SOME BASIC TERMS IN ECONOMICS

Price: It is the money value of goods and services. Price of a good is fixed by the forces of demand and supply of the good.

Cost: Cost refers to the expenses incurred to produce or acquire a given quantity of a good.

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Income: Income represents the amount of monetary or other returns, either earned or unearned small or big, accruing over a period of time to an economic unit.

Goods and Services: Goods are tangible products sold to customers by seller and services are activities performed by service provider for the benefit of the recipient. Both are the outputs of an economic system. For example: car, pen, computers are goods while health-care, education and legal advice are services.

Final Good: The Good that has been sold and have passed out of the active economic flow. It cannot undergo any further transformation at the producer's end. **For Example: Cotton - spinning mill – yarn – Textile Mill – Cloth – Article of Clothing – Sold to Consumer.** Here article of clothing is final good. Such an item that will not pass through any more stages of production or transformations is called a final good. However, many final goods are transformed during their consumption. **For Example:** Tea leaves that is used to make tea at our home. Cooking at home is not an economic activity. So, here tea is a final good. If the same **cooking or tea brewing was done in a restaurant, tea leaves is not counted as final good,** as it would be sold to customers after tea brewing. Hence, this is an economic activity.

Consumption Good: Goods like food and clothing, and services like recreation that are consumed when purchased by their ultimate consumers are called consumption goods or consumer goods.

Capital Good: The goods that are used in production process. For Example: tools, implements and machines. While capital goods help in production process, they themselves don't get transformed in the production process. They are also final goods but not to be consumed ultimately. Capital goods gradually undergo wear and tear.

Consumer durables: Commodities that do not undergo wear and tear quickly. They undergo wear and tear with gradual use and often need repairs and replacements of parts. They are not purchased frequently. **For Example**: television sets, automobiles or home computers.

Fixed Asset: Fixed assets are the assets that are used in business for more than one accounting year. Fixed assets (technically referred to as "depreciable assets") tend to reduce their value once they are put to use. They are used by business in generating income. These assets are grouped into various categories, such as land, building and plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs.

Depreciation: It means decline in the value of a fixed assets due to use, passage of time or obsolescence. If a production firm procures a machine and uses it in production process then the value of machine declines with its usage. Fixed assets are subject to decline in value and this decline is technically referred to as depreciation.

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2
CHAPTER
National Income

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2.1. NATIONAL INCOME: CONCEPT, SIGNIFICANCE AND CHALLENGES

National Income (NI) is the **total value of goods and services** produced by the country in a given financial year. It provides a comprehensive measure of economic activities of a nation. National Income is of great importance for any economy. From formulating national policies to planning and evaluating progress, NI data is essential.

Change in NI is an **indicator of progress of a nation.** The data on national income provides estimates on the country's purchasing power. It is helpful in knowing a country's per capita income that reflects the economic welfare of a country. Thus, it provides a picture of standard of living in the country.

Statistical data on national income not only helps in making economic analysis but also helps in **policy formulation**. Moreover, it helps in formulating fiscal policy, monetary policy, and foreign trade policy apart from helping in making modifications and amendments wherever necessary. It, thus, **serves as an instrument of economic planning**. It helps business houses/ private players in planning their production activities. It is also helpful in forecasting the effect of economic policies on the level of production & employment. The **performance of the government economic policies can be evaluated** based on the growth in National Income.

NI helps in **comparing national income and per capita income** of a country with those of other countries. This may assist in making suitable changes in our plans and approach to achieve rapid economic development of the country. It is helpful in providing knowledge of **structural changes occurring in the economy**. It throws light on the share of different sectors (agriculture, Industry, Services etc.) in the economy. It provides insight on **the importance of various sectors of the economy and their contribution in the economy**. It gives an idea how income is produced, distributed, how much is spent, saved or taxed.

However, calculating national income may not be as simple as counting income of an individual. India has a large informal sector that has employed a large section of the population. As per the **Economic Survey 2019-20,** there are an estimated **38 crore** unorganized workers in India. It poses a conceptual problem. Here the proper valuation of output becomes difficult.

Government's expenditure in the form of scholarship, pension, unemployment allowances etc. are not counted in national income. Because there is no production or economic activity done in return of the payment. Domestic transfer payments are also excluded from the national income of a country. For example, if an individual receives a cash gift from his father who is also a resident of India, it will not be a part of India's national income. However, any transfer payment from abroad will be a part of a country's national income.

There are a number of services that are unpaid in an economy. **For Example**: domestic work done by housewives. She is not paid for her service and her service is not directly counted in national income. Subsistence farmers who produce food for themselves and their family members consume a

major portion of their own output every year. Since this portion is not sold through the market, it is excluded from national income calculation.

It is very difficult to **find the true values of government services** (public goods like national defense, law and order, etc.) since these are not sold through the market. These are provided to people free of cost. Income earned through illegal activities, such as gambling, smuggling, illicit extraction of minerals etc., is not counted in national income. Capital assets like house, land, property, stocks that are sold at a higher price than paid for it at the time of purchase. The gain is excluded from the national income. If salaries or wages are paid in kind, accounting them becomes very difficult.

There are statistical problems too. Care has to be taken to avoid double counting. There are a number of sources for compiling the data and reliability becomes the issue. Accurate and reliable data may not be available for every sector.

2.1.1. National Income Accounting

National Income Accounting is a set of rules and methods used by government for measuring economic activity in a country during a given time period (generally one year). Some of the concepts used in National Income Accounting are as follows:

1. Gross Domestic Product **(GDP)** & Net Domestic Product **(NDP)**
2. Gross National Product **(GNP)** & Net National Product (**NNP**)
3. Gross National Income **(GNI)** & Net National Income (**NNI**)
4. Per Capita Income (PCI)

2.2. VARIOUS MEASURES OF NATIONAL INCOME

There are different ways of measuring National Income each giving more importance to certain criteria like geography, citizenship etc. Different measures of National Income can present different pictures of the economy in their own specific ways.

2.2.1. Gross Domestic Product (GDP)

GDP is defined as the total value of all **final goods and services** produced in a year within a country. It is a **territorial concept** i.e., it measures the value of final goods and services produced within the geographical boundary regardless of nationality of the individual or firm. **For example**: Mobile phones manufactured in India by a Japanese company will be included in India's GDP. Similarly, an Indian company, let's say Tata, manufacturing cars in Japan will be counted as Japan's GDP.

> **Domestic territory** = Geographical territory + India's embassy in foreign countries + India's military stations – Foreign embassy in India + 200 nautical miles from the coastal area

GDP is a **quantitative measure** as it tells only the price (monetary) aspects of goods produced and not the quality of goods that are produced. GDP **does not involve transactions made for intermediate goods.** This is done to avoid double counting of goods. **For example**, if a burger is treated as a final product for GDP calculation, then buns used in burgers will not be counted as a final product.

2.2.2. Net Domestic Product (NDP)

NDP is the net form of GDP i.e., GDP **minus** the total value of the **'wear and tear' (depreciation)** that happens in assets during the production of goods and services. For any good or service to be produced, there is some loss in profit due to depreciation of capital goods like machinery, etc. For example: Let's say that a machine (X), which is used for production of cars, has a life of 10 years. So, while calculating the net value of cars produced in a year, 10% of the value of machine (X) has to be reduced so as to account for depreciation.

NDP= GDP- Depreciation

NDP is always less than GDP as depreciation can't be zero for an asset. NDP reflects technological progress of a country as technological innovations can help in reducing the level of depreciation.

2.2.3. Gross National Product (GNP)

GNP is the value of all final **goods and services produced by residents/citizens** of a country irrespective of their geographical location. GNP includes the total domestic and foreign output produced by residents of a country (GDP), plus factor incomes earned in foreign economy by

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residents, minus income earned in the domestic economy by nonresidents. Hence, for GNP nationality/citizenship becomes more important in contrast to national territory/boundary in GDP. Income from abroad includes: Private remittances, interest on external loans earned by the country/ nationals and external grants.

Private Remittances is the net outcome of the money which inflows and outflows account of the 'private transfers' by Indian nationals working outside of India (to India) and the foreign nationals working in India. On this front India has always been a gainer. **Interest on External Loans** includes: balance of inflow (on the money lent out by the economy) and outflow (on the money borrowed by the economy) of external interests. **External Grants** include balance of grants flow to and from India.

The term "residents" refers to those individuals (and institutions) whose economic interest lies in the country in which they live (or are located). Economic interest implies basic economic activities of production, consumption and investment.

To understand GNP in a better way, let us consider an example: When Indian companies such as TCS produce services in the US, the value of those services are not added in the Indian GDP but they are utilized while calculating the Indian GNP.

In case of an economy with great levels of inflows of FDI and very less outgoing FDI, the GDP would generally be more than the GNP. On the other hand, if in an economy, more of its nationals move abroad to work than foreigners who come in and perform any economic activity, its GNP would be larger than its GDP.

GNP= GDP + [inward remittances of a country – outward remittances from the country]

GNP = GDP + NFIA.

Where NFIA is the net factor income from abroad i.e. inward remittances of a country – outward remittances from the country.

For example, GDP= ₹100000 while income earned by Indians in foreign = ₹1000 and income earned by foreigners in India = ₹2000. Then, GNP of India= 100000 +1000 -2000 = ₹99000.

2.2.4. Net National Product (NNP)

NNP refers to the value of **net output** of the economy during a year. It is obtained after **deducting** the loss due to **depreciation from GNP.**

NNP = GNP – Depreciation

Relationship between GDP, GNP, NDP and NNP

GNP = GDP + NFIA = NDP + Depreciation + NFIA

NNP = GNP- Depreciation = GDP+ NFIA – Depreciation

2.2.5. The concept of Factor Cost and Market Price

Factors of production: Factors of productions are resources that are used for production of goods and services. They form basics of any economic activities. Economists divide factors of production in four categories: **land, labor, capital, and entrepreneurship.**

Factor cost is defined as cost derived from employing all factors of production. Therefore, factor costs are rent (for land), wages (for labor), interest (for the capital) and profit (for the entrepreneur). It is the **actual production cost** at which the goods and services are produced by the firm. Factor cost removes the impact of any subsidy or indirect taxes.

Market price is the actual **price paid by the customers** while buying from the market. It includes the factor cost (total cost of production) plus the taxes levied over it. If any subsidy is given on that product, it is subtracted as subsidies decrease the final price of the product.

Market Price = Factor cost + Indirect taxes- Subsidies

2.2.6. National Income (NI)

National Income is a measure of the sum of all net factor incomes earned by the citizens of a country for their land, labor, capital, and entrepreneurial talent, whether within the country or abroad. It is equal to the **Net National Product (NNP) at Factor Cost. NNP at Fc** is the total of payments made to the factors of production owned

by citizens of a country adjusted for depreciation.

NNP at Fc is a perfect measure of National Income. It adds the remunerations from abroad and subtracts payments to abroad (NFIA), which means the **real total income**. It also subtracts the depreciation as it is a loss in the income. It is the real income of the people as it does not add indirect taxes like sales taxes, excise taxes etc. (not the payments for factors of production)

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

2.2.7. Per Capita Income

Per capita income is the average income of a person of a country in a particular year. It is the income per head of the population. It is obtained by dividing national income with total population.

Per Capita Income = National Income/Total Population

2.3. SOME RELATED TERMS

2.3.1. Base Year

Base year is a **reference year** with respect to which GDP numbers for the following as well as preceding years are computed. It is the year chosen to **enable inter-year comparisons** of national accounts. At present (Nov. 2021), the base year for GDP calculation in India is 2011-2012.For example, if the GDP of a country was 100 units in 2010 and it was 150 units in 2020, then GDP growth for the decade can be calculated as GDP growth rate = GDP 2020 – GDP 2010 / GDP 2010 *100 = 150-100/100* 100 = 50% is the decadal growth rate of GDP. Here, 2010 is considered as the base year as we measured the growth based on that year.

To capture the structural changes in the country, base year is changed periodically. For example, in 1990 there were no mobile phones while after the 2000s these mobile phones are produced and it has to be added to the GDP calculation. So base year needs to accommodate as many items as possible and hence it is changed from time to time.

2.3.2. Nominal GDP and Real GDP

Nominal GDP is the measure of value of all final goods and services calculated at current market prices. It **does not require any adjustments for inflation.**

Real GDP is the current year production of goods and services valued at base year prices (constant price) **i.e. adjusted for inflation to reflect changes in real output.** For example, for the year 2020-21, a country produced 100 units of X and the price of one unit of X is ₹10 for this current year and the price per unit was ₹5 for the base year 2011-12. Then, the nominal GDP is ₹1000 (100x10) and Real GDP= 500.

NOTE: Current prices (nominal prices) are those indicated at a given moment in time. Constant prices (real prices) are corrected for changes in prices in relation to a baseline or reference year.

Why Real and Nominal GDP?

Sometimes, the value of goods and services just rises because of **price rise** (inflation) and not due to a real increase in the production of goods and services. Hence, we use Real GDP to see the real result of an increase in production, which in turn tells about employment, economic growth, etc.

2.3.3. GDP Deflator

GDP deflator is the measure of the general price rise i.e. inflation. It is used to **arrive at the real GDP.** GDP deflator is published on a quarterly basis since 1996 with a lag of two months. It is the ratio of nominal GDP to real GDP.

IF **GDP Deflator <1**, that means there is deflation in the economy. If **GDP Deflator > 1**, that means there is inflation in the economy. The deflator is a more comprehensive measure of inflation because it covers the entire range of goods and services produced in the economy. It **excludes imported products** as it is based on GDP (Domestic product).

GDP Deflator = Nominal GDP/ Real GDP

For example, for the year 2020-21, a country produced 100 units and the price of one unit is ₹10 for this current year and the price of one unit was ₹5 for the base year 2011-12; then, nominal GDP= ₹1000, Real GDP= ₹500 and GDP Deflator =1000/500 = 2

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2.4. VARIOUS METHODS OF GDP ESTIMATION

All goods and services produced in a country are counted and given a value in terms of money. Whatever is produced in a country is either used for consumption or savings. Thus, a country's output can be calculated at any of three levels; production, income and expenditure. Three methods are as

1. Value-added method or Production method
2. Income method
3. Expenditure method

If these three methods are done correctly then we can conclude that-

Output = Income = Expenditure

This is because the three methods are circular in nature. It begins as production, through recruitments of factors of production, generating income and going as incomes to factors of production. Let us understand with an example how these three approaches are equivalent:

Company A (producer of raw material)- sugar company	Company B (producer of Final Product)- Beverage company
Wages paid to its employees = 10000 Revenue received from sale of its product= 20000 Product sold to Household= 5000 Product sold to Company B as raw material= 15000	Wages paid to its employees= 5000 Revenue received from sale of its product=25000 Raw material purchased from Company A= 15000

Let us assume that Company A doesn't use any inputs purchased from other businesses and no one is paying taxes.

Product Method: Company A produces output worth Rs. 20000 and Company B produces output worth Rs 25000. To avoid this double counting, **we sum value added rather than output**. Company B purchased raw material worth Rs. 15000 from Company A. Value addition by Company B is worth Rs (25000- 15000) = 10000. We assume that Company A doesn't use any inputs purchased from other businesses, so its value added equals its revenue of Rs. 20000. Thus, total value added in the economy = Value addition by company A + value addition by company B = **20000+10000 = 30,000**

Income method: Company A's profit is its revenue minus wages paid to its employees i.e. (20,000-10,000=10,000). Company B's profit is equal to its revenue minus wages paid to its employees minus the cost of raw material i.e. (25000-5000-15000=5000). The total wages (income) earned in the economy is equal to (10000+5000=15000). Therefore, the total GDP through income method = Income of company A +Income of Company B+ Wages earned by employees of the economy = **10,000+5000+15000= 30,000.**

Expenditure Approach: Total expenditure on final product Company A = product sold to households i.e. 5000. Product sold by company A to company B is not considered because company B is not the final consumer and it further sells the product after value addition. Total expenditure on final product of company B = 25000. Total expenditure in economy = Expenditure on final product of company A + Expenditure on final product of Company B = **5000 + 25000 = 30,000.**

2.4.1. Value Added Method/ Production Method/ Output Method

Value Added Method/ Production method/ Output method measures the economic activity by **adding the market values of goods and services produced**, excluding the value of any goods and services used up in the intermediate stages of production. Under this method, the gross value of the output from different sectors like agriculture, industry, trade and commerce etc. is obtained for the entire economy during a year.

It is used to measure the contribution of different sectors of the economy in the country. As it excludes the value of goods and services at intermediate stages of production, the problem of 'double counting' is avoided. **For example,** Shyam produced one packet of chips at ₹10 and he used intermediate goods (potato & oil) of ₹5 in the production, then the gross value added by Shyam = 10-5= ₹5. Therefore, in the GVA method, only the value additions (which are the actual goods and services added) are calculated for GDP estimation.

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Some of the Goods and services that are **not included** in GDP calculation. For Example: Sale and purchase of used cars, Non-economic goods such as air and water, transfer Payments such as scholarships, pensions etc.

2.4.2. Income Method (Factor Earning Method)

Income Method/ Factor Earning Method gives the total income earned by citizens and businesses of a country. It approaches national income from the distribution side. It is based on the assumption that for whatever goods and services are produced, an income is also generated. This follows from the simple idea that the revenues earned by all the firms put together must be distributed among the factors of production as factor payment.

There are **four types of factors of production and four types of factor incomes**. Land, Labor, Capital and Enterprise are termed as Factors of Production while Rent, Wages, Interest and Profit are termed as Factor Incomes. In a nutshell, here national income is calculated by adding up all the incomes generated in the course of producing national products.

There are few items that are **not included** in this method like transfer payments, the receipts from the sale of second-hand goods, windfall gains such as lotteries, corporate tax (it has been already included as a part of company profit).

GDP = Total wage (of labour) + total rent (of land) + total interest (on capital) + total profit (of entrepreneur)

2.4.3. Expenditure Method

Under this method, the **total expenditure incurred by the society** in a particular year is added together. The assumption here is that at equilibrium where demand meets supply, the total cost of spending will be equal to the total cost of producing all goods and services (GDP). In an economy, there are three main agencies, which buy goods and services. These are: Households, Firms and the Government.

Consumption (C): Personal Consumption made by households, the payment of which is paid by households directly to the production firms.

Investment Expenditure (I): investment in capital goods and inventories or stocks by enterprises.

Government Expenditure (G): This category includes the value of goods and services purchased by the Government.

X-M= Expenditure on net export, that means, deducting the import expenditure from the export earnings.

Items that are not included are- expenditure made on second hand goods, expenditures on purchase of old shares and bonds in the secondary market, expenditures towards payment incurred by the government like old age pension and expenditure on intermediate goods.

GDP = C+G+I+(X-M)

2.5. GROSS VALUE ADDED (GVA)

GVA is defined as the **value of the final output produced minus the value of intermediate goods**. It represents the contribution of labour and capital to the production process. It provides value in terms of money to goods and services produced in an economy after deducting the cost of raw materials that have been used for the production of those goods and services. **GVA at basic prices** will include production taxes and exclude production subsidies available on the commodity. **GVA at Factor prices** include **production subsidy and exclude production taxes**. GDP at market prices include both production and product taxes and excludes both production and product subsidies.

Production taxes or subsidies are taxes/ subsidies paid or received in relation to production and are independent of the volume of actual production. Few examples are: Railways, input subsidies to farmers, subsidies to villages and small industries. **Product taxes and subsidies** are taxes/ subsidies paid or received on per unit of product. Some examples of product taxes are excise tax, sales tax, service tax and import and export duties. Product subsidies include food, petroleum and fertilizer subsidies.

2.5.1. Comparing GDP and GVA

There are two ways to estimate economic growth in a country: **Supply side and Demand side**. Under

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supply side, the value-added by the various sectors in the economy are added up to derive the **gross value added (GVA).** Under the demand side, **GDP** is arrived at by adding up all expenditures done in the economy. We also know that GDP is the sum of the (private consumption + gross investment + government investment + government spending + (exports-imports)). GDP reflects on the demand conditions in the economy.

The GVA data is helpful in understanding how the various sectors of the real economy are performing. As there is a sector-wise breakdown, GVA data is helpful in making policy interventions. It helps policymakers decide which **sectors need incentives or stimulus** and accordingly formulate sector-specific policies. From **a global data standards and uniformity perspective,** GVA is an integral and necessary parameter in measuring a nation's economic performance. GDP is a good measure in comparative studies (comparing economies). A country which seeks to attract capital and investment from overseas needs to conform to the global best practices in national income accounting.

2.6. NEW CHANGES IN NATIONAL ACCOUNTS IN INDIA

The **Central Statistics Office (CSO)** released the **new and revised data of National Accounts in 2015.** This was done in accordance with the **recommendation** of the **National Statistical Commission (NSC)**. It brings the whole process into **conformity** with the **United Nations System of National Accounts (SNA)** of 2008.

	Earlier	**Changes announced in 2015**
Shifting of Base year	From **1999-2000 to 2004-05** in January 2010	Change of base year from **2004-2005 to 2011-2012** **Note:** The **Ministry of Statistics and Programme Implementation** (MOSPI) is considering changing of the base year for GDP calculation from **2011-12 to 2017-18**.
GDP Calculation	Measuring **GDP at factor cost.**	Measuring of the GDP **by GVA at market prices.** GDP at **basic prices instead of at factor cost**
Broadening Data Pool	Earlier data from the **Annual Survey of Industries (ASI)** was used to determine the activity in the manufacturing sector.	Now, **annual accounts of companies filed with the Ministry of Corporate Affairs —** MCA21 are being used. **New series will also include**: The results of national sample surveys such as enterprise survey, employment unemployment survey, all India debt and investment survey, Situation assessment survey of farmers and survey on land and livestock holdings Population census, agriculture census and Livestock census.
Improved Financial Corporations	limited to a few mutual funds and estimates for the Non-Government Non-Banking Finance Companies as compiled by RBI	Expanded by including stock brokers, stock exchanges, asset management companies, mutual funds and pension funds, as well as the regulatory bodies, SEBI, PFRDA and IRDA
Local bodies and autonomous institutions	estimates for local bodies and autonomous institutions were prepared on the basis of **information received for seven autonomous institutions and local bodies of four States** Delhi, Himachal Pradesh, Meghalaya and Uttar Pradesh	There has been an improved coverage of local bodies and autonomous institutions, covering around 60% of the grants/ transfers provided to these institutions.

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Changes in calculation of agricultural income	Data only included value added in farm produce.	The new data includes value addition in Livestock as well.

2.7. LIMITATIONS IN GDP MEASUREMENT

A **rise in the GDP** of a country **does not ensure the welfare** of the citizens. This is because the rise in GDP may be concentrated in the hands of few individuals. GDP does **not reflect the inequality** present within the country. It does not give an idea on how uniform the wealth is distributed. Few activities in an economy are **not evaluated in monetary terms**. For example, **domestic work women perform at home**. Cash and barter transactions that are not formally recorded are not covered. The black market remains outside the domain of GDP calculation which is used for illegal activities.

GDP does not consider the economic **value of the environment**. For example: a refinery, while carrying out production, may pollute a nearby river. In return, it may harm the people using that water. Pollution may also kill fish or other organisms of the river on which fish survive. As a result, the fishermen of the river may lose their livelihood. Such harmful effects that a refinery may inflict on others, for which it will not bear any cost, are called **externalities**. In this case, the GDP is not taking into account such negative externalities. **Gender disparities** are not reflected through the GDP measure.

2.8. OTHER GROWTH/DEVELOPMENT INDICATORS

INDEX	PARAMETER	PUBLISHED BY	INDIA'S POSITION
Human development index	(1) Health (life expectancy at birth), **(2)** Education (means year of schooling and expected year of schooling), **(3)** Standard of living (gross national income on per capita basis)	UNDP	**HDI 2020: India ranked 131** Increase of HDI value over 50% between 1990-2019. Life expectancy of Indians at birth in India rose by nearly 12 years during the same period.
Human Capital Index	Health and education data of children from 174 countries	World Bank	**2020: 116,** **2019: 116** India's score increased to 0.49 in 2020 from 0.44 in 2018
Gender inequality index	(1) **Reproductive health:** measured by maternal mortality ratio and adolescent birth rates **(2) Economic status:** measured by female labor force participation rate **(3) Empowerment:** Measured by the proportion of parliamentary seats occupied by females and by secondary and higher education attainment levels.	UNDP	**2020: 123** **2019: 122**

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Global gender gap index	(1) Educational attainment (2) Health and survival (3) Economic participation and opportunity (4) Political empowerment	World Economic Forum	2021 India's ranking: **140/ 156**. 2020 India's ranking: **112/153**. **Most of the decline occurred on the political empowerment sub-index**. Here, India regressed 13.5 percentage points, with a significant decline in the number of women ministers (from 23.1 per cent in 2019 to 9.1 per cent in 2021). **India is the third-worst performer in the South Asia region**. Because of its large population, India's performance has a substantial impact on the region's overall performance. Only Pakistan and Afghanistan ranked below India.
UN World happiness report	Parameters are six variables: **(1)** GDP per capita, **(2)** social support, **(3)** Healthy life expectancy, **(4)** Freedom, **(5)** Generosity, **(6)** Perceptions of corruption	UN Sustainable Development Solutions Network	India has been ranked 139 /149 countries in 2021.

Planetary pressures- adjusted Human Development Index (PHDI): The PHDI adjusts the standard HDI by a country's level of carbon dioxide emissions and material footprint, each on a per capita basis. This was first measured in 2020. Norway, which tops the HDI, falls 15 places if this metric is used, leaving Ireland at the top while India would move up eight places in the ranking

Inequality- adjusted Human Development Index (IHDI): The IHDI combines a country's average achievements in health, education and income with how those achievements are distributed among the country's population by "discounting" each dimension's average value according to its level of **inequality**. In simple terms, the IHDI indicates **a percentage loss in HDI due to inequality.** For **India,** the IHDI value for 2019 is **0.537 (16.8% overall loss).**

Multidimensional poverty index: It identifies multiple deprivations at the household and individual level in health, education and standard of living. It is published by the **UN Development Program (UNDP) and the Oxford Poverty and Human Development Initiative (OPHI).**

MDI Parameters: It is based on **three dimensions** which are divided into **ten indicators:**

Education	Health:	Standard of living
1. Years of schooling 2. Child enrollment (1/6 weightage each, total 1/3)	3. Child mortality 4. Nutrition (1/6 weightage each, total 1/3)	5. Electricity, 6. Flooring, 7. Drinking water, 8. Sanitation, 9. Cooking fuel, and 10. Assets (1/18 weightage each, total 1/3)

A person is multidimensional poor if he/she is deprived of one-third or more of the weighted indicators. Those who are deprived in one-half or more of the conventional methodology are considered living in extreme multidimensional poverty.

In India's case, **NITI Aayog** is the nodal agency that has been assigned the responsibility of leveraging the monitoring mechanism of the Global Multidimensional Poverty Index (MPI) to drive reforms. India lifted as many as 270 million people out of poverty between 2005-06 and 2015-16. The study finds that, on average, poverty levels

will be set back 3 to 10 years due to pandemic (COVID-19). In Global MPI 2020, **India was 62nd among 107 countries** with an MPI score of 0.123 and 27.91% headcount ratio, based on the NFHS-4 (2015-16) data.

Globally, 1.3 billion People are still living in multidimensional poverty. 67% of multidimensional poor people are in middle-income countries.

Social progress index: It measures the extent to which a country provides for the social and environmental needs of citizens. It is published by **Social Progress Imperative**. **India scored 56.80 out of 100** in Social Progress Index 2020; with a rank of 117 among 163 nations. Parameters for SPI are shown in the table below:

Misery index: It is equal to the sum of inflation and unemployment rate. It was created by **Arthur Okun**. Higher the index, the more misery felt by the average citizens. A variation of the original misery index is the Bloomberg misery index, developed by the online publication. Its present parameters are Unemployment rate, Inflation rate, Bank's Lending rate (recently added).

Gross National Happiness Index: It was first mentioned in the constitution of Bhutan. The term was coined by the fourth king of Bhutan, Jigme Singye Wangchuck, in the 1970s. The index developed from **33 indicators** categorized under **nine domains**, including standards of living, good governance, health, psychological well-being, etc.

It is a survey of the state of global happiness. The annual report ranks nations based on gross domestic product per person, healthy life expectancy and the opinions of residents. **Parameters are six variables**: GDP per capita, social support, Healthy life expectancy, Freedom, Generosity, Absence of corruption. India has been ranked 139 out of 149

Parameters for SPI

Basic human needs	Well- being	Opportunity
Nutrition and basic medical care: Example Undernourishment, Maternal mortality rate Child stunting, death from infectious disease.	**Access to knowledge** Women with no schooling, Primary school enrollment, Secondary school attainment, Access to quality education	**Personal Right** Political right Freedom of Expression, Freedom of Religion and Access to justice
Water and Sanitation **Example**: death attributable to unsafe water	**Access to Information & Communication** Mobile telephone subscription, Internet user, Access to online governance, Media censorship.	**Personal Freedom and choice** Early Marriage Satisfied demand for contraception Corruption
Shelter Access to Electricity, Household air pollution attributable deaths, Usage of Clean fuel	**Health and Wellness** Life Expectancy at 60, Premature death from non-communicable disease, Access to essential service, Access to quality health care.	**Inclusiveness** Acceptance of Gays and Lesbians, Discrimination and violence against minorities, Equality of Political power by gender, By socioeconomic position, by social group
Personal Safety Homicide rate, Perceived criminality, Political killings and tortures Traffic deaths	**Environmental Quality** Outdoor air pollution attributable deaths, Greenhouse Gas emission, Particulate matter. Biome protection.	**Access to advance education** Expected years of Tertiary education, Women with Advanced education, citable documents

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countries in the list of UN World Happiness Report 2021.

Green GDP (GGDP): GGDP is a term generally used for expressing GDP after adjusting for environmental damage. When the natural environment is indicated into the system of national accounts, it becomes a **Green National account**, also known as environmental accounting. China was the only country that used this concept in 2006. However, it stopped in 2007. In 2013, **Parthdas Gupta** committee submitted the report to the Government of India to consider Green GDP. However, it is yet to be implemented.

GGDP is expected to account for the use of national resources, as well as the cost includes medical costs generated from the indicators such as air and water pollution. It could bring the sustainability of the various business models and industries into question by highlighting their direct impact on the environment. It can help us measure a country's preparedness for sustainable economic development.

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3 CHAPTER

Inflation and Business Cycle

3.1. INFLATION

Inflation refers to a **sustained/continuous rise in the general price level** of goods and services in an economy over a period of time. The important thing that we must understand is that inflation is a rise in the prices of a basket of goods and services. If the price of only one good or few goods alone has gone up, it does not constitute inflation. Thus, Inflation measures how much more expensive a set of goods and services has become over a certain period, usually a year. **For example**, suppose with 50 rupees we could have bought 1 liter milk in Jan. 2020; but, in Jan 2021 we need 55 rupees to buy the same quantity of milk. So, the price of milk has inflated by 10% in a year. However, it does not mean that the entire economy has seen the same level of inflation.

3.2. TYPES OF INFLATION

Different types of inflation can be identified on the **basis of degree or speed with which the prices rise**. The distinction may also be based on the processes through which inflation is induced. It is also possible to classify inflation on the basis of time. Sometimes inflation is sporadic, at other times it is comprehensive.

3.2.1. Based on Rate/Speed of Price Rise

On the basis of prices inflation may be divided into four types: 1) creeping inflation, 2) walking inflation, 3) running inflation and 4) jumping or galloping or hyper-inflation.

Creeping inflation is a condition when prices are gently rising. The Inflation rate is usually under (or up to) 3%. It is the mildest form of Inflation and also known as mild inflation or Low Inflation. **Walking inflation** is a condition when prices are rising by more than 3% but less than 10 % per annum. It is a danger signal of the occurrence of running and jumping inflation under which the rise in prices takes place at a faster rate. **Running Inflation** is when prices start to rise at a significant rate, i.e., between 10% to 20% a year. Under **Galloping Inflation** prices rise every moment and inflation rises up to 20% or more. **Hyperinflation** is a situation when price rise is out of control. It is an indication of the highest degree of abnormality in the monetary system of a country. Under the conditions of such an inflation, all assets having a fixed income lose their real value. **For example,** in 2018, Venezuela, as per IMF prediction, prices rose 13000%.

3.2.2. Based on the Underlying Reason of Inflation

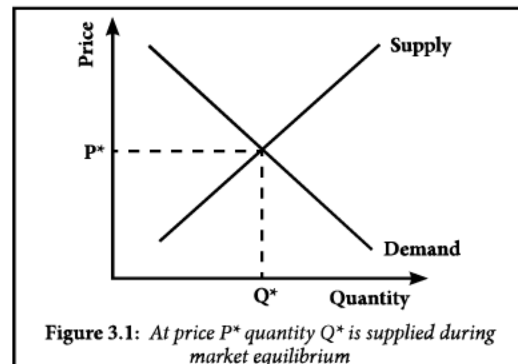

Figure 3.1: *At price P* quantity Q* is supplied during market equilibrium*

At market equilibrium, the quantity supplied (Q) is equal to the quantity demanded (Q). When

there is any mismatch between demand or supply, the price is also affected. Based on this, we have two types of Inflation: **Demand-pull inflation and Cost-Push Inflation.**

Demand-pull inflation occurs when the demand for goods and services increases faster than an economy's productive capacity. In the short run, as businesses cannot significantly increase production and supply (S) will remain constant. In this case, the equilibrium moves from point A to point B and prices will tend to rise, resulting in inflation. Demand pull inflation is a result of increased spending power of consumers in an economy.

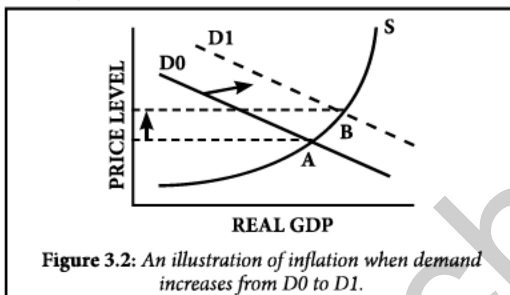

Figure 3.2: *An illustration of inflation when demand increases from D0 to D1.*

As we have seen in the national income chapter, the total demand (aggregate) in the economy is equal to the total income and total income is equal to the total expenditure (spending) in the economy. Thus, Aggregate Demand = C + I + G + (X-M). Where, Consumption (C), Investment (I), Government Spending (G), and Net Exports (i.e., Export-Import) (X-M). So, an increase in any of these may lead to inflation by increasing the aggregate demand.

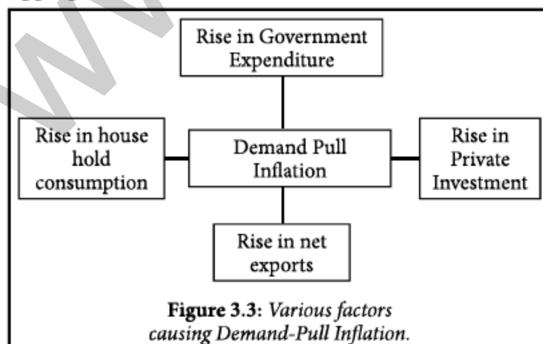

Figure 3.3: *Various factors causing Demand-Pull Inflation.*

Remember, C + I + G + (X-M) is the same as GDP and an increase in these parameters causes economic growth. So, it is clear that **growth cannot happen without a minimum level of inflation** (inflation is not always bad). We need the right amount of inflation to be allowed, which is fixed at **4±2% by the Monetary Policy Framework of RBI** for sustained economic growth.

Cost-Push Inflation occurs when prices of production processes or inputs increase (wages, rent, interest, cost of doing business, logistics, etc.). For example, when the minimum wages increase or the interest rate for loans increases, the price automatically rises. Cost push inflation occurs from reduced ability of producers to produce goods at a certain price point.

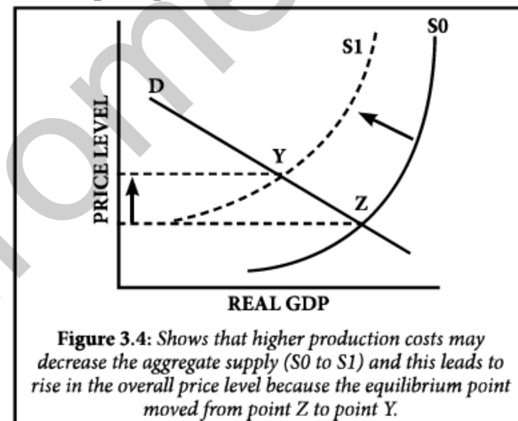

Figure 3.4: *Shows that higher production costs may decrease the aggregate supply (S0 to S1) and this leads to rise in the overall price level because the equilibrium point moved from point Z to point Y.*

3.3. IMPACT OF INFLATION ON VARIOUS ECONOMIC PLAYERS (VALUE OF MONEY DECREASES WITH INFLATION)

Certain level of inflation is always desirable in an economy. Without inflation, the economy will stagnate. Inflation acts as an incentive for producers to produce more and keeps businesses profitable. It also prevents consumers from waiting for lower prices before making purchases, thus, boosting consumption. However, high level of inflation disrupts the economy, erodes the value of money and paves the way for social and economic upheavals, besides being highly demoralizing.

Those who **lose due to inflation:**

1. **Creditors/ Lenders-** The real value of money obtained back from lending may be eroded due to inflation. So, if the rate of interest is unable to beat the inflation rate,

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the lender may end up making a loss too. For better understanding, let's say X lent Y 100 rupees at 7% interest in 2020. But next year (2021), when Y pays back Rs 107, the year had almost 10% inflation. In other words, a notebook that costed 100 rupees in 2020, costs 110 rupees in 2021. This means, even though X got 7% more returns (Rs.107), X cannot buy a notebook in 2021 with the same earned money while X could have bought the same notebook last year before lending.

2. **Bondholders**- Bondholders suffer as inflation erodes onto the interest earning (that's why we have inflation-indexed bonds).
3. **The common man**- It erodes the purchasing power of the common man. For **individuals, inflation** can lead to a fall in the value of their savings also.
4. **Industries** - Demand-pull inflation, to an extent, is good for industries as their sale increases and profit increases. On the other hand, cost-push inflation decreases the buying capacity and ultimately the profits of industries.
5. **Investments and employment**- Inflation decreases the buying capacity and will cause an economic slowdown impacting investments adversely. A slowdown may increase unemployment.
6. **On taxpayers**- **Bracket creep** is a condition which occurs when inflation pushes taxpayers into higher income tax brackets. This results in an increase in income taxes without an increase in real income of the taxpayer.
7. **The overall economy**- Uncertainty over future **inflation** can discourage investment and savings. Also, if **inflation** were rapid enough, it can cause shortages of goods as consumers begin hoarding expecting that prices will increase in the future. It may affect the cost of living and may worsen poverty.

Those who **benefit out of inflation:**

1. **Borrowers** - They benefit out of inflation as the effective real money paid in the subsequent year is less than what he/she borrowed.
2. **Exchange Rate:** With the increase in inflation, the currency of the economy depreciates, which decreases the real cost of products in rupees making exports more competitive. But imports will become costlier.

Inflation premium: It is the bonus brought by inflation to the borrowers. Borrowers now have to return a lesser value of the currency as inflation has eroded the value of the currency.

3.4. MEASURES OF INFLATION

Economists measure the price levels with a price index. A **price index** is a number based on a basket of goods and services and its movement reflects the movement in the average level of prices. If a price index rises 5%, it means the average level of prices has risen by 5%. In other words, the price index is an indicator of the average price movement over a period of time of a fixed basket of goods and services.

The constitution of the basket of goods services is done keeping into consideration whether changes are to be measured in retail, wholesale or producer price etc. The basket will also vary for economy-wide, regional, or sector-specific series.

3.4.1. Consumer Price Index (CPI)

Consumer Price Index measures the average change in retail prices of goods and services. It is released by the National Statistical Office (NSO). (**CSO and NSSO got merged into NSO**). Various categories and sub-categories have been made for classifying consumption items and on the basis of consumer categories like urban or rural. Based on these indices and sub-indices obtained, the final overall index of price is calculated. It **gives an idea of the cost of living**.

Types of CPI:

1. CPI for Industrial workers (IW)
2. CPI for Agricultural Labourer (AL)
3. CPI for Rural Labourer (RL)
4. CPI (Rural / Urban / Combined)

The CSO, Ministry of Statistics and Programme Implementation (MOSPI) in 2015 revised the base year of CPI from 2010 to 2012. **The RBI started**

using CPI (combined) as the sole inflation measure for the purpose of targeting inflation.

CPIs	Base year	Compiled by
CPI -IW	2016	Ministry of Labour and Employment
CPI-AL	1986-87	Ministry of Labour and Employment
CPI-RL	1986-87	Ministry of Labour and Employment
CPI Rural / Urban / Combined	2012	Central Statistical Office (CSO)

Revised series of CPI (Weight computed on the basis of Consumer Expenditure Survey (CES), 2011-2012)

Group Description	Revised series of CPI		
	Rural	Urban	Combined
Food and Beverages	34.18	36.29	45.86
Pan Tobacco and Intoxicant	3.26	1.36	2.35
Clothing and Footwear	7.36	5.57	6.53
Housing	-	21.67	10.07
Fuel and Light	7.94	5.50	6.84
Miscellaneous	27.26	29.53	28.32
Total	100.00	100.00	100.00

3.4.2. Wholesale Price Index (WPI)

It measures the changes in the prices of goods sold and traded in bulk by wholesale businesses to other businesses. It is published by **Office of Economic Adviser (OEA), Ministry of Commerce and Industry**.

The weights of the three major group of items in WPI are shown below

Major Group	Weight
Primary Articles (Eg- Food Articles, Vegetables, Milk, Minerals, etc.)	**22.62**
Fuel & Power (Eg- LPG, Petrol, etc.)	**13.15**
Manufactured Products (Highest weightage) (Eg- manufacture of food products, sugar, manufacture of textiles, etc.)	**64.23**
All Commodities	**100.00**

It provides for the level of inflation at the wholesale transactions level for the economy. This helps in timely intervention by the Government to check inflation, in particular, inflation in essential commodities, before the price increase spills over to retail prices. WPI is also used for indexation (adjustment to inflation levels) by users in business contracts so that both parties do not lose out due to inflation. Global investors also track WPI as one of the key macro indicators for their investment decisions.

3.4.2.1. New Wholesale Price Index (WPI)

The Base Year for WPI was changed from 2004-05 to 2011-12 in May 2017. The **number of items** in the basket has been **increased** from *676 to 697.* The new wholesale price index **does not include taxes** in order to remove the impact of fiscal policy. This also brings the new WPI series closer to the Producer Price Index and is in consonance with the global practices. The item level indices are being **compiled based on the Geometric mean** as compared to the Arithmetic mean used in the WPI 2004-05 series. As a part of the revised WPI series, a separate **WPI Food Index** has been launched. WPI Food Index, along with CPI Food Price Index, would help monitor the food inflation effectively in India.

WPI is **a purely commodity index** and does not include services, on the other hand, CPI includes both goods and services. Further, **WPI** measures inflation **at the first stage of transaction** while CPI measures inflation at the final stage of transaction.

3.4.3. GDP Deflator

It is a ratio of the value of goods and services an economy produces, in a particular year at current prices to that of prices that prevailed during the base year. If the GDP deflator is found to be 2, it

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implies a rise in price (inflation) level by a factor of 2 in the current year compared to the base year. The GDP deflator is acclaimed as a better measure of price behaviour because it covers all goods and services produced in the country

GDP Deflator = Nominal GDP/ Real GDP

3.4.3.1. Difference Between WPI, CPI and GDP Deflator

WPI	CPI	GDP deflator
Measures inflation at the wholesale level	Measures inflation at the retail level	Measures inflation at the level of overall economy
Covers only goods	It covers both goods and services which are consumed by the customers in the representative basket	Measures overall goods and services produced in the economy
Includes all goods in the Indian wholesale market	Includes all goods and services consumed	Includes only domestically produced goods and services
Weightage of Food Group is 24.4%	Weightage of Food Group is 39.06% (higher)	Not a specific basket and includes all products as proportional to GDP calculation
Released every month	Released every month	Available only on a quarterly basis when GDP figures are available
Published by Office of Economic Advisor, Ministry of Commerce	Published by CSO	Published by Ministry of Statistics and Programme implementation

3.4.4. Producer Price Index (PPI)

It calculates the movement of price from the seller's point of view. It can be calculated either when the goods leave the place of production or as they enter the production process. It excludes any taxes, transport and trade margin that the purchaser may have to pay. The producer price index (PPI) is published by the Bureau of Labor Statistics (BLS)

3.4.5. Index of Industrial Production (IIP)

It shows the **growth rates in different industry groups** of the economy in a stipulated period of time. The IIP index is computed and published by the **Central Statistical Organization (CSO)** on a monthly basis.

The index of Industrial Production is available at the level of Industrial Sectors and sub-sectors. The **main branches are 'Mining', 'Manufacturing' and 'Electricity'**. The index of Industrial Production is also available according to the "use" of the product, that is, for example, Primary Goods, Consumer Durables, Capital Goods, Intermediate Goods, Infrastructure/Construction Goods and consumer non-durables.

Sector	Weight
Mining	14.4
Manufacturing	77.6
Electricity	8.0
General Index	100.0

Weightage Pattern of IIP (Industrial Production Sectors)

Group	Weight
Primary	34.1
Capital Good	8.2
Intermediate Good	17.2
Infrastructure/Construction Goods	12.3
Consumer Durables	12.8
Consumer Non-durables	15.3
General Index	100

Weightage Pattern of IIP (Use-based Groups)

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The **eight core industries** of India represent about 40% of the weight of items that are included in the IIP. The Eight Core Sectors/Industries are:

1. Electricity
2. Steel
3. Refinery products
4. Crude oil
5. Coal
6. Cement
7. Natural gas
8. Fertilizers

3.4.6. Other Indices

Service Price Index (SPI): The index captures the movement of prices in various **services** like insurance, banking transport and communication.

Residex: It is designed to track changes in **housing prices** at neighborhood, city and national levels. It is an initiative of the National Housing Bank (NHB). **It is calculated with 2007 as the** base year.

3.5. MISCELLANEOUS CONCEPTS RELATED TO INFLATION

3.5.1. Deflation, Disinflation, Reflation and Stagflation

Deflation is a **decrease in the general price levels** of goods and services. It is the opposite of inflation. During deflation, prices of goods and services tend to fall. It occurs when the inflation rate falls below 0%. Thus, inflation is negative during deflation.

Deflation increases the purchasing power (value) of money. People can buy more from the same amount of money. People may have less propensity to spend and more to save as they defer purchases in expectation of a further decline in prices. Deflation is good for lenders and bad for borrowers. Deflation increases the real value of debt. Thus, deflation discourages borrowing (and, by extension, consumption and investment) and along with a decline in consumption, also leads to an economic slowdown. The slowdown can cause high unemployment, increase layoff, fall in the wage rates, decrease profits, low demand, low income, restricted credit supply in the economy. Deflation often leads the economy to depression. Deflation can be checked by increasing the credit supply in the economy, thereby boosting the demand by expansionary policies.

A similar sounding but quite different concept is disinflation. **Disinflation** is a slower rate of inflation. It is simply a slowing of Inflation. **For example –** If the inflation rate for years 2016, 2017, 2018, 2019 are 10%, 8%, 6% and 4% respectively. Then it is a situation of dis-inflation in the economy as inflation is slowing down. The general price level rises in disinflation, but the rate of inflation decreases over the period.

Unlike inflation and deflation, which refer to the direction of prices, disinflation refers to the rate of change in the rate of inflation. Disinflation is not considered as problematic because prices do not actually drop and disinflation does not usually signal the onset of a slowing economy.

Deflation	Dis-Inflation
Prices of goods and services fall.	Prices of goods and services do not fall. Their price rise but the overall rate is slow
It is the result of a decline in the overall price level in the economy.	It is overall fall in inflation rate
Inflation is negative	Inflation is positive. However, the rate of inflation slows down (for example, from 3% to 2%)
It signifies the direction of prices of goods and services.	It signifies the rate of change in the rate of inflation.
Harmful to the economy.	Usually not harmful to the economy

Reflation is a fiscal or monetary policy enacted after a period of economic slowdown or contraction. Here, the goal is to **expand output, stimulate spending and curb the effects of deflation.** As such, the term "reflation" is also used to describe the first phase of economic recovery after a period of contraction. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates.

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Stagflation is a situation where the inflation rate is high and at the same time, the economic growth rate slows down and unemployment is also high. **Stagflation = High Inflation + High Unemployment + Stagnant Growth.** It raises a dilemma for economic policy since actions designed to lower inflation may exacerbate unemployment and vice versa. It is unusual because policies to reduce inflation make life difficult for the unemployed, while steps to alleviate unemployment raise inflation. This has to be addressed from the supply side of economics by boosting more production.

3.5.2. Open Inflation and Suppressed Inflation

When the government and the monetary authorities of a country do not take any measure to control the spending of the people, there occurs a sharp rise in demand and prices, causing open inflation. In contrast, when government imposes fiscal and monetary controls to check open inflation, it is known as suppressed inflation.

3.5.3. Headline Inflation and Core Inflation

Headline Inflation refers to the change in value of all goods in the basket. It is the raw (overall) inflation figure on the basis of the Consumer Price Index (CPI). The headline inflation figure is not adjusted for seasonality or for the often-volatile elements. In India, Consumer Price Index Combined (CPI -C) represents Headline Inflation.

Core inflation refers to the change in value of goods and services excluding those commodities that have extremely volatile price movements. For example: food items, energy products etc.

Core Inflation = Headline Inflation – inflation of volatile products such as food & fuel

3.5.4. Bottleneck Inflation

This type of Inflation is known as **structural inflation**. In this type of Inflation, supply falls suddenly and demand remains at the same level. Example: During GST implementation, there was a sudden supply shock as the companies and others couldn't comply with supply norms all of a sudden.

3.5.5. Base Effect

Base effect is the **effect of choosing different reference points while comparing two data** that may give different results in terms of absolute change and percentage change. When the inflation rates were too low in the corresponding period of the previous year, even a smaller rise in the Price Index would arithmetically give a high rate of inflation now. Example: The price index of January 2016 is 110 and that of January 2017 is 120. Now Inflation for January 2017 = (120-110)/110 *100, which comes out to be 9.09%. Further, suppose that the price index for March 2017 is 180 and that of March 2018 is 190. Now, Inflation for March 2018 = (190-180)/180*100, which comes out to be 5.55%. We see that in both the cases the increase in the price index is 10 but the rate of inflation is different. This is due to the base effect.

3.5.6. Inflationary Gap and Deflationary Gap

An **inflationary gap** is a type of economic gap that exists when the demand for goods and services exceeds production due to factors such as higher levels of overall employment, increased trade activities, or elevated government expenditure.

In case of Demand-Pull Inflation, aggregate demand is greater than aggregate supply of goods and services (at full employment). This excess demand represents an Inflationary Gap. The inflationary gap results in a price rise. Prices will continue to rise till this gap exists. **For example** – Due to the rise in government expenditure, the purchasing power of people increases. This creates excess demand in an economy resulting in an inflationary gap.

Deflationary Gap is the amount by which actual aggregate demand falls short of aggregate supply at the level of full employment. This may result in a fall in prices due to weak demand and may lead to disinflation or even deflation.

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3.5.7. Inflation Spiral

It is a situation in an economy that occurs due to wage and price interaction. When **wages push prices up** and **prices pull wages up**. This wage-price interaction was seen as a plausible cause of inflation in the year 1935 in the US economy, for the first time.

Purchasing Power Parity: It is a theory of comparing different countries' currencies through a "basket of goods" approach. Purchasing power parity is used worldwide to compare the income levels in different countries. Let's say **that a pair of shoes costs Rs 2500 in India**. Then it should cost $50 in America when the exchange rate is 50 between the dollar and the rupee.

3.5.8. Phillips's Curve

The Phillips curve is a graph that establishes an **inverse relationship** between **inflation** and unemployment in an economy. Higher inflation is associated with lower unemployment and vice versa. This is because with economic growth comes inflation, which in turn should lead to more jobs and less unemployment.

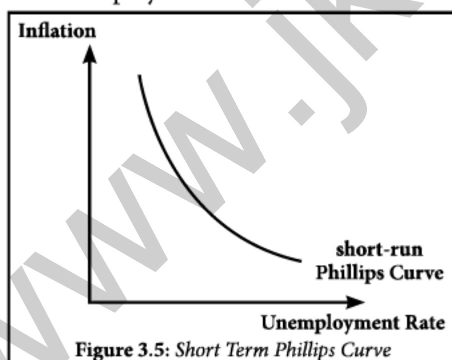

Figure 3.5: *Short Term Phillips Curve*

But in the **long run,** there is no ultimate relationship between inflation and unemployment. This is because sustained inflation can lead to stagnation which will cause loss of jobs. So, boosting inflation just for a short-term period to provide relief of employment may not be sustainable in the long run. That is the exact **reason why we need an independent central bank for long-term inflation targeting** measures as the government would like to always increase spending to be in the good books of people.

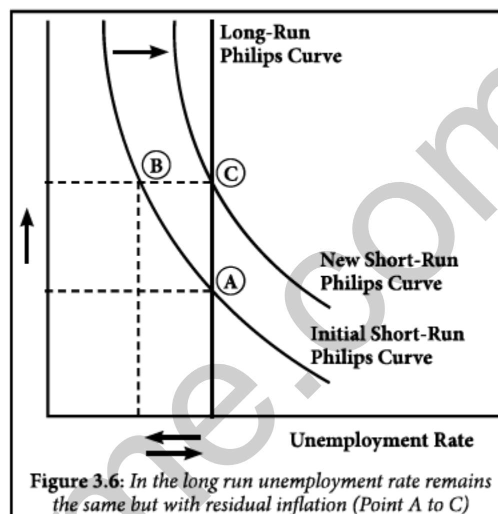

Figure 3.6: *In the long run unemployment rate remains the same but with residual inflation (Point A to C)*

3.6. MEASURES TO CONTAIN INFLATION

For controlling **Demand Push Inflation,** aggregate demand in the economy has to be reduced. Government takes various steps like going for fiscal consolidation **[Contractionary Fiscal Policy]**, eg: Increase in Personal Income tax. RBI adopts **dear money policy** like increasing repo rate, increasing CRR and SLR or selling Government Security through Open market Operation. Sudden exports of items may be curbed by imposing Minimum Export Price.

For controlling **Cost Pull Inflation,** aggregate supply has to be augmented and cost of production has to be brought down. **Government** takes various **measures** like providing subsidies, providing for maximum price at which a product can be sold, improving supply-side factors such as dismantling APMCs, fertilizer subsidy reform, etc.

3.7. BUSINESS CYCLE

Business Cycle is the fluctuations in economic activity that an economy experiences over a period of time. Business cycles are generally measured using the rise and fall in the real gross domestic product (GDP) or the GDP adjusted for inflation. It is also known as the economic cycle or trade cycle.

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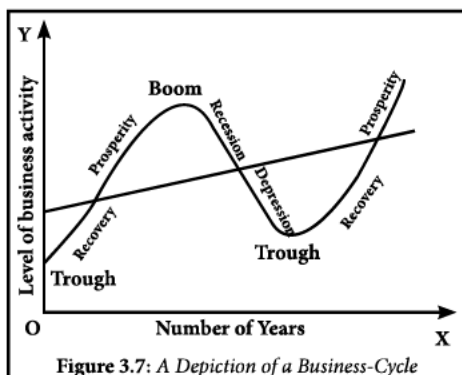

Figure 3.7: *A Depiction of a Business-Cycle*

A business cycle goes through various **phases: Recession, Depression, Recovery, and Boom. Recession** is a slowdown or contraction in economic activities. It is when the GDP growth rate of a country is negative for two consecutive quarters or more. Example – 2008 global recession. **Depression** is an extreme fall in economic activity that lasts for years, rather than just several quarters. For example – the great depression (starting from 1929) lasted roughly a decade. **Recovery** is the phase in which the economy begins to recover from the negative growth rate. The Demand starts to pick up due to low prices. Finally, **Boom** is a phase of strong upward fluctuation in economic activities.

3.7.1. Double Dip Recession

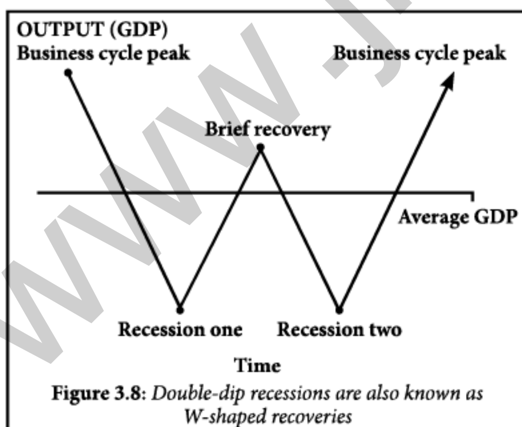

Figure 3.8: *Double-dip recessions are also known as W-shaped recoveries*

Double Dip Recession is an economic scenario in which a recession is followed by a brief recovery, then another recession. Example - In 1980, in the US, mainly due to a spike in oil prices after the Iranian revolution.

3.7.2. Policies of Cyclical and Counter-Cyclical Nature

Cyclicality of fiscal policy refers to a change in the direction of government expenditure and taxes based on economic conditions. If the government follows expansionary fiscal (increased spending + reduced tax) policy during expansion phase in the economy and contractionary fiscal policy (decreased spending + increased tax) during recession phase then it is called **pro-cyclical fiscal policy.** This amplifies the business cycle as it deepens recession and boost expansion.

On the other hand, if the government follows expansionary fiscal (increased spending + reduced tax) policy during recession phase in the economy and contractionary fiscal policy (decreased spending + increased tax) during expansion phase then it is called **counter-cyclical fiscal policy.** This dampens the business cycle as it softens recession and moderates expansion.

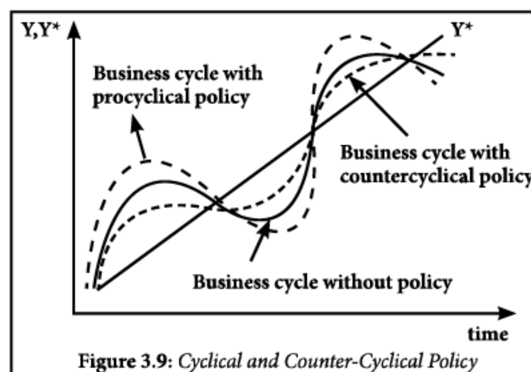

Figure 3.9: *Cyclical and Counter-Cyclical Policy*

4 CHAPTER Monetary Policy

4.1. INTRODUCTION

Monetary Policy is the macroeconomic policy laid down by the Central Bank to manage the **money supply** in the economy using interest rates and other tools. It ensures that there is a required money supply for all legitimate economic activities while at the same time also ensures that money **is not available so freely to create inflationary pressure.** In India, The Reserve Bank of India (RBI) is vested with this responsibility of conducting monetary policy as mandated under the Reserve Bank of India Act, 1934.

4.1.1. The concept of Monetary Policy

The total stock of money in circulation among the public at a particular point of time is called money supply. It impacts the demand side of the economy as the amount of money with the public basically represents their capacity to buy (the aggregate demand). When the market is in equilibrium, this demand is met by the supply of goods and services (the GDP). In other words, the GDP and other economic growth parameters along with inflation can be controlled by controlling money supply.

4.2. TYPES OF MONETARY POLICY

Contractionary or tight or hawkish or dear money policy is adopted by the central bank (RBI) to **reduce the money supply** in the economy to control inflation in the economy or to strengthen the value of rupee (to check depreciation). Central Bank (RBI) can take following steps: Increases Repo Rate, Increases Reverse Repo Rate, Increases Bank Rate, Increases Cash Reserve Ratio (CRR), Increases Statutory Liquidity Ratio (SLR), RBI sells government securities through Open market operations (OMO).

Expansionary or easy money policy or dovish monetary policy or cheap money policy is adopted by the central bank (RBI) to increase the money supply in the economy. By boosting money supply (liquidity), demand and investments in the economy can be raised, leading to economic growth. It can be done by any of the following: Decreases Repo Rate, Decreases Reverse Repo, Decreases Bank Rate, Decreases Cash Reserve Ratio (CRR), Decreasing Statutory Liquidity Ratio (SLR), RBI purchases government securities through OMO.

4.3. GOALS OF MONETARY POLICY

The objective of monetary policy of India has been 'controlled monetary expansion'. It is argued that in a developing economy, money supply must be expanded sufficiently to match the growth of real national income. Some of the goals of Monetary Policy in India are:

1. To accelerate economic **growth** (by providing appropriate liquidity and inflation targeting)
2. To maintain **price stability** (by controlling inflation)
3. To promote **employment** (by boosting economic growth)
4. To encourage flow of credit into priority and neglected sectors (by policy measures as discussed later).
5. To stabilize the exchange rate.

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4.4. INSTRUMENTS OF MONETARY POLICY

To achieve the above-mentioned objectives of monetary policy, RBI is entrusted with the certain monetary policy instruments that can be broadly classified into quantitative measures and qualitative measures.

Credit Control		
Quantitative Measures		**Qualitative Measures**
Reserve Ratios	1. **1.Cash reserve ratio (CRR)** 2. **Statutory Liquidity Ratio (SLR)**	1. **Credit Rationing** 2. **Consumer Credit Control** 3. **Marginal Requirements** 4. **Moral suasion** 5. **Direct Control**
Open Market Operation		
Policy Rates	1. **Bank Rate** 2. **Repo Rate** 3. **Reverse Repo Rate** 4. **Marginal Standing Facility**	

4.4.1. Quantitative Measures

Quantitative measures alter the money supply in the overall economy. The effect is indirect in nature as the main change happens in money supply which spills over to various sectors. Instruments under quantitative measures are bank rate, reserve ratio (CRR and SLR), LAF (REPO AND Reverse REPO), Open market operation.

4.4.1.1. Reserve Ratio: Cash Reserve Ratio and Statutory Liquidity Ratio

Cash reserve ratio (CRR) is the percentage of the total public deposit with the bank which they have to **keep with RBI in cash** at any point of time as a reserve. There is no fixed range for CRR and it can vary from 0 to 100%. Usually, interest is not paid on such deposits. If Commercial Banks have excess cash reserves on the basis of which they are giving too much of loans, then RBI will raise the cash reserve ratio. Similarly, the Central Bank will lower down the Cash Reserve Ratio when the Central Bank desires that the Commercial Banks should increase the volume of credit in order to bring about an economic revival in the economy. If the CRR is high, the commercial bank's capacity to create credit will be less and if the CRR is low, the commercial bank's capacity to create credit will be high. At present (January 2022), CRR is 4%.

Statutory Liquid Ratio (SLR) is the percentage of total public deposits which banks have to maintain with themselves in the form of specified liquid assets (Cash, G-sec, gold) at any point of time. As per the amendment in 2007 in RBI act 1949, SLR can vary **from 0 % to 40%.** Through SLR, RBI creates a secondary market for the government securities as banks prefer to hold these securities (bears interest) rather than cash. At present (January 2022), the SLR is 18 percent of the NDTL of the banks. (NDTL = Net Demand and Time Liabilities)

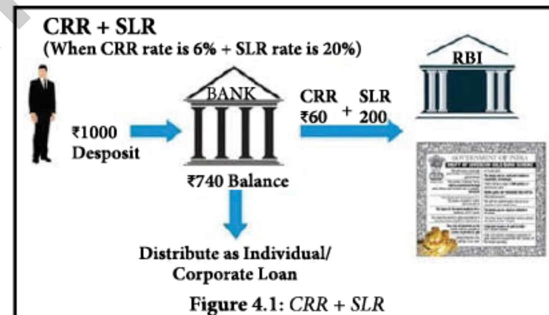

Figure 4.1: *CRR + SLR*

Impact of SLR/CRR :

CRR/SLR helps to regulate liquidity and credit growth in the economy by altering the money supply.

↓ SLR/CRR→ ↑ money with banks → ↓ interest rate → ↑ consumption→ ↑ investment→ ↑ output→ ↑ growth

Difference between SLR and CRR

SLR	CRR
In case of SLR, banks are asked to have reserves with themselves of liquid assets which include cash, gold and RBI approved securities.	The CRR requires banks to have **only cash** reserves with the RBI.

Banks earn returns on money parked as SLR.	Banks earn no return on money parked as CRR.
SLR has to be maintained with the bank itself.	In CRR, the cash reserve is maintained by the banks with the Reserve Bank of India.
It controls excess credit growth by making banks invest in few instruments which are SLR permissible avoiding credit to the public.	It helps mainly in controlling liquidity by trapping cash with RBI

4.4.1.2. Liquidity Adjustment Facility: Repo and Reverse Repo

Liquidity Adjustment Facility (LAF) is a tool used in monetary policy by the RBI, that allows banks to borrow money through repurchase agreements (repos) or banks to park excess funds with the RBI (alternatively we can say that RBI borrows from the bank) through reverse repo agreement. It is a facility extended by the RBI to the scheduled banks and primary dealers of liquidity. Regional rural banks cannot avail this service. To avail this service, the minimum amount should be 5 crore and multiples of 5 crore thereafter. LAF is done by two mechanisms. Repo rate and Reverse repo rate

Repo rate is the rate at which **commercial banks borrow money from RBI** in case of shortage of funds. Repo rate differs from Bank Rate as Repo involves selling securities to the RBI, along with the repurchase agreement. Repo mechanism is **usually used by banks for overnight purposes** or up to a few days. To control inflation RBI increases the repo rate that makes borrowing from the central government costly and thereafter money supply in the economy reduces (Contractionary Policy). While RBI lowers repo rate to increase the money supply in the economy (**Expansionary policy**).

Reverse repo rate is an instrument for **lending funds to RBI** by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price. It is the short-term borrowing rate at which RBI borrows money from banks. Increase in the reverse repo rate means that the banks will get a higher rate of interest from RBI and banks prefer to lend their money to RBI which is always safe instead of lending it to others (people, companies) which is always risky. To control inflation RBI increases the reverse repo rate which leads to reduction of money supply in the market. On the other hand, to increase money supply in the market, RBI decreases its reverse repo rate.

Reverse repo rate is always less than the repo rate. At present (January 2022), repo rate is 4.0% and reverse repo rate is 3.35%.

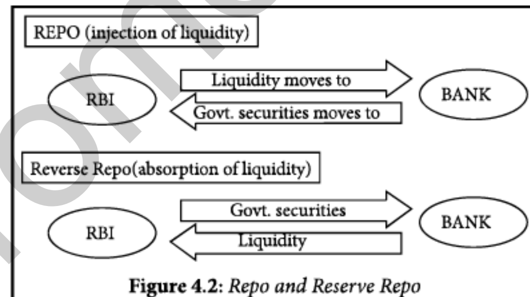

Figure 4.2: *Repo and Reserve Repo*

Difference between Repo and Reverse Repo

Repo Rate	Reverse Repo Rate
Repo rate is charged by RBI when commercial banks sell their securities.	Reverse repo rate is the rate at which RBI borrows money from banks within the country.
Repo rate is used to control inflation.	Reverse repo rate is used to control money supply in the market.
The aim of Repo rate is to fulfill the deficiency of funds.	The objective of Reverse Repo Rate is to ensure liquidity in the economy.
Repo Rate is charged on Repurchase Agreement.	Reverse repo rate is charged on the reverse repurchase agreement.

4.4.1.3. Bank Rate

Bank rate refers to the 'standard rate' at which the central bank (RBI) extends advances to the commercial banks and other financial institutions. Under this, there is **no repurchasing agreement**

signed or no collateral involved or no securities sold. Whenever the banks are faced with reserve shortages, they can approach RBI as RBI is the lender of last resort to the banks. They approach the central bank to borrow money by discounting their bills of exchange. Hence, it is also called the discount rate. At present (January 2022), the bank rate is 4.25%.

Banks borrow funds from the central bank and lend the money to their customers at a higher interest rate, thus, making profits. When RBI increases the bank rate the cost of borrowing increases for the banks which is also transmitted to end customers. Due to increase in cost, credit volume decreases and money supply in the economy also reduces; thereby helping to counter inflation.

Difference between Repo Rate and Bank Rate

Bank Rate	Repo Rate
Bank rate is charged against the loan offered by the central bank to commercial banks.	Repo rate is charged for the repurchasing of securities sold by the commercial bank to the central bank.
No collateral is required for a loan taken under bank rate.	Repo rate uses government securities as collateral, which are repurchased at a later date.
Bank rate caters *long-term* financial requirements of commercial banks.	Repo Rate focuses on the *short-term* financial needs of the commercial bank.
Increase in Bank Rate directly affects the lending rates offered to the customer, restricting people to avail loans and damages the overall economic growth.	Increase in Repo Rate is usually handled by the banks and doesn't affect customers directly.

4.4.1.4. Open Market Operations (OMO)

Under open market operation, the Central Bank buys and sells government securities in the financial market to influence money supply in the economy. There are two types of OMO:

1. **Outright Purchase or Permanent OMO (POMO):** This is permanent and involves the outright selling or buying of government securities.
2. **Repurchase Agreement (REPO):** This is for short-term and banks are subject to repurchase at a decided time (discussed earlier).

When RBI sells government securities then liquidity in the market reduces, with the less money in the market the demand for goods will decrease and consequently rate of inflation also comes down. When RBI feels there is a liquidity crunch in the market that is the shortage of money supply then RBI resorts to purchase of government securities.

4.4.1.5. Marginal Standing Facility

MSF is a liquidity support arrangement provided by the RBI to banks if the latter does not have the required securities above the SLR limit. **It was launched by RBI in 2011-12**. Under this, RBI gives short term loans to scheduled commercial banks on overnight basis up to a certain percentage of their net demand and time liabilities (NDTL). MSF being a penal rate, **is always fixed above the repo rate**. It would be the last resort for banks once they exhaust all other borrowing options including the liquidity adjustment facility or even the "overnight call market rate" where the rates are lower in comparison with the MSF. Under MSF, banks can take loan up to 1% of NDTL. The minimum amount which can be accessed through MSF is rupees 1 crore and in multiples of rupees one crore. So, by increasing this penal rate, banks will be careful while lending in excess and thereby decreasing the excessive credit growth in the economy. At present (January 2022), Marginal Standing Facility Rate is 4.25%.

4.4.1.6. Other Monetary Tools used by RBI

1. Market Stabilization Scheme (MSS)

Market Stabilization Scheme (MSS) was launched by the RBI in April 2004 as an additional channel to reduce liquidity. Under it the government issues T-Bills (treasury bills) in addition to its normal borrowing requirements. The amounts raised under the MSS will be held in a separately identifiable cash account entitled Market Stabilization Scheme

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Account. The Government Bonds issued under the **Market Stabilization Scheme are called MSS bonds.** It is issued on behalf of the government by the RBI for the specific purpose of pulling out the excess liquidity from the system when regular government bonds prove inadequate. These bonds have maturity of less than six months however the tenure differs depending on the requirement.

2. **Call Money Market**

Call Money Market (CMM) is the rate at which short term funds are borrowed and lent in the money market. Participants in the call money market in India include banks (excluding regional rural banks), Primary Dealers (PDs), development finance institutions, insurance companies and select mutual funds. The **duration of the call money loan is 1 day**. Banks resort to this type of loans to fill the asset liability mismatch, comply with the statutory CRR and SLR requirements and to meet the sudden demand of funds. Demand and supply of liquidity affect the call money rate. A tight liquidity condition leads to a rise in call money rate and vice versa.

3. **Standing Deposit Facility Scheme (SDFS)**

Standing Deposit Facility Scheme (SDFS) was proposed by the Union Budget 2018–19. It is a remunerated facility that will not require the provision of collateral for liquidity absorption. This mechanism allows the RBI to absorb surplus funds from banks without collateral especially when the economy is flush with excess funds (as was seen after the demonetization of the high value currency notes post- November 2016).

4.4.2. Qualitative Measures / Selective Measures

Qualitative Measures affect the flow and direction of credit to particular sectors in a positive or negative manner. It does not impact the overall money supply thereby limiting the hazards for those who may still need credit at a particular price. So, it is very selective in its effect. Instruments under qualitative measures are moral suasion, Margin Requirement, Rationing of credit, direct action etc.

Under **credit rationing,** the Central Bank fixes the quota of credit for various sectors of the economy. It means, it fixes a maximum limit for a sector. Objective is to restrict all liberalized loan conditions for a particular sector. For example, priority sector lending (PSL) requirements is 40% of total loan. It is further divided into many sectors like agriculture, small medium enterprises, home loan, students' loan, weaker sections etc.

RBI can vary **margin requirement** to control flow of money in particular sectors. Margin is the difference between the market value of a collateral security and the amount of loan that can be sanctioned by a bank against it in a particular sector. RBI increases margin requirements for a particular sector to restrict the flow of money in that sector while to increase money supply in a sector, RBI decreases the marginal requirement for that sector.

RBI prescribes **differential rate of interest** for different sectors of the economy. To increase money supply, RBI reduces the rate of interest for a sector. On the other hand, to decrease money supply RBI increases the rate of interest for that sector. RBI fixes the maximum amount of loan (**ceiling on credit**) that can be provided by a bank to an economic entity in a particular sector. For example, the ceiling on student loans is 25 lakhs for domestic studies and 50 lakhs for foreign studies.

Moral suasion is the use of compulsion or informal suggestion by the RBI on commercial banks for changing the credit flow in the economy. These are only suggestions (through circular, species, seminar etc.) not directions banks are not legally obliged to follow. For example, RBI Governor may request to reduce the credit for polluting sectors like coal and to promote green credits. Few banks may follow these commands on moral grounds.

Direct action is adopted when a commercial bank does not cooperate with the central bank in achieving its desirable objectives. The Central bank can even penalize the bank by changing some rates. At last, it can even put a ban on a particular bank if it does not follow its directives. For example, banks not tackling the NPA's are put under **Prompt Corrective Action (PCA)** framework and the credit growth from those banks are severely restricted.

4.5. MONETARY POLICY FRAMEWORK

The Government of India and Reserve Bank of India signed a Monetary Policy Framework

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Prompt Corrective Action

PCA is a framework used by RBI to enable supervisory intervention at appropriate time and require the supervised entity to initiate and implement remedial measures in a timely manner, to restore its financial health.

PCA delineates three risk thresholds. Triggering of each threshold will result in invocation of PCA, with a gradually increasing set of restrictions ranging from restrictions on dividend distribution to prohibition on opening branches to restrictions on capital expenditure.

Parameters	Risk Threshold 1	Risk Threshold 2	Risk Threshold 3
Capital Adequacy Ratio falls	300 basis points from current level of 15-12%	300-600 bps from 12-9%	600 bps from 9%
Net Non-Performing Assets is b/w	6-9%	9-12%	>12%
Tier 1 capital ratio, falls	Up to 200 bps below the min Tier I Capital Ratio [10% – 8%]	More than 200 bps but up to 400 bps below min Tier I capital ratio [8% – 6%]	More than 400 bps below the min Tier I capital Ratio [<6%]

Agreement in 2015. In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework. The objective of the monetary policy framework is to primarily maintain **price stability**, while keeping in mind the objective of **growth**. By this framework, the aim of monetary policy of RBI was made to be inflation targeting. The targeted range of inflation should be **2% to 6% (4±2%)**.

Section 45ZB of the amended RBI Act, 1934 provides for an empowered six-member Monetary Policy Committee (MPC). The **MPC determines the policy interest** rate which is required to achieve the set inflation target. The **committee comprises six members**, three from RBI and other three external members appointed by the government.

1. RBI Governor (Chairman)
2. RBI Deputy Governor (in charge of monetary policy)
3. One officer of RBI to be nominated by the Central Board.
4. Member nominated by the central government
5. Member nominated by the central government
6. Member nominated by the central government

Members nominated by the central government are recommended by a **selection-cum-search committee** headed by the cabinet secretary. RBI governor is also a member of this selection-cum-search committee. These members are appointed for 4 years and are not eligible for reappointment. The quorum for a meeting shall be four members and each member has one vote. **Decisions** are made on the basis of **majority** and in case of tie, RBI governor has a casting vote but there is no veto to the governor. As per the Act, RBI has to organize at least four meetings of the MPC in a year.

4.6. MONETARY POLICY TRANSMISSION (MPT)

Monetary transmission refers to the process by which a central bank's monetary policy signals (like repo rate change) are passed on, through the financial system, to businesses and households. The cycle of transmission can be like:

↓ Repo rate → ↓ Interest rate → ↑ Consumption→ ↑ Investment→ ↑ Output→ ↑ Growth

4.6.1. Issues with Monetary Policy Transmission in India

Ability of Monetary Policy to control the money supply in the market depends upon the efficiency of monetary policy transmission. For efficient monetary policy transmission, lending rates decided by the banks must be sensitive to the

policy rates (i.e., repo, reverse repo, MSF and bank rate) announced by the central bank. However, **incomplete monetary transmission** was observed and despite reduction in policy rates by RBI, lending rates by banks were not coming down. **For example**: Between February and August 2019, the RBI cut the repo rate by 110 basis points from 6.5% to 5.4% [100 basis points make a percentage point], but the interest rate charged by banks on fresh loans that they extended during this period fell by just 29 basis points. (Only 27% of the policy rate cut was really transmitted to the economy).

Basic reason for incomplete monetary transmission is **high dependence of banks on deposited money** (around 80%). Banks take a very small proportion of their funds from RBI under repo. To attract depositor money, banks give high interest rates on deposits. Further, a significant proportion of deposits are in the form of term deposits for which banks have committed to pay a fixed interest rate for a certain period. Banks decide their lending rate based on the interest rate they are paying for deposits. When RBI reduces repo rate, it is not possible for banks to proportionately reduce lending rate because they cannot reduce interest rate suddenly. If interest rates are reduced by banks, depositors will park more of their savings in other **small saving instruments** (public provident fund, Sukanya Samriddhi Yojana, etc) that pay much higher interest rates (interest rates for small saving instruments are administered lending rate, decided by government and not linked to market). This would deny banks access to money to do business ie. lending. Also, banks have a commitment to pay fixed interest rate on term deposits which makes it further difficult to reduce lending rates.

The next problem arises from the high proportion of **Non-Performing Assets (NPA)** in banks. To make up for the losses, banks are forced to keep higher weighted average lending rates. Also, due to requirements like **SLR and CRR** along with **Priority Sector Lending (PSL),** the amount of money that banks can lend profitably comes down significantly making it difficult for banks to remain profitable while passing on rate cut benefits.

To improve the monetary policy transmission, RBI has mandated banks to move from Internal Benchmark Lending Rate (IBLR) (base rate and Marginal Cost of funds-based Lending Rate) to external benchmark lending rates (EBLR), effective 1st October, 2019.

Base rate is the minimum interest rate at which commercial banks could lend to customers. It was calculated on three main parameters — the cost of funds, unallocated cost of resources and return on net worth. This rate was dependent on individual banks and they could change it whenever their cost of funds or other parameters changed. However, monetary policy changes were not being transmitted because banks raise money from other sources. **Marginal Cost of funds-based Lending rate (MCLR)** is based on marginal cost (the cost of funds for the next loan to be given) and hence every new loan/ credit will be impacted. Despite these changes, the transmission was still low and hence RBI moved away from MCLR to EBLR.

Under **External Benchmark Lending Rates** all new floating rate loans (i.e., personal/retail loans, loans to MSMEs) are linked to an external benchmark to ensure faster transmission of monetary policy rates. Banks can choose from one of the four external benchmarks — **repo rate, three-month treasury bill yield, six-month treasury bill yield or any other benchmark interest rate published by Financial Benchmarks India Private Ltd**. It means that the actual lending rates will not remain linked to the internal data of the banks (as the case has been for MCLR) and banks will be forced to link the interest rates of their new loans with an external and market-determined benchmark.

Existing customers wanting to switch to the repo-linked rate can do so on mutually acceptable terms. The interest rate under the external benchmark shall be reset at least once every three months. It was done to **improve the transmission** of policy rates into the lending rates of banks, to **bring transparency** in the methodology followed by banks for determining interest rates on advances, to ensure availability of bank credit at **interest rates which are fair** to borrowers as well as banks, to enable banks to become more competitive, and enhance their long run value and contribution to economic growth.

4.7. NEWER MEASURES UNDER MONETARY POLICY OF RBI

4.7.1. Long Term Repo Operations (LTRO)

LTRO is a tool under which RBI provides loans to banks at the prevailing repo rates for one to three years. For this purpose, RBI accepts government's securities with matching for higher tenure as the collateral. The banks can get a minimum subscription of 1 crore and in multiples, thereof without any maximum limits. LTRO is expected to bring down the cost of funds for banks, ensure cash flow to the productive sector and boost investments leading to the growth of the country.

4.7.2. Operation Twist

Operation twist is a monetary policy strategy of simultaneous buying of long-term bonds and selling short-term bonds. When the central bank uses the proceeds from the sale of the short-term securities to buy long-term government debt papers, it leads to easing of interest rates on the long-term papers. RBI has conducted this simultaneous purchase and sale of government securities in 2019 under open market operations. Since there is an inverse relation between bond prices and yields, with purchase of more long-term bonds the demand for these bonds will rise. This leads to rise in demand pulled bond prices and the yield comes down. This fall in long term bond yield benefits the long-term borrowers as they have to pay less for the long-term bonds. The benefit of such a step is that bond yields are reduced without affecting the money supply (i.e., no impact on inflation).

4.8. BASEL NORMS/ACCORDS

Basel norms or Basel accords are a **set of global voluntary banking regulations** related to capital risk, market risk and operational risk, issued by **Basel Committee on Bank Supervision (BCBS)**. Basel Committee on Bank Supervision (BCBS) is housed in the headquarters of Bureau of International Settlement, Basel (Switzerland). The purpose of the accords is to (1) coordinate banking regulations across the globe (2) strengthen the international banking system. There are **three accords** known as Basel I, Basel II and Basel III. Basel III is the third installment of the Basel Accords and was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–08. Basel III was agreed upon by the members of the Basel Committee on Banking Supervision in November 2010, and was scheduled to be introduced from 2013 until 2015; however, implementation was extended repeatedly to 1 January 2022 and then again until 1 January 2023, in the wake of the Covid-19 pandemic.

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CHAPTER

Public Finance and Fiscal Policy

5.1. INTRODUCTION

Public Finance is the study of the financial activities of governments and public authorities in an economy. It describes and analyses the expenditures of governments and the techniques used by governments to finance these expenditures. Finance is the fuel for the engine of governance. Fiscal policy is the strategy adopted by the government to raise revenue and spend it for the development of a country. The main instrument of fiscal policy is the budget. Deciding 'how much to spend, where to spend and how to raise money for spending' is the main purpose of fiscal policy.

We have already discussed about monetary policy in the previous chapter. Although Fiscal and monetary policy influence the economic performance of a country, fiscal policy is different from the monetary policy. While fiscal policy deals with taxation and government spending and is often administered by a government department; monetary policy deals with the money supply, interest rates and is often administered by a country's central bank.

5.2. BUDGET

The term budget has been derived from a French word, '**Bougette**", which means a leather bag or wallet. Budget is a document which contains estimates of the revenue and expenditure for a year. **Article 112** of Indian constitution refers to the budget as an **Annual Financial Statement** that is a statement of receipt and expenditure of the government of India in a financial year.

In other words, budget means a statement of the government's needs and resources. It is a legal document designed for optimal allocation of scarce resources taking into account socio-economic and political consideration. It **ensures legislative control** over the executive through debate and discussion on budgets, cut motions, enactment process etc. This is in accordance to Article 114(3) of the Constitution which states that "no amount can be withdrawn from the Consolidated Fund without the enactment of such a law by Parliament."

The budget is not merely a statement of receipts and expenditures. Along with it, three policy statements are mandated to be presented by the Fiscal Responsibility and Budget Management Act, 2003 (FRBMA). The **Medium-term Fiscal Policy Statement** sets a three-year rolling target for specific fiscal indicators and examines whether revenue expenditure can be financed through revenue receipts on a sustainable basis and how productively capital receipts including market borrowings are being utilized. The **Fiscal Policy Strategy Statement** sets the priorities of the government in the fiscal area, examining current policies and justifying any deviation in important fiscal measures. The **Macroeconomic Framework Statement** assesses the prospects of the economy with respect to the GDP growth rate, fiscal balance of the central government and external balance.

5.3. TYPES OF BUDGETS

Budget is generally made for one year, as in the case of India. However, there can be a long term budget as well. Long-term budget plans for

expenditure and revenue over multiple years. India does not have a long-term budget, but it has a long-term fiscal policy as mandated by FRBM act. Further, when a budget is prepared by the executive and responsibility for its execution lies with the executive, after approval of budget by the legislature, it is known as **executive budget**. This is the form of budget in India. Alternatively, when a budget is prepared by a committee of the legislature on the request of the executive, it is known as a **legislative budget**. India does not have this concept.

Zero based budget (ZBB) refers to planning and preparing the Budget from scratch or 'zero base'. In this method of budgeting, every expense is evaluated each time the budget is made. It is based on the concept that every expense should be justified for each new period. In India, ZBB was first introduced in the Department of Science and Technology in 1983. For example, let's say there is a poverty alleviation scheme like MGNREGA and every year 1000 crores are allotted as per normal budgeting. But ZBB tells us that there should be no fixed amount to be allotted and every year, before the budget, MGNREGA should be evaluated for its past performance and the target of poverty reduction to be achieved the following year and the outlay for MGNREGA should be made accordingly. Another way of budgeting is traditional/incremental budgeting which decides outlay on the basis of the previous year budget.

Performance budget is a system of presentation of public expenditure in terms of functions, programs, activities and projects that primarily reflect the input cost and outputs achieved. In simple terms, it is a budget which has outlays with performance targets that have been achieved for the amount of cost being put in. For example, in a performance budget of the Ministry of Health and Family Welfare, the government says that with an allocation of 1000 crores for Janani Suraksha Yojana (JSY) preceding year, the MMR has reduced from 212 to 190. This means, the money that was spent has shown a significant outcome and based on this performance money will be allotted for the following year. A system of performance budgeting by ministries was introduced in 1969, following the recommendations of the Administrative Reforms Commission.

However, certain weaknesses were observed in the performance budget documents such as (1) lack of clear one-to-one relationship between the Financial Budget and the Performance Budget (2) more focus on physical "outputs" that are more readily measurable than the "outcomes" that are the end objectives of State intervention and the financial outlays. To overcome these weaknesses, an outcome budget was introduced.

Outcome budget seeks to bring correlation between outlay, output and outcome. Outlay is the amount that is provided for a given scheme or project in the Budget. Output refers to the direct and measurable product of program activities, often expressed in physical terms or units. Outcome is the collective result or qualitative improvements brought about in the delivery of these services, often expressed in terms of improvements over earlier indicators and benchmarks. It aims to look at the performance of various ministries handling development programs. In simple terms, it sets measurable and monitorable targets for the allocation on every plan project under various ministries. For example, in an outcome budget to the Ministry of Health and Family Welfare, a government can allocate a total of ₹5 lakh crores on a condition that the ministry should bring down IMR to less than 25 and MMR to less than 110 before the end of financial year. From the financial year 2006-2007, every ministry presents a preliminary outcome budget to the Ministry of Finance. Ministry of finance is the authority that compiles all such outcome budgets.

Gender Budgeting looks at the government budget from a gender perspective to assess how it addresses the needs of women in the areas like health, education, employment etc. It is not a separate budgeting process. It seeks affirmative action to address specific needs of women. It looks at the budget in a way to mainstream the gender objective, to ensure that benefits of development reach women. It monitors both the expenditure and public service delivery based on women targets and achievements. There are Gender Budgeting Cells (GBC) being set up in all ministries/departments to promote the task of Gender Budgeting. Gender budgeting was first introduced in budget 2005-2006 and the budget is usually presented as two parts: (1) Part A deals with Women Specific Schemes which deals with 100% allocation to women. Eg: Beti

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Bachao Beti Padhao scheme (20) Part B deals with Pro Women Schemes, where there is preferential allocation to women. Example, in the Stand-up India Scheme there is a special target to promote women entrepreneurs.

Planning programming and performance budget (PPBS) is a technique for optimizing allocation of funds in the budget through exercise of proper choice among programmes which compete for limited resources. It involves three steps: (1) Planning- Identification of goals and objectives (2) Programming- Prioritizing the goals (3) Budgeting- Allocation of funds.

5.4. COMPONENTS OF A BUDGET

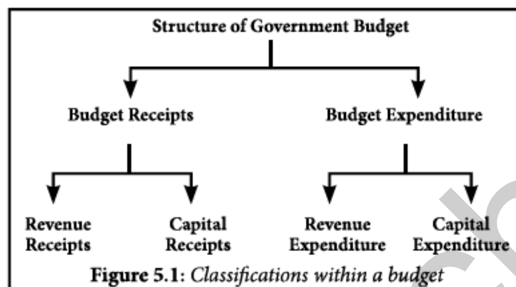

Figure 5.1: *Classifications within a budget*

Budget constitutes two accounts: **Revenue Account and Capital Account.** Revenue Account shows the current financial year receipts of the government and the expenditure that has to be met from these receipts. For the ease of understanding, these are one-way transactions. For example, government collecting tax is a one-way transaction which falls into revenue account. Similarly, government spending for salaries.

Capital Account is an account of the assets as well as liabilities of the government which takes into consideration changes in capital. It can be seen as a two-way transaction. For example, when government borrows, it has to pay back in future. Similarly, when government spends on infrastructure, one way money is spent and on other way an asset is created. This account comprises foreign direct investments, portfolio investments, etc. It gives a summary of the net flow of both private and public investment into an economy.

These two accounts are further classified into **Receipt and Expenditure**. **Revenue Receipts** are those receipts which do not lead to a claim on the government in future. They are therefore termed non-redeemable (can't be claimed from the government). In simple terms, these receipts do not create any liability or any reduction in the assets of the government. They are divided into tax and non-tax revenues.

Tax revenue is the income earned by tax efforts of government. It has been further divided into: **Direct taxes** revenue, such as income tax on personal income and corporation tax on firms, and **Indirect taxes** revenue like excise taxes (duties levied on goods produced within the country), customs duties (taxes imposed on goods imported into and exported out of India), Goods and Services Tax etc. **Non-tax revenue** is the revenue other than taxation for the government. It mainly consists of interest receipts on account of loans by the central government, dividends and profits on investments made by the government, fees and penalties and other receipts for services rendered by the government.

Capital Receipts are all those receipts of the government which create liability or reduce financial assets. Liability is created when government receives money by way of loans. Sale of government assets, like sale of shares in Public Sector Undertakings (PSUs), reduces the total amount of financial assets of the government.

The main items of capital receipts are market borrowing, loans from the central bank, recovery of loans granted by the central government and those receipts out of selling of government properties and disinvestments. The Capital Receipts can be further divided into **Debt-Capital receipts and Non-Debt Capital receipts.** Those receipts that create a repayment burden on the government are **Debt Capital receipts**. It includes borrowings of the government from RBI through sale of G-Securities/ T-Bills, market borrowings, loans from other countries or international organizations etc. **Non-debt Capital receipts** are those receipts that do not create a future repayment burden on the government. It includes disinvestment proceeds of the government (sale of properties or stake in organizations), receipts from recovery of loans etc.

On the expenditure side, **revenue expenditure** are those expenditures which do not create any assets. These are the expenditures incurred for the routine, usual and normal day to day running of the government. It includes interest payments, subsidies, wages to government employees, pensions, social services and so on.

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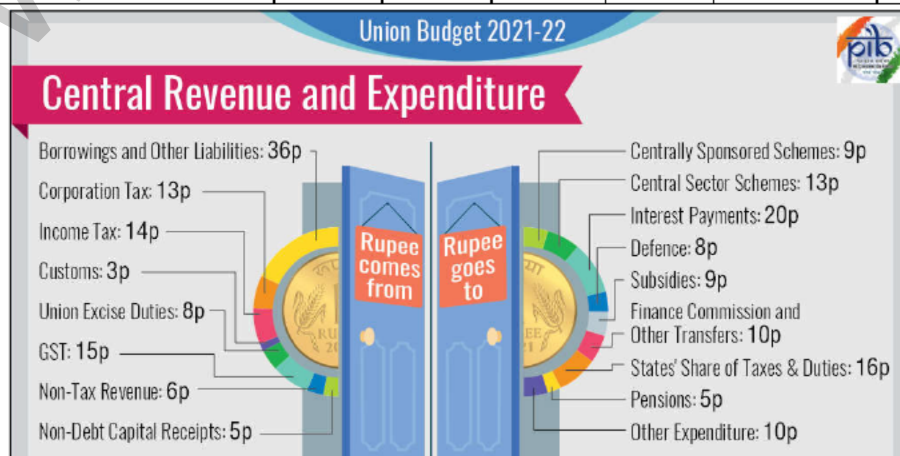
Revenue Account			
Receipt			**Expenditure**
Tax		**Non-Tax**	
DIRECT Income Tax Corporate Tax Property Tax	**INDIRECT** GST Central Excise Tax Custom Duty	Profits and dividends the government gets from its public sector undertakings, Interest Received, Grants which the governments receive from state governments or foreign countries.	Interest payment by the government on the internal and external loans; Salaries, Pension and Provident Fund; Subsidies, Defense Expenditure; Grants given by the government to Indian states and foreign countries.

Capital expenditures are those expenditures that create some asset or reduce the liability for the government. These include loans to public enterprises, loans to States, Union Territories and foreign governments, acquisition of valuables and spending on infrastructure etc.

Capital Account		
Receipt		**Expenditure**
Debt Borrowings by the Government (Internal as well as External)	**Non-Debt** Disinvestment Loan Recovery	Loan Repayments by the Government Capital Expenditures on defense by the Government Capital Asset

Receipt and Expenditure	2016-17	2017-18	2018- 19	2019-20	2020-21 (PA)	2021-22 (BE)
Revenue Receipts (Tax + Non Tax)	8.9	8.4	8.2	8.3	8.3	8.0
Tax revenue (net of states' share)	7.2	7.3	7.0	6.7	7.2	6.9
Non-tax revenue	1.8	1.1	1.2	1.6	1.1	1.1
Revenue Expenditure	11.0	11.0	10.6	11.6	15.6	13.1
Revenue Deficit	2.1	2.6	2.4	3.3	7.4	5.1
Capital receipt	3.9	4.1	4.0	4.9	9.5	7.6
Capital expenditure	1.8	1.5	1.6	1.6	2.2	2.5
Fiscal Deficit	3.5	3.5	3.4	4.6	9.2	6.8
Primary Deficit	0.4	0.4	0.4	1.6	5.8	3.1



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5.5. DEFICITS IN PUBLIC FINANCE

When government revenues exceed the expenditures, the budget is said to be in surplus. A budget surplus is not always a good sign. Budget surplus points to a possibility that the government is not spending enough in creation of new assets, not raising salaries, not promoting credit uptakes or even lacks the ability to undertake developmental work. However, deficits in budgets are more common, where government expenditure exceeds revenues collected. There can be many forms of deficit depending upon the components taken into consideration.

Budget Deficit is the difference between the total expenditure and total receipts of the government. Usually, the budget deficit is zero as the government always matches the shortfall in revenue with borrowings or other measures.

Budget Deficit = Total Expenditure (T E) - Total Receipts (T R)

Revenue Deficits are defined as the excess of revenue expenditure over revenue receipts. When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy or borrowing to finance a part of its day-to-day consumption expenditure. Since a major part of revenue expenditure is committed expenditure (interest repayment, pension, salaries etc.), it cannot be reduced. In a bid to reduce revenue deficit, the government often reduces productive capital expenditure or welfare expenditure. This is the most undesirable part of the budgetary deficit from the perspective of economic development.

Revenue Deficits = Revenue Expenditure – Revenue Receipts

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

Fiscal Deficit = total expenditure – total receipts (except borrowings)

The fiscal deficit is financed through borrowing and hence, it indicates the total borrowing requirements of the government from all sources. Borrowing creates a problem of not only **(a)** payment of interest but also of **(b)** repayment of loans. Ultimately, the government may be compelled to borrow to finance even interest payment leading to emergence of a vicious circle and debt trap.

The other option to finance fiscal deficit is for the government to borrows from the RBI and RBI does this by printing more currency notes (monetization of deficit*). This results in circulation of more money that may cause inflationary pressure in the economy. Fiscal deficit retards future growth due to interest payment pressure. Government can also borrow from foreign countries. This increases dependence on foreign countries which may lead to interference of other countries in domestic economic and political policies. (*We will discuss this in more detail in next topic)

The central government has projected a fiscal deficit of 6.8 percent of Gross Domestic Product (GDP) for the financial year 2021-22. The government aims to steadily reduce the fiscal deficit to 4.5% of GDP by 2025-26.

Primary Deficit is the difference between the current year's fiscal deficit and the interest paid on the borrowings of the previous years. It is measured by subtracting the interest payments from fiscal deficit. In simple words, it tells about deficit of current year alone. The goal of primary deficit is to measure present fiscal imbalances. Any two years for example might be compared and so many things can be found out clearly such as, which year the government depended more on loans, the reasons behind higher or lower fiscal deficits, whether the fiscal deficits have gone down due to falling interest liabilities or some other factors, etc.

Primary Deficit = Fiscal Deficit – Interest payments (on previous borrowings)

Effective revenue deficit adjusts for the capital expenditure undertaken by states from the grants they receive from the center. Grants to the states are accounted for the revenue expenditure, yet certain grants are used in creation of capital assets by states. These grants that are given to the states and still being used for the creation of capital assets, are deducted from revenue deficit to get effective revenue deficit. The concept of Effective Revenue Deficit was introduced in the Union Budget 2012-13.

Effective revenue Deficit= Revenue Deficit – grants for the creation of capital assets

5.6. DEFICIT FINANCING

Deficit Financing is a practice adopted for financing the excess expenditure (deficit) with outside resources. The expenditure gap is financed by either **borrowing from RBI (monetized deficit)** or through **borrowing from the market**. Governments have mostly relied on borrowing from the market, giving rise to government debt. The concepts of deficits and debt are closely related.

One of the main criticisms of deficits is that they are inflationary. This is because when government increases spending (higher expenditure) or cuts taxes (leading to reduced revenue receipts), aggregate demand increases as economic agents (people/firms) now have more money with them. Producers may not be able to produce higher quantities that are being demanded at the ongoing prices. Prices will, therefore, have to rise. There is also a decrease in investment due to a reduction in the amount of savings available to the private sector. This is because if the government decides to borrow from private citizens by issuing bonds to finance its deficits, these bonds will compete with corporate bonds and other financial instruments for the available supply of funds. If some private savers decide to buy bonds, the funds remaining to be invested in private hands will be smaller. Thus, some private borrowers will get **'crowded out'** of the financial markets as the government claims an increasing share of the economy's total savings.

Instead of borrowing from a domestic source, government can also borrow from external sources. External borrowing brings in foreign currency. It is preferred over the internal borrowings due to elimination of 'crowding out effect'. If the government itself goes on borrowing from the banks of the country, other investors may be left out. An increased borrowing programme means that the public debt will go up. A large portion of revenue collected will be used for paying the interest from these loans leaving little amount for productive use.

As discussed earlier, another way for deficit financing is through **monetization of deficit**. It involves monetization of fiscal deficits with money, instead of debt (borrowing) to be repaid at some future dates. So, it is a form of "non-debt financing". As a result, under monetization, there is no increase in net public debt. Monetization of deficit can be done under 2 ways: Direct monetization and Indirect monetization.

Under **Direct Monetization**, RBI prints new currency and purchases government bonds directly from the government using this currency. In **Indirect Monetization**, deficits are monetized as the government issues bonds in the primary market and RBI purchases an equivalent amount of government bonds from the secondary market in the form of Open Market Operations (OMOs).

Direct monetization of deficit was in practice in India till 1997, whereby the central bank automatically monetized government deficit through the issuance of ad-hoc treasury bills. Treasury bills are money market instruments, are short term debt instruments issued by the government of India and are presently issued in three tenors (91, 182 and 364 days). In 1994 and 1997, two agreements were signed between the government and RBI to completely phase out funding through ad-hoc treasury bills. Later on, with the enactment of Fiscal Responsibility and Budget Management (FRBM) Act, 2003, RBI was completely barred from subscribing to the primary issuances of the government. The FRBM Act as amended in 2017 contained an escape clause which permits monetization of the deficit under special circumstances.

Ways and Means Advances

In an economy, all receipts are received with a lag while expenditures are incurred immediately. For example: direct tax for the period of April-June quarter will be collected at the end of the quarter, however, during this period, government has to pay salaries, pension, subsidies etc. To address this mismatch, RBI provides a temporary overdraft, a facility called ways and means advance. It is for a time period of 90 days and the amount of overdraft is ₹ 20,000 crores during April to September and ₹ 600 crores during October to March.

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5.7. PUBLIC DEBT

The Central Government Debt includes all liabilities of the Central Government contracted against the Consolidated Fund of India (defined as **Public Debt**), and liabilities in the Public Account, called **Other Liabilities**.

Public debt is further classified into **internal** and **external** debt. Internal debt consists of **marketable debt** and **non-marketable debt**. Marketable debt comprises of Government dated securities and Treasury Bills, issued through auctions. Non-marketable debt comprises of intermediate Treasury Bills (14-day ITBs) issued to State Governments/ UT of Puducherry and select Central Banks, special securities issued against small savings, special securities issued to public sector banks/ EXIM Bank, securities issued to international financial institutions, and compensation and other bonds. Other liabilities include liabilities on account of State Provident Funds, Reserve Funds and Deposits, Other Accounts, etc.

Public debt includes the total liabilities of the Union government that have to be paid from the Consolidated Fund of India. Sometimes, the term is also used to refer to the overall liabilities of the central and state governments. However, the Union government clearly distinguishes its debt liabilities from those of the states. It calls overall liabilities of both the Union government and states as **General Government Debt** (GGD) or **Consolidated General Government Debt.**

There are limits to which revenues from the taxes can be raised to meet ever increasing expenditure. Therefore, government resorts to public borrowing. Public Debt includes internal debt and external debt. **Internal debt** indicates the amount of loan raised by the central and state government from within the country. **External debt** is that amount which Central Government borrows from international financing agencies for financing various developmental projects. These agencies include World Bank, International Monetary Fund, etc. It has to be repaid in the currency in which it was borrowed. Over the years, the Union government has followed a considered strategy to reduce its dependence on foreign loans in its overall loan. Internal debt constitutes more than 93% of the overall public debt.

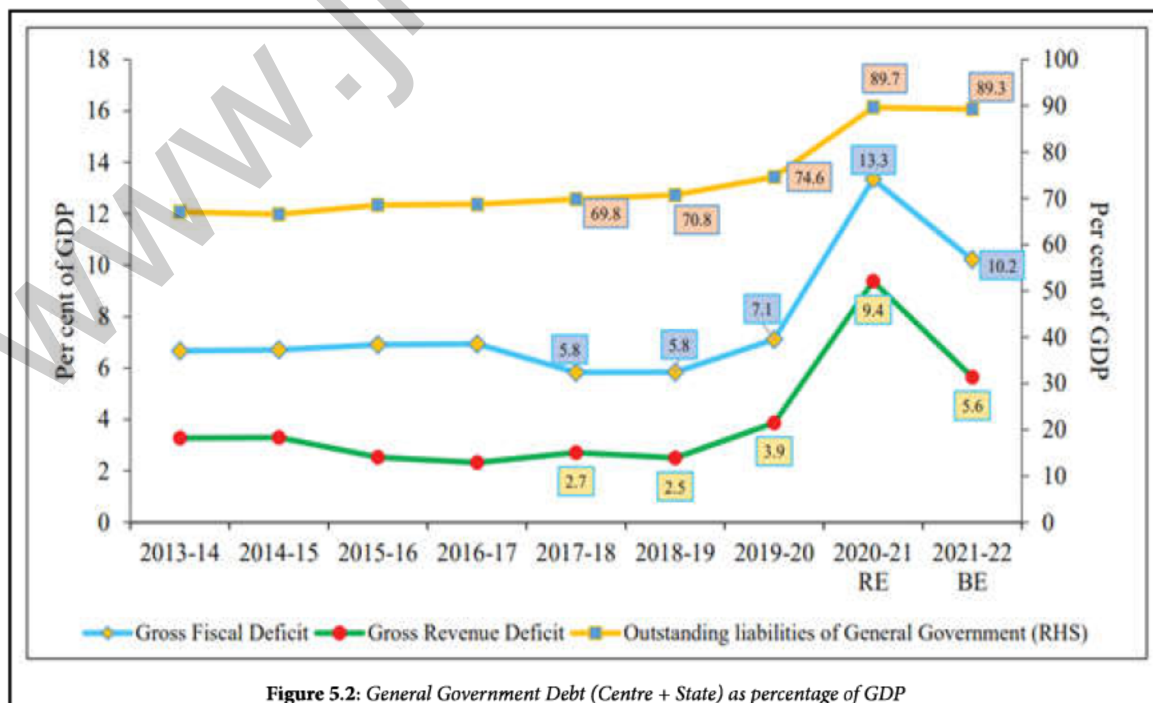

Figure 5.2: *General Government Debt (Centre + State) as percentage of GDP*

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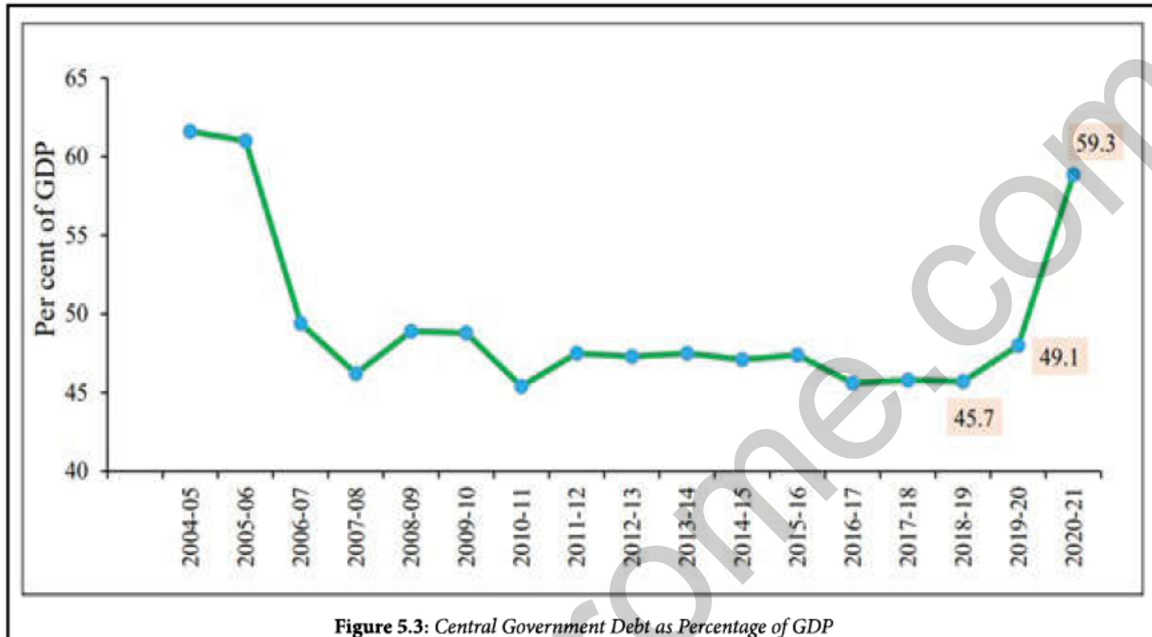

Figure 5.3: *Central Government Debt as Percentage of GDP*

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Debt to GDP ratio (Centre)	47.6	45.6	45.8	45.7	49.1	59.3

Debt Position of the Central Government (in ₹ Lakh Crore)							
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Internal Debt	47.38	53.05	57.42	64.01	70.75	80.20	99.09
External Deb	3.66	4.07	4.08	4.45	4.74	5.44	6.15
Public Debt	51.05	57.11	61.50	68.45	75.49	85.65	105.24

Debt vs. Deficit:

While deficit measures the expenditure-revenue gap in a particular year, debt tells how much the government has borrowed over the years to bridge the expenditure-revenue gap. In simple terms, all deficits over the years add to become the total debt.

5.7.1 Debt to GDP Ratio

Debt-to-GDP ratio is the **ratio** between a **country's debt and its gross domestic product**. It is an indicator on how capable a country is in paying its debts. It gives a clear picture how much a debt a country owes and how much it produces to pay off its debts. The higher the debt-to-GDP ratio, the less likely the country will pay back its debt and the higher its risk of default. A low debt-to-GDP ratio is a measure of a healthy economy that produces and sells goods and services without accumulating future debts.

Central government's debt remained stable at around 45% of the Gross Domestic Product (GDP), although the liability (in monetary terms) has increased substantially over the last decade. However, Debt to GDP ratio have risen sharply in 2020-21 on account of two reasons (a) higher borrowing due to COVID-19 pandemic (b) contraction in GDP.

5.8. FISCAL POLICY

Fiscal policy is the policy of the government related to the level of government purchases, the level of transfers, and the tax structure. It aims to use its three major instruments – taxing, spending and

borrowing – for the development of the economy. The Government of India frames its fiscal policy keeping in mind certain objectives that include:

1. To mobilize adequate resources for financing various programmes and projects adopted for economic development.
2. To achieve an optimum utilization of resources and resource mobilization; To raise the rate of savings and investment for increasing the rate of capital formation.
3. To promote necessary development in the private sector through fiscal incentive.
4. To control the inflationary pressures in economy in order to attain economic stability.
5. To remove poverty and unemployment; to reduce regional disparities; to reduce inequality in the distribution of income and wealth.

Fiscal Stance refers to posture/attitude of the government reflected through its fiscal policy in terms of taxation and spending. Fiscal stance can be expansionary (stimulatory), neutral or consolidatory.

Fiscal neutrality is the situation when the net effect of taxation and public spending is neutral; neither stimulating nor dampening demand. The term can be used to describe the overall stance of fiscal policy; a balanced budget is neutral, as total tax revenue equals total public spending.

Fiscal Stimulus consists of attempts by governments or government agencies to financially stimulate an economy. An economic stimulus is the use of monetary or fiscal policy changes to kickstart growth during a recession. Governments can accomplish this by using tactics such as lowering interest rates, increasing government spending and quantitative easing, to name a few.

Fiscal Consolidation refers to the actions and policies adopted by the Governments (national and state levels) to reduce their deficits and decrease the accumulation of debt. The path adopted for fiscal consolidation in India is enumerated in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003.

5.8.1. Evolution of Fiscal Policy In India

Through the fiscal policy, the government of a country controls the flow of tax revenues and public expenditure to navigate the economy. If the government receives more revenue than it spends, it runs a surplus, while if it spends more than the tax and non-tax receipts, it runs a deficit.

Fiscal policy of the government of India has impacted the economy considerably. The objective of fiscal policy during the 1950s and 1960s was mainly to increase the growth rate of the economy through increasing public investment and overall economic planning. Taxation was used as an instrument for reducing private consumption and for transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Fiscal policy during the 1970s consciously focused on achieving greater equity and social justice and both taxation and expenditure policies were employed towards this end. Accordingly, income tax rates were raised to very high levels. Government's expenditure also widened to cater to the rising subsidies in addition to developmental expenditure.

During the 1980s fiscal deterioration took place and eventually it became unsustainable, though the growth rate did rise significantly with enhancement in public investment in infrastructure. The 1980s witnessed a steady increase in market borrowings along with an increase in Reserve Bank's support to such borrowing. India's balance of payments crisis of 1991 led to economic liberalisation. The reform of the tax system commenced and the fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal responsibility and budget management (FRBM) Act 2003 was instituted.

Problems with High Fiscal Deficit

As discussed before, high fiscal deficit creates inflationary pressure and crowds out private investment. High fiscal deficit, financed through borrowings, imply that the future governments/generations should pay for these interest burdens. It is like taxation of the younger generation. Too much borrowing might decrease the credit ratings of the government bonds (due to risk of default).

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This decrease in ratings makes it more costly for the government to raise new loans (poorer the credit rating the higher the risk and costlier the credit). This puts a burden on interest payments and it may lead to Debt Trap.

However, a very low level of fiscal deficit may not be always desirable. There may be situations, such as the need for increased government spending for post-pandemic recovery, that requires the government to incur higher Fiscal deficit.

5.8.2. Fiscal Responsibility and Budget Management (FRBM) Act 2003

The fiscal consolidation that followed in 1991 failed to give the desired results as there was no statutory obligation to do so. This is why the Fiscal Reforms and Budget Management Act (FRBMA) was enacted on 26 August, 2003 to provide the support of a strong institutional/ statutory mechanism. It aims to make the Central government responsible for ensuring inter-generational equity in fiscal management and long-term macro-economic stability. According to FRBM, the government should **eliminate revenue deficit** and reduce **fiscal deficit to 3%** (medium term) of the GDP.

FRBM Act provides a legal institutional framework for fiscal consolidation. It is now mandatory for the Central government to take measures to reduce fiscal deficit, to eliminate revenue deficit and to generate revenue surplus in the subsequent years. The Act binds not only the present government but also the future Government to adhere to the path of fiscal consolidation. The Government can move away from the path of fiscal consolidation only in case of natural calamity, national security and other exceptional grounds which Central Government may specify (**Escape Clause**).

The Act prohibits borrowing by the government from RBI. Thus, it makes the monetary policy independent of fiscal policy. Also, the Act bans the purchase of primary issues of the Central Government securities by the RBI after 2006, preventing monetization of government deficit. Further, the Act requires the government to lay before the parliament three policy statements in each financial year namely: Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Policy Statement.

To impart fiscal discipline at the state level, the Twelfth Finance Commission gave incentives to states through conditional debt restructuring and interest rate relief for introducing Fiscal Responsibility Legislations (FRLs). All the states have implemented their own FRLs.

5.8.2.1. FRBM Review Committee (N.K Singh Committee)

The government constituted a committee to review FRBM in 2016 under the **chairmanship of N.K Singh.** Some of the recommendations of this committee are as follows:

1. **Debt to GDP ratio** of 60% should be targeted with a 40% limit for the center and 20% limit for the states and it proposed yearly targets to progressively reduce the fiscal and revenue deficits till 2023. (**Debt rule**)
2. It suggested setting up an **Autonomous Fiscal Council,** which will be tasked with monitoring the government's fiscal announcements for any given year.
3. The Committee noted that under the FRBM Act, the government can **deviate** from the targets in case of a national calamity, national security or other exceptional circumstances notified by it, but the deviations should not be more than **0.5%** of GDP in a year. (**Escape Clause**)
4. The Committee recommended that the 15th Finance Commission should be asked to recommend the **debt trajectory for individual states**. This should be based on their track record of fiscal prudence and health.
5. **Borrowings from the RBI:** According to the suggestion of the committee, government must not borrow from the Reserve Bank of India (RBI) except when:
   a. The Union government has to meet a temporary shortfall in receipts.
   b. RBI subscribes to government securities to finance any deviations from the specified targets.

c. RBI purchases government securities from the secondary market.

The Government has accepted (in Union Budget 2018–19) debt rule and escape clause.

5.8.3. Fiscal Consolidation in India

The average combined fiscal deficits, of the Centre and states after 1975, had been above 10 percent of the GDP till 2000–01. More than half of it had been due to huge revenue deficits. It was at the behest of the IMF that India started the politically and socially painful process of fiscal reforms, a step towards fiscal Consolidation.

India began the process of rationalization of the tax structure in the 1990s. The Tax Reforms Committee (TRC) was constituted and it recommended two major reforms on direct taxes — one was the simplification and rationalization of the direct tax structure (**Chelliah Committee, 1992**); the other was to introduce a service tax to widen the tax base.

Since the 1990s, a number of steps has been taken by the government at the Centre in the direction of fiscal consolidation and there has been incessant attempts to do the same at the level of states. Various steps were initiated by the government for cutting down its revenue expenditure. For Example: cutting down the burden of salaries, pensions and the PFs, cutting down the subsidies, etc.

The government increased its revenue receipt by reforming its tax structure. Examples of such tax reforms include simplification and rationalization of income tax and corporate tax, introduction of Cenvat, VAT, Service Tax, GST, etc. The **Ways and Means Advances (WMA)** scheme was announced in 1997 under which the government commits to the RBI about the amount of money it will give as part of its market-borrowing programme, to bring transparency in public expenditure and to put political responsibility on the government. The **Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003,** which puts legal obligation on the government to commit to a roadmap of fiscal consolidation. DTAA has been renegotiated and **tax treaties** has been signed with various countries to minimize tax evasion and avoidance through tax havens. A mechanism to include state governments under the umbrella of fiscal responsibility was advised by the 12th Finance Commission. It allows the state governments to borrow money from the market for their developmental needs without permission from central government, provided they pass their fiscal responsibility acts (FRAs). By March 2016, all states and UTs had implemented their FRAs.

Related Concepts:

Fiscal Drag: Fiscal drag means slow down of economic growth as a result of people moving into higher tax brackets and paying larger a proportion of their income as tax that ultimately reduces the demand in an economy. For example, Mr. A who was earning 2.4 lakhs need not pay tax. But due to inflation, his income also grew and it became 2.8 lakhs. Now, since he has moved to a tax bracket above 2.5 lakhs, he has to pay tax.

This increases the tax revenue for the government without actually increasing the tax rates. But this also increases the tax burden on people which reduces consumer spending. This leads to fall in aggregate demand and can lead to deflation in the economy.

Golden Rule: It is a rule which suggests that over an economic cycle, the government should borrow only to 'invest' and not to finance the 'current expenditure'.

6 CHAPTER Financial Market

6.1. INTRODUCTION

In economics, a **market** refers to a **mechanism** comprising different systems, institutions, individuals, infrastructures and rules that **enables different parties to engage in an exchange**. Exchange can be in the form of barter where goods and services are offered for other goods and services. However, in most markets goods and services are offered in exchange for money.

Financial market is a market where **financial assets are created and traded**. It functions as a transmission mechanism between investors (or lenders) and the borrowers (or users) that facilitates transfer of funds. Creation of financial assets can be in form such as the initial issue of shares and debentures by a firm. Assets traded in the financial market not only include financial instruments like equity shares, bonds debenture etc. but also commodities such as gold, gem stone and other precious metals.

6.1.1. Functions of Financial Market

1. It facilitates **interaction** between buyers and sellers thus, enabling trade and resource mobilization.
2. Financial markets provide a **mechanism for price discovery** to determine the relative value of different items based upon prices at which individuals are willing to buy or sell those items.
3. As financial markets are regulated by regulatory authorities and governed by rules, they provide **security and confidence** while dealing in financial assets.
4. Financial markets enable firms to **raise capital** for building new facilities, replacing machineries and expanding their business through issue of shares, bonds and other types of financial instruments. Financial markets also give different types of investment opportunities to individuals.
5. Financial markets **ensure liquidity** by providing a mechanism for an investor to sell the financial asset.
6. It **facilitates transactions** and **provides information** at a low cost. Financial markets provide valuable information about securities being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have to otherwise spend to try and find each other.

6.1.2. Types of Financial Market: Money Market and Capital Market

Financial markets in India have two segments. One catering to the requirements of **short-term funds, and the other to the requirements of long-term funds**. The short-term financial market is known as the **money market**, while the long-term financial market is known as the **capital market**. The money market fulfills the requirements of funds for the period up to 364 days, while the capital market does the same for the period above 364 days.

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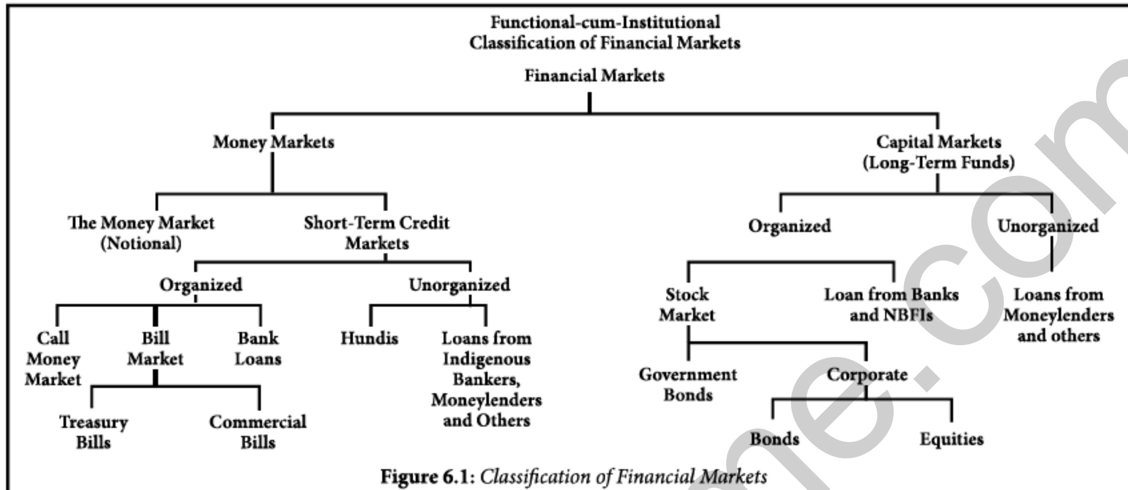

Figure 6.1: *Classification of Financial Markets*

Money Market	Capital Market
Deals in short term financial transactions. (<1year)	Deals with medium and long-term financial transactions.
It is the source of working capital finances for firms.	Finances for expansion of business that promotes capital formation.
Usually more liquid instruments as they are short term.	Less liquidity potential as they are long term instruments.
Examples- certificate of deposits, T-bills, commercial paper, trade bills etc.	Examples- shares, debentures, bonds and government securities etc.
RBI is the regulator of money market in India	Capital market is regulated by the SEBI, RBI and Ministry of Finance
Mainly banks are involved, along with a few NBFCs.	All financial institutions.
Both organized and unorganized sectors operate in the Indian money market.	It is a thoroughly organized sector.

6.2. MONEY MARKET IN INDIA

Money Market is a market for **short-term funds.** It provides an avenue for equalizing the surplus funds of lenders and the requirements of borrowers for short periods (from overnight up to a year). The Indian money market **consists of the Reserve Bank of India, Commercial banks, Cooperative banks and other specialized financial institutions.** It should be noted that the money market does not deal in cash or money as such but simply provides a market for short-term credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are a close substitute for money.

6.2.1. Classifications of Money Market in India

Money market in India has two segments: **Unorganized Money Market and Organized Money Market.**

Unorganized money market refers to **short term financial markets** that are not regulated like organized money markets in India, but are recognized by the government. Unorganized money markets have been present in India since ancient times and even before the development of organized money market. The unorganized money market in India can be further divided into three categories: **Unregulated Non- Bank Financial**

Intermediaries, Indigenous Bankers and Money lendesr.

1. **Unregulated Non- Bank Financial Intermediaries** include instruments like chit funds, nidhi companies and loan companies.

   a. **Chit Fund (fraternity fund)** refers to an agreement arrived at by a group of individuals to invest a certain amount through periodic installments over a specified period of time. The chit fund provides access to savings and borrowings for people with limited access to banking facilities. It is a popular savings institution in India and one of the main parts of the unorganized money market industry.

   Chit funds in India are managed, conducted and regulated according to the **Chit Funds Act of 1982**. Since chit funds are under concurrent list, both, Union and States, have the powers of regulations. Chit funds are the Indian versions of rotating savings and credit associations found across the globe.

   We can understand the functioning of a chit fund through **an example:** Consider a chit fund with 100 subscribers contributing ₹ 100 every month. The monthly pool is ₹ 10,000, and this is auctioned out every month. The winning bid would be the highest discount and this discount would be distributed among the subscribers. Let's say that the winning bid is ₹ 1000. The winning bidder would receive Rs 9,000 (Rs 10,000 – 1,000), while the rest of the subscribers would receive ₹ 10 each (i.e. 1000/100). Winners cannot enter the auction again and will be liable for the monthly subscription as the process is repeated for the duration of the scheme. The company managing the chit fund (foreman) would retain a commission from the prize amount every month.

   b. **Nidhi Company** is a company with the object of cultivating the habit of thrift and saving amongst its members. It receives deposits from and lends to its members only for their mutual benefit. It is a company **registered** under the **Companies Act, 2013** and is **regulated by the Ministry of Corporate Affairs.** Nidhi Company is a class of Non-Banking Financial Company (NBFC) and, so, RBI also has powers to issue directives related to their deposit acceptance activities. However, since these Nidhis deal with their shareholder members only, RBI has exempted them from the core provisions of the RBI Act and other directions applicable to NBFCs.

2. **Indigenous Bankers** are individuals or private firms which receive deposits and give loans and thereby, **operate as banks**.

3. **Money Lenders** are individuals or groups involved in giving **small personal loans at a very high interest rate.** Generally, they give loans from their own wealth. They constitute the most localized form of money market in India and operate in the most exploitative way.

Organized money market refers to a **diverse set of regulated short-term financial market**. Depending upon different categories of businesses and industrial firms, India has **eight different organized money market** instruments: 1. Treasury bill market 2. Cash Management Bill (CMB) 3. Call money market 4. Certificate of Deposit 5. Trade bills 6. Commercial paper market 7. Repurchase Agreement (Repo & Reverse Repo) market 8. Money Market Mutual Fund.

1. Treasury Bill

Treasury Bills are short-term (up to one year) **borrowing instruments of the Government** of India, that enable investors to park their short-term surplus funds while reducing their market risk. It is issued as a **promissory note by the RBI on behalf of the government.**

The T-bills are issued at a price less than their face value (discounted) and redeemed at face value. The profit of holding is the discount which an investor gets. No interest is paid on these bonds. **For example,** an investor can buy a ₹100 (91-day) T-bill for a discount of ₹10, i.e., at ₹ 90. At the end of 91 days, the investor will get the face value, i.e., ₹100 and hence a profit of ₹10.

These bills are **secured instruments** as it has **government backing** and hence virtually zero-risk weightage associated with them. There are five types of the T-Bills: (a) 14-day (Intermediate TBs) (b) 14-day (Auctionable TBs) (c) 91-day TBs (d) 182-day TBs (e) 364-day TBs.

Out of the above five variants of the T-Bills, **at present, only the 91-day T-Bills, 182-day T-Bills and the 364-day TBs are issued by the government**. The other two variants were discontinued in 2001. The secondary market of T-Bills is very active and they have a higher degree of tradability and hence, it is a **very liquid instrument.**

2. Cash Management Bills

Cash Management Bills instruments issued **by the government to meet its temporary cash flow mismatches**. They are almost similar to T-bills, with the only difference being CBMs are issued for periods less than 90 days while T-bills are usually issued for more than 90 days. It was introduced by the Government of India in consultation with the RBI in 2010.

3. Call Money Market

Call Money is the **inter-bank funds** market in India. It deals in lending and borrowing by banks among themselves. It deals in very short-term loans that are from **1 to 14 days**. Interest charged on such loans is called the call money rate, which is determined by the market.

Earlier, the operation was localized within an area, **later RBI created a centralized system in Mumbai.**

> **MIBOR** = Mumbai Interbank **Offered Rate** - It is the rate at which lending is offered by the bank that has excess money.
>
> **MIBID** = Mumbai **Interbank Bid Rate** - It is the rate of interest that a bank would be willing to pay to secure a deposit from another bank in the Indian interbank market.

4. Certificate of Deposit

Certificates of Deposit (CDs) are **short-term instruments** issued by **Commercial Banks and Financial Institutions (FIs)**. This instrument is issued in lieu of the funds deposited at a bank for a specified time period. These are similar to savings accounts and are virtually risk-free. Hence, they are freely transferable from one party to another. Their **maturity period** is between **7 days to one year for commercial banks**. **For Financial Institutions,** the maturity is **not less than a year and not more than three years.** The minimum value of issuance is ₹ 1 Lakh and for higher values, it should be in multiples of ₹ 1 lakh.

5. Trade Bill

Trade bill is a short term, **negotiable money market instrument** created from a genuine **commercial transaction**. If traders (buyer) buy some goods on credit, sellers will get the payment after the end of the credit period. But if any seller needs the money immediately, the seller can draw a **bill of exchange** with the buyer. This bill of exchange/trade bill indicates the **amount of money** payable and the **date** on which payment is to be made. This trade bill can now be discounted (encashment of the bill) with the bank before its maturity. On the date of maturity, the bank can directly get the payment from the drawee, i.e., the buyer of goods. When trade bills are accepted by Commercial Banks, it is known as **Commercial Bills**. It is an important source of short-term funds for trade and industry.

6. Commercial Papers

Commercial Paper (CP) is a type of **unsecured** money market instrument issued in the form of a promissory note **issued by a corporate house** for raising short term credit. The issuing corporate houses should be a listed company with a working capital of not less than ₹ 5 crore. Commercial paper can be issued for a **minimum of 7 days and a maximum of up to one year.** It is issued in denominations of ₹ 5 lakh or multiples thereof. For the better safety of investors, all participants require a credit rating from a credit rating agency.

7. Repo/ Reverse Repo

Repo is a **short-term money market** instrument that **enables banks** and other financial institutions to **borrow money from the RBI** by **selling government securities** with a **promise of repurchase** at a predetermined rate and date. In reverse repo, banks and other financial institutions lend money to the RBI for short term by buying government securities with a promise to sell back these securities at a predetermined rate and time. Repo and reverse-repo rate are announced by the

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RBI and they are **monetary policy tools** to control money supply. Reverse-repo allows banks to earn some extra income on their otherwise idle cash and repo enables banks to solve their short-term money requirements.

8. **Money Market Mutual Funds**

Money market mutual funds are **mutual funds that invest** money of its shareholders **in short term, high-quality liquid instruments,** such as treasury bills (T-Bills), repurchase agreements (Repos), commercial papers, and certificates of deposits etc.

6.3. CAPITAL MARKET

Capital market is a market dealing in **long term** (minimum 365 days) financial **instruments including bonds and equities/shares**. Entities that invest in bonds become creditors, while entities that invest in share/equity acquire proportionate ownership. It is an organized market that brings together the parties who demand the funds (industry and business) and those who supply the funds (investors). It is a link between savings surplus sectors (like households) and saving deficit sectors (like industries). Capital market provides **long term investment** without which **creation of productive assets** is not possible. The capital market comprises the **Primary capital market** and the **Secondary capital market**.

6.3.1. Primary Capital Market and Secondary Capital Market

Primary market is a part of the capital market where the securities are created, while the **secondary market** is a part of the capital market where these securities are traded by investors In simple terms, the first buying or selling of a financial instrument happens in the primary market, while the resale or subsequent selling and buying, until maturity, happens in the secondary market.

The **main difference between primary and secondary market** lies in the fact that while the former deals with the securities that the issuer issues for the first time, the latter deals in the existing securities. Unlike **primary market,** which results in **capital formation,** the **secondary market** facilitates only **liquidity and marketability** of outstanding debt and equity instruments.

6.3.2. Primary Market

The fund-raising in the primary market can be classified as follows: **Public Issues, Right Issues, Private Placements, and Preferential Issues.**

1. **Public Issue** is the mode of fundraising where **private corporations offer their shares for the first time to the public** in a new stock issuance. It is known as Initial Public offering **(IPO)**. It allows a company to raise capital from public investors. Companies must meet requirements by stock exchanges and the SEBI to hold an IPO.
2. **Right Issues** is also a popular mode of fund raising by private corporations where a company makes an offer to existing shareholders to buy additional shares in the company at a discounted price (rights offer price) within a prescribed period. **Unlike IPO,** a **rights issue is not offered to the general public,** but only to the existing shareholders in proportion of their existing holdings. The eligible shareholders can either subscribe to the rights issue partly or fully; or can let the offer lapse by not opting to exercise their rights to purchase the additional shares; or can transfer their rights entitlements to other persons.
3. **Preferential Issues** is an issue of shares or convertible securities by listed or unlisted companies to a select group of investors. A person holding preferential shares has the **right to be paid from company assets before common stockholders** if the company goes into bankruptcy. They usually do not have voting rights, and are rewarded only by dividends.
4. **Private Placement** is a mode of raising funds by **sale** of securities to a **relatively small number of select investors.** Investors invited to participate in private placement programs include wealthy individual investors, banks and other financial institutions, mutual funds, insurance companies, and pension funds.

6.3.3. Secondary Market

Secondary market is that part of the capital market where **previously issued financial instruments are sold and bought**. It is a market for outstanding securities i.e., securities already issued and purchased by investors. There are **three types** of instruments in the Secondary capital market.

1. **Pure instruments**: These include shares, bonds, and debentures. They do **not share features** of one another.
2. **Hybrid instruments**: They have a **combination of features of pure instruments,** for example: a combination of bond & equity.
3. **Derivatives:** These instruments have no value of their own but **derive their value** from one or more underlying financial assets. Some examples of derivatives include futures and options.

6.4. EQUITY AND SHARES

Shares are the **smallest unit into which total share capital** of a company is **divided**. Share capital is the part of the capital of a company that comes from the issue of shares. Entities that own the shares of a corporation are called its **shareholders Stocks** may be understood as a collection of shares, although both stocks and shares are used interchangeably. **Equity** is a measure of ownership of an asset and represents the money value of the asset after all the debts attached with the asset have been paid off. Shares are easily tradable but equity can not be easily traded. For dilution of ownership, a portion of equity is first converted into shares and then shares are traded.

Let us understand this with an example, Mr. A has a company with total assets of 100 cr. and liability of 20 cr. This means Mr. A has 100% equity of his company and the value of total equity is 80 cr. Mr. A wants to expand his business for which he needs 40 crores. For this, Mr. A has decided to issue 1 crore shares each worth 40 ₹ to raise 40 crores from the market. This implies that Mr. A will be left with 50% equity representing ₹ 40 crores. Mr. B has bought 50 lakhs shares that were issued by Mr. A by paying 20 crores. With this, Mr. B has acquired 50% of the issued shares that represent 25% equity in the business. (Although it appears that Mr. A has lost money, equity held by Mr. A becomes more valuable as the company expands and its valuation increases.)

Shares are of two types i.e., **equity shares and preferential shares. Equity shares** are also known as ordinary share. Through these shares, the company raises capital for its business. **Ownership rights** are given to the shareholder proportional to the amount of shareholding. Equity shareholders also have **voting rights.** Dividends to equity shareholders depend on the profit and company policy. They are a higher risk instrument since returns are directly linked to the company's profit and share price.

Shareholders of **preference shares** are given preference over equity shareholders. They **receive dividends first** i.e. before equity shareholders When a company is liquidated, its assets are sold and shareholders are paid. In this case, also, preference shareholders are paid first. They have **no voting rights** in a company. However, they have ownership in the company but they cannot be part of its management. Preference shares offer fixed dividends so they are not traded in a stock market. Profits are not decided as per-share price. The share price of a company can go up and down, but the **return to preference shareholders is pre-decided and fixed**. Hence, they are a lesser risk and fixed return type of instrument.

6.5. BONDS

Bond is a **long-term debt instrument** in which an investor (public) lends money to an entity (corporate, government). The entity borrows the funds for a defined period of time at a variable or fixed interest rate. A bond is less risky than a share as it is a fixed interest rate instrument. For example: If a company has issued bonds, then it is liable to pay back (as per predetermined arrangement of interest) no matter the value of its share price. As less risk is associated with bonds, profits are also less (as compared to shares). Bonds are used by companies (corporate bonds), municipalities, states, and sovereign governments to raise money to finance a variety of projects and activities.

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Government securities are also a type of bond. These are known as **treasury bills** when issued for a short period (less than 1 year) and are called **bonds** when issued for more than one year. These instruments also have a fixed rate of interest. In India, the central government issues both, treasury bills and bonds or dated securities while the state governments issue only bonds or dated securities, which are called the **State Development Loans** (SDLs). G-Secs carry practically no risk of default and, hence, are called **risk-free gilt-edged instruments**.

Investors **buy bonds at face value** (the price of a bond) or a principal amount that is returned at the end of a fixed period. **Borrowers give interest payments** to bondholders at a fixed rate or at a variable rate.

Bearer bond is a type of bond that is **unregistered** i.e., it is not registered on any name and **whoever bears/holds the bond is accepted as its owner**. Coupons of interests are linked with the security and not the registered owner.

Bonds usually fall into two categories: **Secured and unsecured bonds**. **Secured bonds** are backed by an underlying asset and in case the company defaults i.e., fails to repay the principal and interest at the end of maturity of a bond, then bondholders can stake a claim to the underlying assets. **Unsecured bonds** are not backed by any underlying asset (also known as debentures).

Related Terms:

1. **Face value:** It is the money value representing the worth of bond at maturity.
2. **Coupon rate:** It is the interest rate paid on a bond by the issuer.
3. **Tenure:** Time period after which a bond matures.

6.5.1. Bond Yield

Bond yield is the **rate of returns realized** on a bond. Bond yield doesn't include the principal amount. The rate of return is not fixed — it changes with the price of the bond.

Suppose a buyer **'A'** buys a bond of ₹ 30 @10% yearly rate of interest from the government. It means that the government will be liable to pay an interest of ₹ 3 (yearly) to the borrower. Bond yield, in this case, is 10%. Now 'A' wants to sell the bond. The selling of bonds would take place in a secondary market that has many sellers and buyers of the bonds.

When sellers are more in number. It means that bonds are in large supply. If there are many sellers of bonds in the secondary market as compared to the buyers, buyers here will be the king. **'A'** will have to sell his bond at a lower price than the price for which he purchased it (because there are other sellers who want to sell their bonds). Let us assume that 'A' sells it at ₹ 20 to a buyer.

We should remember that this buyer shall continue to get the interest of ₹ 3 as promised initially by the government because interest is calculated on the face value of the bond (₹ 30 in this case). This means that the buyer will get an interest of ₹ 3 on a bond worth ₹ 20 while 'A' was getting the same interest on his investment of ₹ 30.

Here, the buyer will gain because he is getting an interest of 15% (as ₹ 3 is 15% of ₹ 20 while it was 10% of ₹ 30). In this case, **the bond price went down** (from ₹ 30 to ₹ 20) while **bond yield increased** (from 10% to 15%). When bond yield increases, demand for bonds also increases. So, an **increased demand will propel the bond prices up** thereby leading to a **reduction in bond yield,** which will further lead to reduction in demand. The opposite happens when the sellers are less and buyers are more. Here, the bond prices rise and bond yield goes down.

6.5.2. Impact of a Declining Bond Yield

Consider a scenario where the world is suffering from a recession and the global economy is reeling under a low growth rate. In such circumstances, an **investor** would prefer to invest his money in a **safe avenue** which safeguards his investment rather than looking for high return investment options. So, the investor would invest in **government securities**. This would lead to an increased demand for g-secs in the market. When the demand for G-sec increases, its price goes up. Upward trend in bond prices leads to lower yield. So, a **fall in bond yield,** amongst many other things, can also indicate **slowdown in the economy.**

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A decline in yield can be **good for the equity markets** because money starts flowing out of debt investments into equity investments. As bond yields go down, the equity markets tend to perform better, and as bond yields go up, equity markets tend to falter.

A declining bond yield also **reduces risk of bankruptcy**. When bond yields go up, it is a signal that corporations will have to pay a higher interest cost on debt. As debt servicing costs go higher, the risk of bankruptcy and default also increases. This typically makes mid-cap and highly leveraged companies vulnerable.

6.5.3. Major Factors Impacting Bond Yield

1. Interest rate in an economy and bond prices have an inverse relationship. When interest rate falls, investors seek to invest in instruments that provide higher returns. Since bonds have fixed interest rate, fall of interest rate does not affect them. Hence, bonds become more attractive, their price increases and yield decreases. Opposite happens in case of an increase in interest rate.
2. If inflation is rising or is expected to rise, investors would want higher returns to beat inflation. This decreases the attractiveness of bonds as they offer relatively low fixed interest rates. Thus, demand for bonds decreases causing yields to rise and bond prices to fall. Also, as inflation rises, central banks tend to raise interest rates to control inflation. Thus, as explained in the above point, bond prices would fall.
3. If the government wants to borrow more, then it will have to issue more bonds, leading to an excess of bonds in the bond market which will decrease the bond prices and bond yield will go up.

Zero Coupon bonds

Zero coupon bonds are bonds that have **no periodic interest payment** and they are **sold at a huge discount** to the face value. On maturity, the bond holder receives payment equivalent to the face value of the bond.

6.6. DEBENTURES

Debenture is a financial instrument used by **private companies** to raise **long term capital via debt**. Debentures are not backed by any specific security i.e., they are **unsecured**. People generally buy debentures because of the reputation and trust in the debenture issuing company. Many investors prefer debentures since they offer **higher rate of interest** than bonds. The holders of debentures do not get shareholding. **Convertible debentures** can be **converted into shares of equity stock** after a specified period

6.7. DERIVATIVES

Derivative is a financial instrument which **derives its value/price from the underlying assets**. It is a contract between two parties and this contract derives its value/price from an underlying asset. The most common types of derivatives are futures, options, forwards and swaps.

Futures/Future Contract is a legally **binding** agreement to **buy or sell** a particular commodity asset or security on a **future date at a predetermined price**. Generally, the underlying asset in futures are commodities like grains, oil, etc. Futures contracts are traded on exchange while forward contracts are traded directly between seller & buyer. Hence, forward is also called an Over-the-Counter (OTC) transaction. Future contracts cannot be customized as per the needs of the parties involved while forwards can be customized.

Options contract is a type of derivatives contract that **gives the buyer/holder of the contract the right (but not the obligation)** to buy/sell the underlying asset at a predetermined price within or at the end of a specified period. Options are also traded on the stock exchange. SEBI regulates the derivatives market in India.

6.8. STOCK EXCHANGE

Stock Exchange is an **institution** that provides a **platform** for **buying and selling of existing securities**. As a market, the stock exchange facilitates the exchange of a security (share,

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debentures, etc.). It helps companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies. There are two major stock exchanges in India: **Bombay Stock Exchange (BSE)** and **National Stock Exchange (NSE)**.

6.8.1. Stock Market Index

The stock market index is a **barometer/indicator of market behavior**. Performance of companies listed on a stock exchange is measured via a stock market index. It indicates day-to-day fluctuations in stock prices. The function of a stock index is to provide investors with information regarding the average share price in the market.

There are around **5000 companies listed on BSE while NSE has around 1600**. It's impossible to measure the performance of every company listed on an exchange. Hence, the concept of an index is employed wherein performance of select few top performing companies is tracked. **Index is based on market capitalization (m-cap) of only a few selected companies.**

Market capitalization is the aggregate valuation of the company based on its current share price and the total number of outstanding stocks. It is calculated by multiplying the current market price of the company's share with the total outstanding shares of the company.

Example: If a company has issued 10 Crore shares with a value of Rs 10 per share, then its market capitalization = 100 Crore.

M-cap of a company= Share price x Number of issued shares

Shares are traded in the secondary market so, share price fluctuates daily. If the value of shares of a company is increasing then it means business is expanding and the company is witnessing growth. Therefore, an index reflects the performance of the underlying companies and of the overall economy.

However, sometimes index can also be dictated by market sentiment. For example: People might start buying shares of a company based on some rumor or political event. This can lead to artificial increase in the share price of a company due to increased demand. Increased share price will reflect an increased m-cap and an increased m-cap will result in a higher value of Sensex/Nifty.

6.8.2. Major Indices in India

There are two major indices in India: **BSE Sensex and NSE Nifty**. The **BSE Sensex** (Sensitive + Index) was launched in 1986. It comprises **30 companies** and its base year is 1978–79. The major criterion for selection in the Sensex is large market capitalization. The index constituents have been revised by the BSE 20 times between 1986 and 2009. The Reliance Industries Ltd (RIL) has the highest weightage of 12.91% in index market capitalisation. **NSE** began equity trading in November 1994, and its volumes surpassed that of the BSE in a very short span of time. **NSE Nifty** index comprises of 50 companies.

Besides these two indices, the other popular indices are the (a) Economic Times Ordinary Share Price Index, (b) Financial Express Ordinary Price Index (c) the RBI Index of Security Prices. The other major indices are the OTCEI index, the CMIE (Centre for Monitoring Indian Economy) index, the CRISIL CNX indices (mid-cap 200, PSE index, IT index and MNC index) and the Business Line (all India) Index. There are also regional stock exchanges. Major regional stock exchanges such as Kolkata, Chennai, Delhi and Ahmedabad have their own indices.

6.9. FEW TERMS RELATED TO FINANCIAL MARKET

6.9.1. Foreign Institutional Investors (FIIs)

FIIs are any **institutional investors** which invest in the **assets belonging to a different country** other than that where these organizations are based. The SEBI (Foreign Institutional Investors) Regulations, 1995, define foreign institutional investor as an institution **established or incorporated outside India**, which proposes to make investment in India in securities. They are eligible to purchase shares and convertible debentures issued by Indian companies under the **Portfolio Investment Scheme (PIS).**

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An FII has restrictions on instruments it can invest:

Can Invest	Cannot Invest
Securities in the primary and secondary markets including shares, bonds, debentures etc. Companies, unlisted, listed or to be listed on a recognized stock exchange in India Dated Government Securities Derivatives traded on a recognized stock exchange Commercial paper Units of schemes floated by domestic mutual funds including Unit Trust of India Security Receipts (SRs) issued by ARCs registered with the Reserve Bank of India.	Company which is engaged or proposes to engage in the following activities: Business of chit fund, or Nidhi Company, or Agricultural or plantation activities or Real estate business, or construction of farm houses excluding development of townships, construction of residential/commercial premises, roads or bridges or Trading in Transferable Development Rights (TDRs).

FIIs are considered as both a trigger and a catalyst for market performance as they encourage investment from all classes of investors, that further leads to growth in financial market trends under a self-organized system.

6.9.2. Participatory Notes (P-notes)

P-notes are instruments that **allow an overseas investor** to **invest** in Indian stock markets **without registering** themselves with SEBI. These are overseas derivative instruments issued by SEBI - registered FII to foreign investors for trading in the Indian stock market. These derivative instruments derive value from underlying securities such as equity and equity-linked instruments. These notes are generally issued by associates of India-based foreign brokerage houses. Morgan Stanley, Credit Lyonnais, Citigroup and Goldman Sachs are the biggest issuers of participatory notes.

6.9.3. Angel Investors

An angel investor is a **wealthy individual** who invests in a small startup company in exchange for ownership equity in the company. Generally, angel investors invest during the **beginning phase** of a startup, investment is made on the potential of a start-up idea and they take only advisory role. Angel investors operate **independently**.

6.9.4. Venture Capital Fund

Venture Capital Fund is made up of **investments from wealthy individuals or companies** who give their money to a **Venture Capital firm** to manage their investment portfolios and to invest in high-risk start-ups in exchange for equity. Generally, Venture capital funds invest at a **relatively later stage** (when start-up idea has been proven) and invest a **larger amount** when compared to an angel investor in exchange for larger equity. VC firms usually demand **some level of operational control** and gain power to influence major decisions of the company they have invested in.

6.9.5. Insider Trading

When a key **employee** having access to **strategic information** about the company uses it for **trading in the company's stock**, it is called insider trading. It is highly discouraged by the Securities and Exchange Board of India as it goes against the principle of fair trading. Here, the other stockholders are at a great disadvantage due to lack of important insider non-public information. It should be noted that not every kind of insider trading is illegal.

6.9.6. Sweat Equity

Sweat equity refers to a **non-monetary contribution** of individuals or founders (in form of labor, time etc.) toward a **business venture** or other project. Sweat equity is rewarded through **sweat equity shares** that are issued by a company to its employees or directors at a discount. It's an investment device that companies use as an incentive to retain their best talent. **Section 79A of the Companies Act** lays down conditions for the issue of sweat equity shares.

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The sweat equity shares of a listed company should be issued in accordance with the regulations made by the Securities and Exchange Board of India (SEBI). In the case of unlisted companies, sweat equity shares cannot be issued before one year of commencement of operations.

6.9.7. Floating Rate Bonds

Floating rate bonds are bonds that have a **variable rate of interest**. The rate of interest of a floating rate bond is linked to a benchmark rate and is reset at a regular interval. It is different from regular bonds as regular bonds have fixed interest rates. It has been introduced to take care of the falling market or to provide a cushion in times of falling interest rates in the economy. In India, the State Bank of India (SBI) was the first to introduce bonds with floating rates for retail investors.

6.9.8. Masala Bonds

Masala Bonds are bonds issued in **Indian currency outside India by Indian entities** to raise funds from foreign investors. The name 'masala' was given by the International Finance Corporation (IFC) to simulate the appeal of culture and cuisine of India on the international platform. The first Masala bond was issued in 2014 by IFC for the infrastructure project. Investors from outside of India, who would like to invest in Indian assets, can invest in masala bonds.

6.9.9. Mutual Funds

Mutual Fund is a **fund created by pooling in** money from a large number of investors to **invest in the share market** (stocks, bonds, money market instruments, and other assets). It is managed by professionally qualified persons with experience in investing in different asset classes. Each mutual fund is run by a group of qualified people who form a company, called an asset management company (AMC), and the operations of the AMC are under the guidance of another group of people, called trustees. Generally, mutual funds provide higher return, but they are subject to market risks.

6.9.10. Hedge Fund

Hedge funds are also **pooled funds** that are used for **investment in a diverse set of instruments** such as buying and selling equities, initiating arbitrage, and trading bonds, currencies, convertible securities, commodities and derivative products. Hedge funds are **professionally managed**. Hedge funds are **more risky** instruments and provide a higher rate of return on investment (compared with mutual funds).

Features	Mutual funds	Hedge Funds
Investors	General public	Only large corpus investors
Risk management	Low degree of risk management	High degree of risk management
Mentality	Investor mentality (buy and hold)	Trading mentality (opportunistic)
Sensitivity	Low sensitivity to price entry and exit point.	High sensitivity to price entry and exit point
Taxation	Tax saving options available	Heavy taxation

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7 CHAPTER Money Supply

7.1. INTRODUCTION

Money is a **medium of exchange**. It is **widely accepted** as a means of payment. It comes in three forms: **commodity money** (backed by inherent value, like gold), **fiat money** (token money, backed by authority), and **fiduciary money** (backed by trust between parties like cheque). Most modern monetary systems are based on fiat money.

Before money was invented, exchange took place via Barter. Commodities and services were directly exchanged for other commodities and services. Goods like furs, skins, salt, rice, wheat, utensils, weapons, etc. were commonly used as money. Such exchange of one commodity for another commodity is known as **"Barter Exchange"** or "Barter System".

After the barter system, the **metallic standard** came into practice. Under it, some kind of metal such as gold or silver was used to determine the standard value of the money and currency. The face value of such currency, usually coins, was equal to their intrinsic metal value.

After the metallic standard, the **paper currency** standard has come into practice. Under this system, paper currency notes issued by the Central Bank circulate as "unlimited legal tender". A more recent type of money is plastic money. **Plastic money** can come in many different forms such as Cash cards, Credit cards, Debit cards, Pre-paid Cash cards, etc.

In a modern economy, money consists mainly of currency notes and coins issued by the monetary authority of the country. In India, currency notes are issued by the Reserve Bank of India (RBI) on behalf of the government of India and coins are issued by the Government of India. The overall quantity of money in existence consists of a currency component and a deposit money component. Currency components are paper currency notes and coins. The former have little or no intrinsic value of their own. All paper currency notes in circulation in India consist of notes issued by the RBI. **Coins are metallic money.** The right of minting coins is the monopoly of the government. Both the paper currency notes and coins are today called token money. Token money is the money whose face value is more than the intrinsic value of the material it is made of.

Every currency note bears on its face a promise from the Governor of RBI that if someone produces the note to RBI, or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. In fact, the notes carry the legend: 'I promise to pay the bearer the sum of xyz (e.g., ten) rupees', counter-signed by the Governor of RBI, except for the one-rupee note which has the signature of the Finance Secretary to the Government of India. The enforcement of the legal value of currency is not just true for paper currency notes, but is also applicable for coins. Hence, coins and currency notes are termed as **fiat money,** issued by the order of government. They cannot be refused by any citizen of the country for settlement of any kind of transaction and hence are also known as **legal tender**.

Apart from currency notes and coins, the balance in savings, or current account deposits, held by the public in commercial banks is also considered as money. It forms the **deposit money** component of the money supply. Deposit Money

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has two components: time deposit and demand deposit. Demand deposits are called so as they are payable by the bank on demand from the account-holder. Other deposits like fixed deposits that have a fixed period of maturity are referred to as time deposits.

7.2. MONEY SUPPLY IN INDIA

Money supply can be defined as the total value of money available in an economy at a point in time. In other words, it is the total stock of money that is held by the public at a particular time. Here the public means households, companies, firms, local authorities etc. This money need not necessarily just be consumed or saved alone. It can be invested, saved or even borrowed. This transaction in money will make sure that the real effect of money is actually more than what is printed. This is known as **the money multiplier** effect (refer section 7.7)

7.2.1. The Velocity of Money

It is a measurement of the average rate at which money is exchanged in an economy during a given time period. For example, if ₹10 is printed, the ₹10 currency will move from A to B if A buys something from B. Similarly, the same ₹10 will move to many more people if according the number of transactions are more and the real use of ₹10 will be higher in a highly active economy. The greater the number of monetary transactions, the greater is the velocity of money.

Velocity of Money = GDP / Money Supply

Velocity of Money usually rises with the GDP. It also affects inflation. Different countries usually have different values of velocity of money, which reflects relative development of their economy. For example, the velocity of money in USA is 2.6, while in India it is 1.3. Economies that exhibit a higher velocity of money tend to be more developed. Velocity of money also varies with the business cycle.

7.2.2. Currency in Circulation

It is the total measure of the currency that has been printed and distributed by the Reserve Bank of India, excluding the amount that has been withdrawn by RBI itself like Cash Reserve Ratio (CRR) etc. Currency in circulation comprises of currency notes and coins with the public and cash/deposits with banks and other financial institutions. As all cash issued by RBI has a sovereign guarantee, currency in circulation is the measure of RBI's currency liability. Based on the different levels of liabilities of money, there are different indicators of money stock.

7.2.3. Measures of Money Stock

Reserve Money (M0): It is known as central bank money, monetary base or high-powered money. In the simplest language, M0 is Currency in Circulation plus Deposits of Commercial Banks with RBI. It is the actual amount of money that is printed by the RBI.

M0 = Currency in circulation + Bankers' deposits with the RBI + 'Other' deposits with the RBI

M1: This is the narrow measure of money supply and can be represented as follows:

M1 = C + DD + OD
Where C = Currency held by the public
DD = Demand deposits with Banks
OD = Other deposits with RBI.

This money supply is the **most liquid measure** as the money included in it can be easily used in making payments or any other transactions without the restrictions of instruments like fixed deposits.

M2: M2 is a broader concept of the money supply. In addition to M1, the concept of money supply in M2 includes saving deposits with the post office savings banks. The reason for distinguishing these postal deposit money is that withdrawing these deposits is not as liquid as that of other deposits with the banks.

M2 = M1 + saving deposits with the post office savings bank

M3: M3 is a broader concept than M1. In M3, **time deposits** with the banks are also included. Thus

M3 = M1 + Time Deposits of all commercial and cooperative banks

M4: It is a measure that includes all deposits with the post office, which includes time deposits as well. However, the contributions made by the public to the national saving certificates are excluded from

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M4.

M4 = M3 + Time Deposits with the Post office.

M0 is the base money in the economy. M1 is most liquid and easiest for transactions whereas M4 is least liquid of all. Liquidity is also tied to the ability of banks to lend the said money. **Money broadens when it is lent**. M1 and M2 are known as narrow money and their values are larger than the stock of M0 or Reserve money. M3 and M4 are known as broad money, and have a much higher value than the narrow money. M1+ M3 are known as commercial bank money. It represents obligations which include current accounts and savings accounts. M3 is the most commonly used measure of money supply.

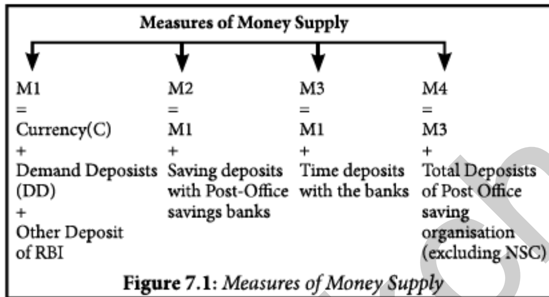

Figure 7.1: *Measures of Money Supply*

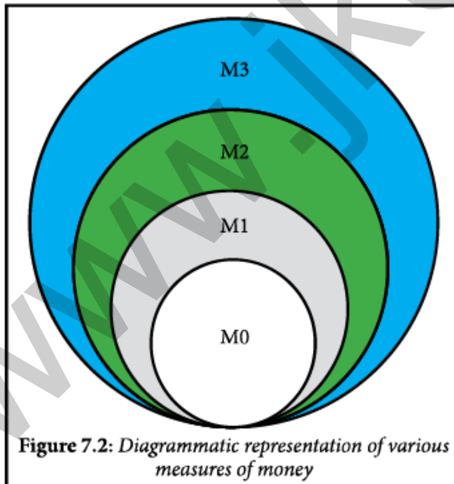

Figure 7.2: *Diagrammatic representation of various measures of money*

7.2.4. Determinants of Money Supply

Money supply changes if the value of any of its components such as Currency, Demand Deposits (DD) or Time Deposits changes. These components change due to the actions of RBI or the commercial banks. Sometimes, the preference of the people to hold hard cash over deposits in the banks affect the money supply and the money multiplier effect.

These influences on money supply can be summarized by the following key ratios:

7.2.4.1. Currency Deposit Ratio

It can be defined as the ratio of money held by the public in cash to that they hold as deposits in banks. It reflects people's preference for liquidity. It can also be seen as a behavioral parameter that depends on the seasonal pattern of spending. For example, CDR increases during the festival seasons as people prefer to have the highest liquidity during these times to meet their spending needs.

CDR = C/D (where C- currency with public and D- deposits with the banks)

7.2.4.2. Reserve Deposit Ratio

People deposit their money in banks. Banks hold a part of these deposits as reserve and can loan out the rest to create profits out of the interest earned on the loan. The Reserve deposit ratio (RDR) is the proportion of the total deposits commercial banks keep as reserves. The reserve consists of vault cash with the banks themselves and deposits of banks with RBI. This reserve is used for meeting the liquidity requirements of the account holders. RBI uses various policy instruments like CRR and SLR to provide a healthy RDR in commercial banks.

RDR = Reserves of bank / Total deposits of banks.

7.2.5. Money Multiplier (MM)

It refers to how a deposit can lead to an increase in the total effect of the money supply. For example, if A deposits 10 lakhs in a bank, the bank will pay interest, that leads to more money. Also, the bank will invest that money and give credit using that. This will cause the effect of money to be more than the actual 10 lakhs. So, in other words MM=M3÷M0 (where M3 is the actual output effect in the economy while M0 is the actual money base). Also, that part of the money which is kept as reserve will not multiply. Hence money multiplier can also be expressed as:

$$\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}$$

7.3. FEW RELATED CONCEPTS

Liquidity- It refers to the ease with which an asset (a resource with inherent or implied value) can be converted into ready cash without affecting its value. In simple terms, liquidity means how quickly you can get your hands on the cash value of an asset which you are holding. It depends on the term of the instrument, the number of buyers, etc. For example, gold has more buyers than land and hence gold is more liquid than land.

Hot Money- The term hot money is used to describe money which quickly moves from one country to another in search of speculative gains. There is an inflow of hot money in an economy if the interest rates in the economy are higher than the rest of the world. But such movements of funds are very volatile and they quickly leave the economy if better returns become available in other countries. Such investors scan the market for short-term, high interest rate investment opportunities. A typical short-term investment opportunity that often attracts 'hot money' is the certificate of deposit. These flows lead to volatile stock markets and large fluctuations in exchange rates of the currency. Inflow of hot money appreciates the exchange rate or increases the value of the currency. On the other hand, outflow of funds depreciates the exchange rate. Hot money flows are very volatile and can cause instability in the economy of the recipient countries, such as inflationary pressures due to sudden flow of capital.

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8 CHAPTER External Sector

8.1. INTRODUCTION

External sector deals with a country's **financial interactions with other nations** via. exports, imports and capital flows. It also covers the dealings with the **global financial and trading institutions**. These channels of trade and capital flow accelerate the economic growth of a country. Economic features related to the external sector include - foreign trade policy, balance of payment, convertibility of currency, foreign exchange rate, government's schemes to promote exports and foreign Investment, etc.

8.2. FOREIGN TRADE

Foreign trade refers to **exchange of goods and services across international borders**. Foreign trade **contributes to economic development** in a number of ways. In the modern world, no country can be self-sufficient in all aspects, thus, foreign trade becomes inevitable. Foreign trade allows for imports of capital goods, without which no process of development can start. It generates pressure for dynamic changes in the economy through (a) competitive pressure from imports, (b) opportunity to compete in export markets and (c) a better allocation of resources. Also, increased openness to trade has been strongly associated with the reduction of poverty in most developing countries.

Foreign Trade Policy (also referred to as **"EXIM Policy"**) is a set of guidelines and instructions that govern the import and export of goods in India. Indian EXIM Policy is a series of policy decisions made by the government in the field of foreign trade, primarily with regard to imports and exports, including export promotion initiatives, policies, and programmes. The Foreign Trade Policy is updated every year on the 31st of March and the modifications, improvements and new schemes become effective from the month of April, each year.

The **Foreign Trade Policy for the period 2015-20** was announced on 1st April 2015 by the Commerce Ministry, Government of India. Later it was extended by 2 years up to March 2022 in the wake of COVID-19 pandemic. Some of the salient features were:

1. **Doubling India's exports** to $900 billion by 2020
2. Incentive for exports and SEZ to continue
3. Imports to be rationalized
4. Foreign trade policy to be aligned with Make in India, Digital India and Skills India initiatives.

FTP 2015-20 introduced two new schemes '**Merchandise Exports from India Scheme** (MEIS) for export of specified goods to specified markets and '**Services Exports from India Scheme** (SEIS)' for increasing exports of notified services. MEIS provided incentives of 2-5%, while SEIS provided 3%-5% incentives on the net foreign exchange earned by exporters located in India. MEIS was pronounced to be violative of WTO's rules on subsidy by its Dispute Settlement Body in 2019. The scheme has been replaced by the **Remission of Duties and Taxes on Exported Products** (RoDTEP) programme from January 2021. RoDTEP reimburses currently un-refunded Central, State, and Local taxes and duties incurred

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in the process of manufacture and distribution of exported products and thereby provides a level playing field to domestic industry abroad. Major components of taxes covered are electricity duty, value-added tax (VAT) on fuels used in transportation/ distribution, mandi tax, stamp duty, etc. **New Foreign Trade Policy 2022-27** came into effect from 1st April 2022 for a period of five years.

8.2.1. Foreign Goods/Merchandise Trade of India

India exports approximately 7500 commodities to about 190 countries, and imports around 6000 commodities from 140 countries. USA continues to be the largest export market for India in April-November, 2021 followed by UAE and China. **Belgium is a new** entrant among the top 10 export destinations, as compared to last year, while **Malaysia** no longer occupies position among the top 10 destinations.

Top 10 Export Destinations in April-November 2021: USA, UAE, China, Bangladesh, Hong Kong, Singapore, Netherland, UK, Belgium, and Germany.

Top 10 Export Commodities in April-November 2021 in decreasing order are: (1) Petroleum Product; (2) Drug Formulations, Biologicals; (3) Pearl, precious, semi-precious stones; (4) Iron and steel; (5) Electric Machinery and Equipment; (6) Organic Chemicals; (7) Marine Products; (8) Products of Iron and Steel; (9) Gold and other precious metal jewelry; (10) Aluminum and products of Aluminum.

> **Note**: Indian pharmaceutical industry is third largest in the world, in terms of volume, behind China and Italy. It is 14th largest in terms of value. **India almost doubled its share in world pharmaceutical** exports in a span of ten years from 1.4 percent in 2010 to 2.6 percent in 2019.

Top five sources of imports in April-November 2021 for India are: China, UAE, USA, Saudi Arabia, Iraq, Switzerland, Hong Kong, Indonesia, Singapore, South Korea.

Top 10 Import Commodities in April-November 2021 in decreasing order are: (1) Crude Petroleum; (2) Petroleum Products; (3) Gold; (4) Coal, Coke and Briquettes etc.; (5) Pearl, Precious, Semi-precious Stones; (6) Electronics Component; (7) Vegetable Oil; (8)Computer Hardware, Peripherals; (9) Organic Chemicals; (10) Plastic raw material.

For the financial year **2021-2022**, despite pandemic induced stress on the economy and disruptions caused by the Ukraine crisis, India achieved **$410 billion worth of goods export** (a historic high).

8.3. BALANCE OF PAYMENTS

Balance of payments is a record of all of the economic **transactions of a country with the rest of the world** over the course of a **year**. It includes transactions in goods, services and assets. It is a statistical record of the country's international economic relationships. There are two main accounts in Balance of Payment: **Current Account** and **Capital Account**.

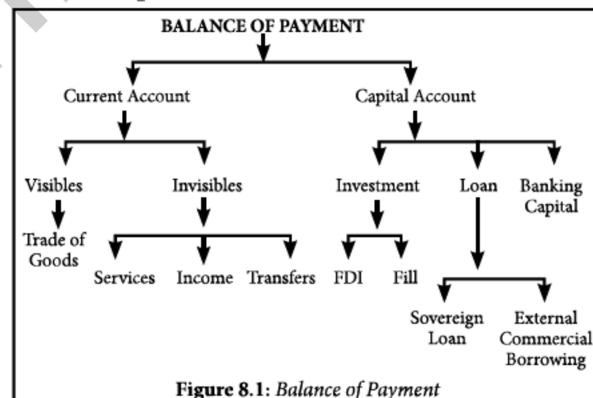

Figure 8.1: *Balance of Payment*

8.3.1. Current Account

Current Account is the **record** of trade in **goods, services and transfer payments** between countries. Trade in services includes factor income and non-factor income transactions. Transfer payments consist of gifts, remittances, and grants. In addition, the current account also includes interest, dividend and profit for servicing of capital transactions.

8.3.1.1. Balance on Current Account

Balance on Current Account has two components: **Balance of Trade (BOT)** and **Balance on Invisibles.**

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Balance of trade (BOT) is the **difference** between the value of **exports** and the value of **imports** of **goods** of a country in a given period of time. It is in balance when exports of goods are equal to the imports of goods. It is in surplus when a country's export is more than its import and it is in deficit when imports are more than exports in a country.

Balance of Invisibles is the difference between the **value of exports and the value of imports of invisibles** of a country in a given period of time. Invisibles include **services, transfers and flows of income** that take place between different countries. Services trade includes factor income i.e. net international earnings on factors of production (like labour, land and capital) and non-factor income i.e. net sale of service products like shipping, banking, tourism, software services, etc.

8.3.2. Capital Account

Capital Account records all **international transactions of assets**. It includes **foreign direct investment (FDI), foreign institutional investment (FII)**, external commercial borrowing (ECBs), trade credit, NRI deposits and other banking liabilities/assets. External assistance (**multilateral and bilateral loans**) also forms part of the capital account. Capital account also include funds held abroad, India's subscription to international institutions, quota payments to IMF etc. It has to be noted that investment in financial instruments like shares in overseas markets is a part of capital account transactions, while dividend/profit earned on such instruments is a part of the current account.

Purchase of assets is a debit item on the capital account. For Example: If an Indian buys a UK Car Company, it enters capital account transactions as a debit item (as foreign exchange is flowing out of India). On the other hand, the sale of assets like the sale of shares of an Indian company to Japanese customers is a credit item on the capital account.

In the capital account, there are two forms of transactions: **private and government**. FDI, FII, ECB etc. are part of private transactions. Government transactions mostly include loans to and from foreign official agencies.

8.3.2.1. Balance on Capital Account

Capital account is in balance when capital inflows are equal to capital outflows. Capital Account is in surplus when capital inflows are greater than capital outflows, whereas deficit in capital account arises when capital inflows are lesser than capital outflows.

8.3.3. Balance of Payments: Balancing Surplus and Deficit

A country that has a deficit in its current account (spending more than it receives from sales to the rest of the world) must finance it by selling assets or by borrowing abroad. Thus, any current account deficit must be financed by a capital account surplus i.e., a net capital inflow.

When a country is said to be in balance of payments equilibrium i.e. (Current Account + Capital Account= 0), the current account deficit is financed entirely by international lending or asset sale without any Forex reserve movements.

Alternatively, the country could use its reserves of foreign exchange to balance any deficit in its balance of payments or it could absorb additional forex to balance any surplus in its balance of payment. It must be noted that ultimately Balance of Payment will always be zero (deficit is financed from forex and surplus is absorbed into forex, thus BOP is always zero)

BOP = Current Account + Capital Account = 0

That is, the demand for foreign exchange is equal to its supply.

Let us understand this with an **example**:

India's Current Account balance in a given year is = -30000$ (USD)

India's Capital Account Balance in a given year is= +40000$(USD)

Error omission by RBI= -100(USD)

Overall balance

NET= -30000+40000 -100= +9900$ (USD)

Here, BoP is positive (surplus), it means that there is net addition of dollars into the forex market. This makes rupee stronger, that ultimately hurts Indian exports. To prevent such an eventuality, RBI intervenes and reduces the supply of dollar by purchasing it (**in this case, surplus value 9900$**) from the market. This will increase the supply of rupee in the market, increase in the Forex Reserve of India and restore the BoP equilibrium (NET BOP= 0).

If BoP is negative (deficit), supply of rupees is more than its demand (i.e., import is more than export). It will eventually make rupee weaker as compared to dollar. Here again, RBI intervenes by supplying dollar from its reserve in the market to achieve BoP equilibrium.

In case of negative BOP, RBI supplies dollar in the market to achieve BOP equilibrium. It indicates decrease in RBI's forex reserve. If RBI does not have sufficient forex reserve to provide for a negative BOP, it results in a **BOP crisis**. One and the only such incident in India occurred in **1991**, when India met with an **economic crisis** relating to its external debt and Indian **government came close to defaulting** on its own financial obligations. India's **forex reserve depleted** to a level that it could barely finance three weeks' worth of imports. The crisis was further compounded by rising prices of essential goods. The crisis compelled India to take an emergency loan from the IMF by pledging 67 tons of India's gold reserves. The loaned amount was also tied to conditions of reforms that triggered the **New Economic Policy (NEP)** of 1991. Some of the reforms that India undertook were devaluation of rupee by 22 percent, reduction of custom duty to a maximum of 30% from the erstwhile level of 130 % for all goods, increase in excise duty by 20% to neutralize the loss of revenue due to custom cut, etc. The government initiated a variety of policies that fall under three heads viz., **liberalization, privatization and globalization.** In recent years, the robust capital flows have helped India build a strong forex reserve of over US $ 600 billion, which is sufficient to provide import cover of over 12 month (January 2022).

8.3.4. The Official Settlements Account

The Official Settlements Account tracks the **change in a country's** liquid and non-liquid **liabilities** to international official holders, as well as the change in **official reserve assets** over the course of a year. A country's official reserve assets include its gold stock, convertible foreign currency and SDR holdings, and its net position in the IMF.

8.3.5. Overall BOP of India

India, being a developing and emerging market economy, generally runs a deficit on the current account (not always; for example, Q1 and Q2 2020-21 has current account surplus). The foreign investments supplement the domestic savings for capital investment.

Balance of Payment must be distinguished from the Balance of Trade. The balance of trade is a statement that summarizes a country's export

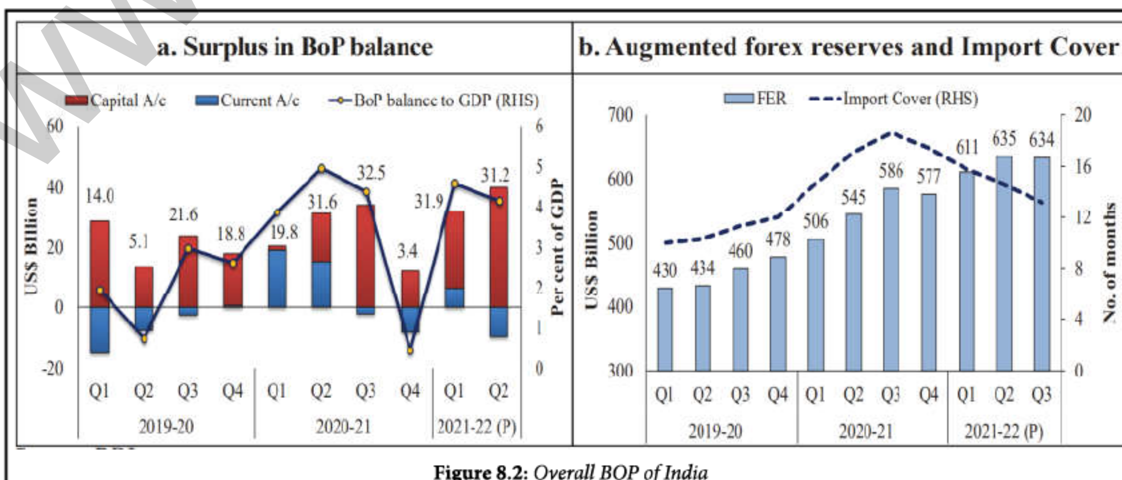

Figure 8.2: *Overall BOP of India*

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and import of **goods** with the rest of the world. On the other hand, BOP is a statement of record consisting of **all economic transactions** of a country with the rest of the world. Thus, while BOT records only transactions related to goods, BOP covers transactions related to both goods and services, giving a clearer view of the economic position of the country. Moreover, BOP includes capital transfers, which BOT does not cover. BOP comprises of current account as well as capital account, but BOT is only a part of current account, not capital account.

8.4. THE FOREIGN EXCHANGE MARKET

The market in which national currencies are traded is known as the foreign exchange market. For example: If an Indian wants to visit the USA, he/she needs American dollars to pay for her/his expenses in USA. He/she has to visit foreign exchange market to obtain dollars at a particular price. The major participants in the foreign exchange market are commercial banks, foreign exchange brokers and other authorized dealers and monetary authorities.

8.4.1. Foreign Exchange Rate

Foreign exchange rate is the rate at which one currency is exchanged for another. The exchange rate is generally defined as the price of one unit of foreign currency in terms of domestic currency. For example, the exchange rate between the rupee and dollar refers to the number of rupees required to purchase one unit of dollar ($1 = ₹77).

In an open market, foreign exchange rate is determined by demand and supply. A country earns foreign currency from exports and uses the earned foreign currency for import. A rise in the price of foreign currency (exchange rate) increases the cost (in terms of rupees) of purchasing a foreign good. This reduces demand for imports and hence, demand for foreign exchange also decreases.

Similarly, a rise in the price of foreign currency reduces the foreigner's cost (in terms of USD) while purchasing products from India (assuming other factors remaining constant). This increases India's exports and hence, supply of foreign currency increases and exchange rate decreases. This way, demand and supply is matched at some exchange rate. (This explanation is based on the assumption of a perfect market where demand and supply are the sole economic forces, prices cannot be manipulated, and the government does not intervene in the market.)

8.4.1.1. Fixed Exchange Rate (or Pegged Exchange Rate)

Under fixed or pegged exchange rates, all exchange rates are determined by the monetary authority. The government or the monetary authority has the power to set the exchange rate by regulation or currency market interventions.

These predetermined rates are prescribed to ensure stability in foreign trade and capital movements. To ensure necessary equilibrium, the government buys foreign currency when the exchange rate declines and sells foreign currency when the rate increases. For this, the government has to maintain large reserves of foreign currencies. In this system, the government can tie the value of the currency to the value of another currency (known as pegging) or it can be fixed in terms of gold or a basket of currencies at parity value or parity price.

8.4.1.2. Flexible/Fluctuating/Floating Exchange Rate

Flexible, floating or fluctuating exchange rate systems are the ones in which the exchange rates are determined by market forces (demand and supply). The monetary authority or the government never intervenes for the purpose of influencing the exchange rate. The US dollar is an example of a floating currency.

8.4.1.3. Merits and Demerits of Flexible and Fixed Exchange Rate Systems

As we know in a fixed exchange rate system, there is intervention of the government or a monetary authority when there is deficit in BOP or for any other purpose (such as currency manipulation). The monetary authority intervenes by use of its official forex reserves. However, if people know that the amount of reserve is inadequate, they would begin to doubt the ability of the government to maintain

the fixed rate which may give rise to speculation of a devaluation of currency. This sometimes leads to aggressive buying of a foreign currency by selling domestic currency, thereby forcing the government to devalue. This is known as a **speculative attack on a currency**. Fixed exchange rates are prone to these kinds of attacks, as has been witnessed in the period before the collapse of the Bretton Woods System.

The flexible exchange rate system gives the government more flexibility and they do not need to maintain large stocks of foreign exchange reserves. The major advantage of flexible exchange rates is that movements in the exchange rate automatically take care of the surpluses and deficits in the BoP.

Bretton Wood System

It was an arrangement that emerged in 1944 that required countries to guarantee convertibility of their currencies into U.S. dollars, with the US dollar convertible to gold bullion for foreign governments and central banks. It simply meant that US would maintain enough gold reserves to back its currency. However, as demand for dollar increased, US could not maintain enough gold reserves to cover its currency. By 1970, the U.S. had seen its gold coverage deteriorate from 55% to 22%.

On 15 August 1971, the United States terminated convertibility of the US dollar to gold, effectively ending the Bretton Woods system and converted the dollar into a fiat currency.

8.4.3. Managed Floating Rate System

Managed Floating Rate is a **hybrid of fixed exchange rate and flexible exchange rate** system. Under this system, the monetary authority or the government **intervenes** in the foreign exchange market only to **smoothen out short-run fluctuations** in the exchange rates. This is done by supplying from or absorbing into the country's foreign exchange reserves. If the short-run demand for foreign exchange in the market is more than its supply, the monetary authority supplies the foreign exchange in the market, thereby moderating depreciation of the currency.

On the other hand, if the short run supply of foreign exchange is more than its demand in the foreign exchange market, it will absorb (purchase) the excess supply, increase its reserves, thereby, moderating appreciations of the country's currency. The policy of managed floating is also called the policy of **leaning against the wind.**

8.4.4. Nominal Effective Exchange Rate (NEER)

The nominal effective exchange rate (NEER) is the **unadjusted weighted average rate** at which one country's currency is exchanged for a basket of foreign currencies. In simple words, it is the exchange rate of one currency against a basket of currencies, weighted by the amount of trade which the country has with the other nations (**not adjusted for inflation**). For example, it is immaterial for India to study just the exchange rate of rupee with dollar. This is because India also trades with Japan in Yen, with China in Renminbi etc. Hence, we need to see the trend of appreciation or depreciation of rupee based on our trade requirements with all the basket of currencies which is given by NEER and REER. The NEER is a metric that calculates a country's international competitiveness in the foreign exchange (forex) market. NEER appreciates as the value of a domestic currency rises against a basket of other currencies in a floating exchange rate system. NEER depreciates when the domestic currency falls against the basket.

8.4.5. Real Effective Exchange Rate (REER)

The weighted average of a country's currency against a basket of other major currencies, **adjusted for inflation**, is known as the Real Effective Exchange Rate (REER). In simple words, **REER is NEER adjusted for Inflation.** This exchange rate is used to determine an individual country's currency value relative to the other major currencies in the index, such as the U.S. dollar, Japanese yen and the euro.

8.4.6. Purchasing Power Parity (PPP)

Purchasing Power Parity is the rate at which one country's currency is converted into another country's currency in order to purchase the same

amount of goods and services in both countries. For example, if ₹100 buys an apple in India and $2 buys an apple in USA, 1$=₹50 in PPP terms. The PPP exchange rates are constructed to ensure that the same quantity of goods and services are priced equivalently across countries. PPP exchange rates are used to convert the national poverty lines in countries across the world to determine the **Global Poverty Line.**

International Comparison Program (ICP)

It is the largest worldwide data-collection initiative, under the guidance of the UN Statistical Commission (UNSC). Under the International Comparison Program (ICP), the World Bank has published new Purchasing Power Parities (PPPs) for reference year 2017, that account for **variations in the cost of living across economies**.

India and ICP

India has participated in almost all ICP rounds since its inception in 1970. In 2017, India maintained and strengthened its status as the world's third largest economy based on PPP. The Purchasing Power Parities of the Indian Rupee per US$ at the GDP level have increased to 20.65 in 2017 from 15.55 in 2011. The **Price Level Index** (PLI), which compares the price levels in different economies by measuring the ratio of PPP to market exchange rate, increased to 47.55 in 2017 from 42.99 in 2011.

8.5. EXCHANGE RATE MANAGEMENT IN INDIA

Since independence, India's exchange rate system has evolved from a par value system (gold backed) till 1971, to pegged value system between 1971-1993 and finally to the current **market-determined exchange rate regime in 1993**. In 1971, Indian rupee was pegged to the US dollar and to the UK pound sterling. From 1975 to 1992, Indian rupee was delinked from pound sterling and pegged to a basket of currencies of India's major trading partners. During this period, RBI determined the exchange rate within a nominal band of +/- 5% of weighted basket of currencies.

8.5.1. Liberalized Exchange Rate Management System (LERMs)

LERMS was announced in 1992-93 budget. Under LERMS, rupee became **partly convertible** and a **dual exchange rate** was developed. Dual exchange rate meant that **40 percent of foreign exchange earnings** of exporters were to be **surrendered at the official rate** and the remaining **60 percent were to be converted at a market-determined rate**. The foreign exchange surrendered at the official rate was used for import of essential items, such as crude oil, fertilizers, lifesaving drug etc., while remaining foreign exchange converted at market rate was used for other imports. As official exchange rate was lower than market exchange rate, it effectively taxed the exports for bulk imports of the government. This mechanism made sure that there was no sudden instability in the external sector of India.

8.5.2. Market-Based Exchange Rate Regime (1993- till present)

Before introducing market-based exchange rate, LERMS was introduced as a transitional mechanism to provide stability during the crisis period. Once stability was achieved, India moved from the LERMS system to a full-fledged market-determined exchange rate system. As a consequence, the dual exchange rate (60:40 ratio) was eliminated, **system of floating exchange rate was adopted**, and exchange rate has been dictated by the market since 1993. However, RBI intervenes by buying or selling foreign currency to ensure stability of exchange rate, cushion 'economic shocks', curb speculations and manipulation in the forex market, and preserve adequate forex reserves. This system is also known as **managed floating exchange rate or dirty float** (as opposed to free float or clean float).

8.6. CONVERTIBILITY OF CURRENCY

Convertibility of currency represents the **ease with which domestic currency can be converted into foreign currency** or vice versa at prevailing market price. Currency convertibility is extremely important for international commerce. When a currency is inconvertible, it poses a barrier to trade with foreigners who have no need for the domestic currency.

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Changes in Exchange Rates	
Determined by Authorities (Government or Central Bank)	**Market determined**
Devaluation of currency Under a **fixed exchange rate regime**, devaluation is the **official reduction** in the value of a country's currency. In simple terms, it's the process by which the monetary authority formally reduces the exchange rate with respect to other currencies. Few effects of devaluation are cheaper exports, costly imports, aggregate demand increase and Improvement in the current account.	**Depreciation of Currency** Depreciation of a currency occurs by forces of demand and supply in a country having a **floating exchange rate system**. The loss in value of a country's currency in comparison to one or more international reference currencies is known as currency depreciation. In depreciation, the purchasing power of currency falls as compared to another country's currency.
Even though in both **depreciation** as well as **devaluation**, the value of currency is lowered, devaluation is very different from depreciation. Devaluation is done at time to time by the government or the monetary authority established by the government, while depreciation happens due to market forces on a continuous basis. Devaluation is an aspect of a fixed exchange rate system and depreciation concerns a floating exchange rate system.	
Revaluation of Currency A revaluation is a measured increase in a country's official exchange rate compared to a predetermined baseline. Wage rates, gold prices, or the value of a foreign currency may all be used as a baseline. Such decisions for increasing the value of the currency are usually taken by the government in a **fixed exchange rate system**. Devaluation is a type of revaluation of currency through a downward adjustment.	**Appreciation of Currency** A rise in the value of one currency in comparison to another is known as currency appreciation. Currency appreciation happens in a **floating exchange rate system**. Appreciation of currency leads to rise in export cost and decline in import cost.

Currency Manipulation/ Currency War

Currency manipulation happens when governments try to artificially tweak the exchange rate to gain an 'unfair' advantage in trade. It occurs when countries deliberately influence the exchange rates by lowering the value of its currency to gain cost competitiveness in international trade. For example, USA **declared China as a currency manipulator** when it allowed the Yuan to suddenly depreciate relative to the dollar.

Why do Countries Manipulate Currency?

When the currency's value is less, it makes **exports cheaper** because value to exported goods comes down in dollar terms (or any other foreign currency). So, if a country is mainly an exporter, it can artificially lower the exchange rates so that the exports of the country can get a boost. This can cause trade and economic losses to other countries.

Key Terms

Hard Currency

Hard currency is the **money issued by a nation** that is seen as politically and economically **stable**. It is often associated with developed countries. Hard currencies are widely held as foreign exchange reserves by central banks. International investors place their faith in hard currencies because they do not depreciate or appreciate drastically. For example-US Dollar, Euro, etc.

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Soft Currency

Soft currency is an **unconvertible** currency that **fluctuates erratically** and/or depreciates against other currencies. It is the opposite of hard currency. It is also known as **weak currency** due to its unstable nature. It suffers from high volatility in exchange rates that makes them undesirable as holdings by foreign exchange dealers. Venezuelan bolivar is an example of a soft currency which saw large devaluation due to reasons like political instability and inflation.

Heated Currency

The term 'heated currency' is used to denote the **domestic currency which is under pressure** (heat) of **depreciation** due to exit of hard currency from the economy. It is also known as currency under heat or under hammering.

Cheap Currency

Cheap currency or cheap money is **money that can be borrowed with a very low interest rate.** When a government starts repurchasing its bonds before their maturity, at full maturity prices, the money which flows in the economy is known as 'cheap currency'. It leads to an increase in money supply and loans are provided at **cheaper rates,** thus, promoting investments and growth of the country's economy. Cheap money is good for borrowers, but bad for investors, due to prevalence of low interest rates on investments like savings accounts, money market funds, bonds etc. Cheap money can potentially also have detrimental economic consequences as borrowers take on excessive leverage that they may not be able to pay back.

Dear Currency

When government issues bonds, the money flows from the public (or economy in general) to the government, leading to reduced liquidity in the market. This is called dear currency or dear money. In the banking sector, it means a period of comparatively higher/costlier interest rates regime. It is the opposite of cheap currency.

8.6.1. Convertibility of the Rupee

On the basis of component of balance of payment, convertibility of rupee has two segments. First convertibility of rupee on current account and convertibility of rupee on capital account.

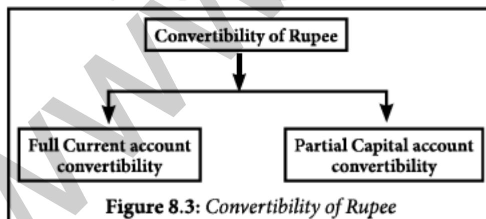

Figure 8.3: *Convertibility of Rupee*

8.6.1.1. Current Account Convertibility of Rupee

Current Account Convertibility refers to the freedom to convert rupees into a foreign currency and vice versa without facing any restrictions for transactions related to current account i.e., exports and imports of goods and services, factor income and unilateral transfers. India has **full convertibility of rupee on current account**. It means all current account transactions in India with all other countries, with regard to trade in merchandise, or service such as education, travel, medical expenses etc. and 'invisibles' such as remittances are met through full convertibility of the rupee into other foreign currencies. The rupee can be used to buy another currency and other currencies can buy Indian rupee without limit. Full current account convertibility of rupee was adopted by RBI in August 1994.

8.6.1.2. Capital Account Convertibility of Rupee

Capital account convertibility refers to the simplicity and freedom to convert domestic currency into some other foreign currency (such as the US dollar, pound, sterling, or Euro) and vice versa for transactions related to capital account i.e., net change in foreign assets and liabilities held by a country. After the recommendation of **S S Tarapore committee** (1997) on capital account convertibility, India is moving in the direction of allowing full capital account convertibility. But at

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present, India has **partial convertibility of rupee on capital account** subject to various limits and restrictions.

Some of the **recent moves** taken by India towards increasing capital account convertibility are (a) increasing the foreign portfolio investment limits in the Indian debt market (b) introducing the Fully Accessible Route (FAR) — through which non-residents can invest in specified government securities without any restrictions (c) the easing of the external commercial borrowing framework by relaxing end-user restrictions. Inward FDI is allowed in most sectors, and outbound FDI by Indian incorporated entities is allowed as a multiple of their net worth.

There are various **reasons** for partial capital account convertibility in India. Firstly, India's domestic banking systems are not so well developed and an exodus of domestic savings to foreign countries is feared in case of full convertibility. Secondly, short-term capital flows can also see quick reversals thereby, adversely affecting the macroeconomic situation of the country including unemployment and inflation. Thirdly, controls on capital account convertibility allow for directing the flows towards more stable forms of capital inflows, as seen with FDIs, rather than 'hot money' flows of FPIs which tend not to stay in one market very long.

8.7. CURRENT ACCOUNT DEFICIT

When the value of **imports** (goods, services, and investment income) **exceeds** the value of **exports**, a current account deficit occurs. A **deficit on current account** means that the nation is a **net-borrower** from other countries. Balance of trade (BOT) is one of the components of balance of current account and if a country imports more goods than what it exports, deficit BOT or trade deficit arises.

The current account is the trade balance plus the net amount received for domestically-owned factors of production used abroad. BOT and current account deficit should not be confused with one another. To illustrate the difference, consider the situation when an Indian owns an apartment building in London. The rent owner receives from the apartment is part of the current account but not part of the trade balance. On the other hand, if the import bill of petroleum increases due to a rise in crude oil price, the trade deficit of India will widen which, in turn, will increase the Current Account Deficit also.

8.7.1. Factors that Cause Current Account Deficit

When a country's spending exceeds what it receives from the rest of the world, it leads to an **outflow of foreign exchange** (low Forex reserves) and **weakens** its **exchange rate**. Weakening of exchange rate makes the imports costlier, leads to high inflation, provokes outflow of investments, etc. Inflation also has other side-effects as people stop saving, lowering the capital formation for investment and growth. A country with rising CAD shows that it has **poor macroeconomic credentials** and investors become less enthusiastic about their willingness to invest there. They may even withdraw their investments. Current Account Deficit may help a debtor nation in the short-term, but it may be a cause of long-term worry as investors begin raising concerns over inadequate returns on their investments.

Reasons for a country having CAD are many. First, if the **currency is overvalued**, imports would be cheaper, resulting in a higher volume of imports. Secondly, if a **country's export sector becomes uncompetitive** with respect to other competitive countries, then export earnings will decline. This will lead to a deficit in the balance of trade. Thirdly, a nation with a low savings rate and a **high consumption expenditure** may have a greater current account deficit. This is due to the fact that consumption will become a larger portion of national income. Products may be imported to meet the majority of consumer demand, but without savings and investments, exports may become costly. Further, if a country's main trading partners experience negative economic growth, then they will buy less of that country's exports, worsening the country's current account. For the Current Account Deficit in India, crude oil and gold imports are the primary reasons behind high CAD.

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Forex Reserve at the end of September - 2021				
FCA	GOLD	SDR	RTP	TOTAL
$ 573.59 B	$ 37.38 B	$ 19.30 B	$5.07 B	$ 635.36 Billions

8.8. FOREIGN EXCHANGE RESERVES

Foreign Exchange Reserves are assets denominated in a foreign currency that are maintained as reserves by a central bank. IMF defines foreign exchange reserves as external assets that are readily available to and controlled by monetary authorities for direct financing of external payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes.

Foreign exchange reserves may include foreign currencies, bonds, treasury bills, gold reserves and other government securities. In 2020, India's forex reserves crossed the $500-billion mark for the first time in history due to higher foreign direct investment, foreign institutional investment. Low oil prices also helped reduce outflows. India's foreign exchange reserves to GDP ratio is around 20%. In January 2022, India's Forex reserves stood at 630 billion USD, the fifth largest forex reserve in the world. China, Japan, Switzerland and Russia are the top-4 countries as per their forex holdings.

8.8.1. Components of Foreign Exchange Reserves in India

The Foreign exchange reserves of India consists of four categories of assets which are: **Gold, Special Drawing Rights (SDRs) of IMF, Foreign Currency Assets (FCA), and Reserve Tranche Position (RTP) with IMF**. Largest portion of the forex reserve is in the form of Foreign Currency Assets, followed by gold.

The Foreign Currency Assets (FCA) comprise multi-currency assets that are held in multi-asset portfolios (bonds, T-bills, government securities and other instruments). As at end-September 2021, out of the total FCA of USD 573.60 billion, USD 383.74 billion was invested in securities, USD 147.86 billion was deposited with other central banks and the BIS and the balance USD 42.00 billion comprised deposits with commercial banks overseas

At end-September 2021, the Reserve Bank held 743.84 metric tonnes of gold. While 451.54 metric tonnes of gold was held overseas in safe custody with the Bank of England and the Bank for International Settlements (BIS), 292.30 tonnes of gold was held domestically. In value terms (USD), the share of gold in the total foreign exchange reserves increased marginally from about 5.87 percent as at end-March 2021 to about 5.88 percent as at end-September 2021.

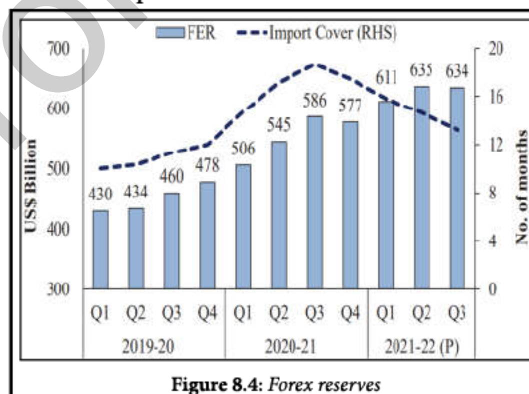

Figure 8.4: *Forex reserves*

8.8.2. Significance of Forex Reserves

Firstly, forex reserve ensures that RBI has backup funds if their national currency rapidly devalues or becomes altogether insolvent. **Secondly**, the cushion of forex reserves give comfort to the government and the RBI in managing India's external and internal financial issues at a time of major contraction in economic growth as seen during covid-pandemic, protecting against threat of a Balance of Payment (BoP) crisis. **Thirdly**, forex reserves help the government in meeting its foreign exchange needs and external debt obligations. **Fourthly**, forex reserves provide a level of **confidence to markets** and investors that a country can meet its external obligations. **Fifthly**, it helps in **attracting foreign trade** and earns a good reputation among trading partners. The rise in reserves have helped the rupee to strengthen against the dollar.

8.9. TRADE AGREEMENTS

A trade agreement (also known as a trade pact) is a wide-ranging tariff and trade agreement that often includes investment guarantees. It happens when two or more countries reach an agreement on terms that promote trade between them.

8.9.1. Various types of Trade Agreement

1. **Based on Number of Countries**

   1.1. **Bilateral** – It's a trade agreement between two countries or entities. For example, preferential trade agreement between India and MERCOSUR or Comprehensive Economic Partnership Agreement between India and UAE.

   1.2. **Multilateral**- It refers to trade agreements between more than two countries or entities, such as Regional Comprehensive Economic Partnership (RCEP).

2. **Based on Degree of Integration**

   2.1. Preferential trade agreement (PTA)

   It is a trade bloc that gives participating countries preferential access to some goods. Usually, a **positive list** is maintained i.e., a list of goods and services that enjoy reduced tariff between the trading countries. This is accomplished by lowering tariffs on select goods rather than fully eliminating tariffs for all products. A trade agreement may be used to create a PTA. It's the first step in the process of economic integration. For example, the **Asia-Pacific Preferential Trade Agreement** or APTA which was signed in 1975 as **the Bangkok Agreement** and is the only trade agreement between India and China.

   2.2. Free Trade Agreement (FTA)

   It is a trade bloc whose members have agreed to abolish tariffs, import quotas, and preferential treatment on the vast majority (if not all) of goods and services traded between them. It is usually associated with a **negative list of items** which are not included rather than a positive list as in PTA. It has less trade barriers than PTA. Examples include the **India-ASEAN FTA**

   2.3. Custom Union (CU)

   An agreement among countries to allow free trade between them and to create common external barriers to any other country interested in exporting to them. **Gulf Cooperation Council (GCC), East African Community (EAC)** are some examples of Custom Unions.

   2.4. Common Market

   A type of custom union where there are common policies on product regulation and free movement of goods and services, capital and labour also. For example, the **Southern Common Market,** also known as the **MERCOSUR**.

   2.5. Economic Union

   It is a type of trade bloc which is composed of a **common market with a customs union**. The participating countries share product control, freedom of movement of products, services, and development factors (capital and labour), as well as an external trade policy. The **European Union** is a prominent example of an economic union.

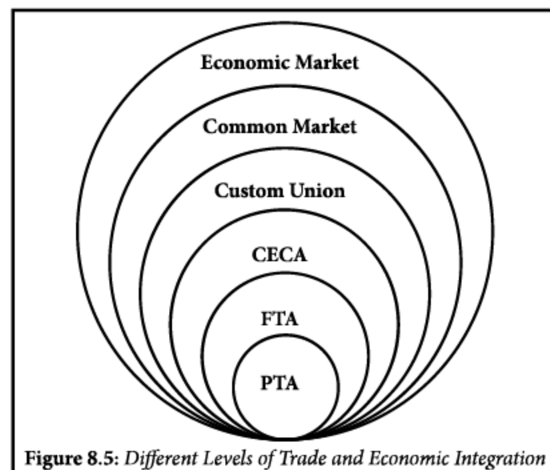

Figure 8.5: *Different Levels of Trade and Economic Integration*

   2.6. Economic and Monetary Union

   If an economic union also has aspects of currency integration (in addition to economic union), it is referred to as an

economic and monetary union. That means these countries or the major group of countries within the bloc have the same currency and are controlled by similar monetary policies. For example, the **Euro zone** within the EU.

8.10. FOREIGN INVESTMENT IN INDIA

Any investment made in India with **funds coming from outside the country** is referred to as a foreign investment. Foreign Investment includes investments made by foreign companies, foreign nationals, and non-resident Indians.

Types of Foreign Investment

I. Foreign Direct Investment (FDI)

II. Foreign Portfolio Investment (FPI)

8.10.1. Foreign Direct Investment (FDI)

FDI is an investment under which an investor establishes or acquires a business entity in a foreign country along with management rights (ownership + management). IMF defines FDI as "an investment through which investors acquire lasting and substantial management control of at least 10% of equity or voting rights in foreign affiliates". FDI is sought after investment because it brings **long lasting capital**, new innovative business models and world-class **management strategies**, and makes Indian companies globally competitive.

Foreign direct investments are distinguished from portfolio investments in which an investor merely purchases shares of foreign-based companies. foreign investorsapproval**Government**

The FDI applications are approved by the concerned Ministries/Departments in consultation with the **Department for Promotion of Industry and Internal Trade** (DPIIT), Ministry of Commerce. DPIIT also issues the Standard Operating Procedure (SOP) for the processing of applications and decisions of the government under the current FDI policy. **Foreign Investment Facilitation Portal** (FIFP) is the online single point interface of the Government of India with investors to facilitate FDI. It is administered by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry.

The government has taken many initiatives in recent years for FDI promotion, such as relaxing FDI norms across sectors such as defense, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others. For example, 100% FDI has been allowed for the marketplace model of e-commerce. However, 0% FDI is allowed for inventory-based models in e-commerce. In 2019, the Central Government amended FDI Policy 2017, to permit 100% FDI under automatic route in coal mining activities. **Production-Linked Incentive Scheme (PLI)** for large-scale electronics manufacturing has been notified for attracting foreign investment.

100% Automatic Route' category are Agriculture & Animal Husbandry, Air-Transport Services (non-scheduled and other services under civil aviation sector), Automobiles, Biotechnology (Greenfield), Broadcast Content Services (Up-linking & down-linking of TV channels, Broadcasting Carriage Services, Asset Reconstruction Companies, Tourism & Hospitality, White Label ATM Operations, E-commerce Activities, Petroleum & Natural gas, Pharmaceuticals, etc.

Sectors where FDI is prohibited: Lottery Business including Government/ Private lottery, online lotteries etc.; Chit Funds; Trading in Transferable Development Rights (TDR); Manufacturing of Cigars, cheroots, cigarillos, and cigarettes (tobacco or tobacco substitutes); Gambling and betting including casinos; Nidhi Company; Real Estate Business or Construction of Farm Houses; Sectors not open to private sector investments – atomic energy, railway operations (other than permitted activities under the consolidated FDI Policy)

8.10.1.1. Components of FDI

FDI has 3 components: **equity capital, reinvested earnings and intra-company loans**. **Equity capital** is the foreign direct investor's purchase of shares of an enterprise in a country other than its own. **Reinvested earnings** comprise the direct investors' share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted

to the direct investor. Such retained profits by affiliates are reinvested. **Intra-company loans or intra-company debt** transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

8.10.1.2. New Changes in FDI Policy in 2020

Government made important changes to its FDI policy in 2020 through what is known as **'Press Note 3'** which sought to curb "opportunistic takeovers/acquisitions of Indian companies". As per the changes introduced, non-resident entities may invest in India, subject to the FDI Policy, except in prohibited sectors and activities. **An individual/ entity of a country that shares a land border with India can only invest via the government route**.

A Pakistani citizen or an organization incorporated in Pakistan may invest in sectors/ activities other than defense, space, atomic energy, and sectors/activities prohibited to foreign investment only through the government route.

Government approval is also needed for a transfer of ownership in an FDI deal that benefits any country that shares a border with India.

These steps were directed to counter increasing investment from China and fear of **opportunistic and hostile takeovers** amidst shortage of capital flows during Covid-19 pandemic. The Press Note 3 expanded the list of countries whose investors are no longer eligible to invest in India under the automatic route. Thus, an investment in India – that would otherwise fall under the automatic route – now falls under the government route if it is from an entity whose **"beneficial owner"** is from such bordering country.

8.10.2. Foreign Portfolio Investment (FPI)

Foreign Portfolio investment (FPI) refers to **investments** made by foreign entities in **financial instruments** like shares, bonds, securities etc. available on an exchange in another country. FPIs acquire ownership (through purchase of shares) without acquiring management interests. FPIs are an important source of foreign capital in any developing country. However, the main motive of FPIs is to make quick profit (not long-term investment) and hence, they are less preferred than FDIs. In India, Foreign Portfolio Investors are subject to certain limits, such as total equity that can be held by a single FPI, total FPI investment in any listed company etc.

India does not allow foreign portfolio investment from individual foreign investors. Only institutional investors, such as hedge funds, insurance companies, pension funds, mutual funds etc., can invest in India. So Foreign Portfolio Investment is allowed from only Foreign Institutional Investors.

8.10.3. Differences between FDI and FPI

FDI	FPI
1. Investment in productive assets: capital investment in machines, technology etc.	1. Investment in financial assets: bonds, shares etc.
2. Ownership+ management rights.	2. Only ownership rights.
3. Long term investment	3. Mostly short-term investment (may be long term)
4. Involved in management and decision making	4. Not involved in management or decision making
5. More desirable	5. Less desirable
6. In India, investment greater than 10%	6. In India, investment less than 10%

The important markers of distinctions between FDI and FII start from the very definitions of the terms. While FDI refers to investments made by foreign investors in order to acquire a significant stake in a company based in another country, FII refers to an international institutional investment in the passive holdings of a foreign company, i.e., investment in a financial asset. FDIs have a higher degree of control over assets and underlying operations than FII. FDI tends to be long-term investments, while FII can be very ephemeral and are known to cause instabilities and volatilities in financial markets. Control over investment flows is much greater for FDI due to stricter capital account convertibility norms. Lastly, while FII brings along

financial capital, FDI comes with funds, technology and other resources along with capital inflow.

8.11. BILATERAL INVESTMENT TREATY (BIT)

Bilateral Investment Treaty is an agreement establishing the **terms and conditions for private investment** by individuals and companies of one country in another country. BIT seeks to increase the clarity for investors and also gives details of the available protections in order to facilitate better informed investment choices by the investors. It establishes an **international arbitration process** for the resolution of disputes. It protects investments against arbitrary decisions and hecklings from the government and its agencies.

However, it is also claimed by experts that BITs function to mostly shield international investors while ignoring the environmental responsibilities and regulations as well as labor rights, social protection measures, and natural resource protection. BITs can also be a source of protracted legislations and disputes between governments and MNCs. For example, lawsuits against state laws such as anti-tobacco legislation, nuclear power regulations, environmental regulations, and other public-interest initiatives try to lobby for corporate interests.

8.11.1. India and BIT

India signed its first BIT with the United Kingdom in 1994. Since then, India has signed 86 bilateral treaties, the most recent of which was signed with Brazil in 2020. BITs have been one of the most important drivers of FDI into India. Since adoption of Model BIT 2016, **India has unilaterally terminated 66-odd BITs** between 2016 to 2019. Since 2016, India has signed just three treaties. India made this announcement in the wake of a surge in lawsuits from foreign investors demanding billions of dollars in compensation for the government's violations of international treaties. India has been dragged to various International Arbitration systems.

8.11.2. Model BIT 2016

India framed a Model BIT in 2016. It aims to act as a **base for negotiating new BITs** with other States, as well as for re-negotiation of the existing ones.

1. The Model defines an investment as an "enterprise". Earlier, 'asset based definition' of investment included intellectual property and other assets, whereas these assets are not considered as assets under the new definition.
2. Adopting an enterprise-based strategy has the goal of narrowing the scope of insured investments and reducing the state's possible liability under investor-state dispute settlement (ISDS) claims. The asset-based concept treats all types of assets, both movable and immovable, as investments that are protected by treaties, despite their minor contribution to national economic growth.
3. It also eliminates the previously included Most Favored Nation (MFN) status for the investments.
4. It also mandates the exhaustion of all Indian courts before going to international mechanisms.

8.11.3. Criticism of Model BIT

By severely restricting substantive and procedural safeguards for foreign investments, the new model BIT tilts the balance in favor of the host state's regulatory power. This is problematic in terms of protecting foreign investment in India and Indian investments abroad. The most favored nation (MFN) provision is absent in the model BIT which is a pillar of non-discrimination in international economic relations.

8.12. TRADE BARRIERS

Government-imposed limits on foreign trade are known as trade barriers. Economists believe that trade barriers are harmful to the economy and reduce overall productivity of the economy. Competitive protectionism is thought to be among the reasons for a rising wave of de-globalization. Trade, jobs, innovations and research are likely to decrease in the deglobalized world.

8.12.1. Types of Trade Barriers

Trade barriers are **government introduced** impediments that **hinder free international**

trade. Trade barriers are raised in order to protect domestic industries, offset the impact of subsidies and other incentives in exporting countries or as a retaliatory action. It can be through tariff or non-tariff barriers.

8.12.1.1. Tariff Barriers

A trade barrier between certain countries that takes the form of unusually **high taxes** imposed by a government on imports or, on rare occasions, exports for the purposes of to discourage imports from/export to a particular country. The underlying reason behind tariff barriers can be economic (protect domestic industry or achieve BOP etc.) or non-economic (political or defence reasons). The barrier is due to incremental costs involved in the trade. For Example: Former US President Donald Trump announced a 25% tariff on imported steel, and aluminum & other commodities from China, India and other nations in 2018. China retaliated by hiking tariffs on imported American soybean & other food products, chemicals, medical equipment & vehicles. India retaliated by hiking tariffs on imported American agriculture commodities like apples and almonds.

8.12.1.2. Non-Tariff Barriers

A non-tariff barrier is a means of limiting trade that does **not require the use of tariffs**. Major types of non-Tariff trade barriers are: licenses, quotas, trade embargoes, sanctions, Sanitary and Phytosanitary (SPS) barriers, local content requirement.

Licenses may be used by countries to restrict the import of products to particular businesses. For example, only when a company receives a trade license, it would be allowed to import certain products. **Quotas** for importing and exporting products and services are often imposed by countries. For example, a country may issue that only 10% of coal should be imported from a country X. This restricts the exports of the county X.

When a nation –or a group of countries– officially bans the exchange of specific goods and services with another country, it is known as a **trade embargo**. Governments may take this measure to support their specific political or economic goals. **Economic sanctions** are imposed on other countries in order to restrict their trade operation. Increased administrative actions –or additional customs and trade procedures– that slow or restrict a country's ability to trade are examples of sanctions.

Sanitary and Phytosanitary (SPS) measures can also be used to create trade barriers. The Agreement on the Application of Sanitary and Phytosanitary Measures (the **"SPS Agreement"**) entered into force with the establishment of the World Trade Organization on January 1, 1995. It sets out the **basic rules for food safety, and animal and plant health standards**. These precautions are taken to protect human, animal or plant life or health. It also seeks to avoid or **restrict harm caused** by the entry, establishment, and spread of **pests from another country**. But these measures can be misused to restrict trade in certain products in the name of poor quality and SPS.

A **local content requirement** policy specifies that a certain level of economic activity associated with the manufacturing of a product must be done in the country where the product is to be marketed. For example, if a company wishes to get a contract from the government, it could be required to ensure that at least a portion of the product is manufactured or procured locally. But such practices can be trade-restrictive. The Domestic content Requirement under Jawaharlal Nehru National Solar Mission (JNNSM) was challenged in WTO on these grounds, as the scheme was about utilizing the domestically manufactured solar modules and cells for solar projects in India setup under JNNSM.

8.13. GOVERNMENT POLICIES TO PROMOTE EXPORTS

Export promotion measures are **public policy** measures by the government of a country to enhance exports from the country. A good example of export promotion in India is the development of SEZ (Special Economic Zones). Export gives a very large market for exporters while also encouraging exporters and manufacturing units to adopt new technologies and manufacture better products more efficiently in order to remain globally competitive. Over the years, India has taken several initiatives for export promotion ranging from **assisting exporters** by providing incentives, easing the process of

certification, licensing etc., improving the logistic sector, to signing free trade agreements for easier access to exported goods in foreign markets. Some of these important initiatives include:

8.13.1. Special Economic Zone (SEZs)

India was one of the first countries in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports, with Asia's first EPZ set up in Kandla in 1965. But the over years, the effectiveness of SEZs in promoting exports has been questioned. The SEZs Policy was announced in April 2000 with the aim of making SEZs an engine for economic development, backed by high-quality infrastructure and a competitive fiscal package at both the federal and state levels, with a single-window clearance process. Subsequently, legal backing was given to SEZs through the **Special Economic Zones Act, 2005**.

8.13.1.1. Features of SEZ

1. It is a specifically delineated **duty-free enclave**.
2. An SEZ is **deemed to be foreign territory** for the purposes of trade operations and duties and tariffs in India.
3. SEZ units are considered to be outside of India's customs territory by law. Hence, Goods and services imported into SEZs from India's domestic tariff area (DTA) are treated as exports, while goods and services made from SEZ to DTA are treated as imports.
4. A SEZ does not require an import license and it also has full freedom for subcontracting.
5. 100% Income **tax exemption** is on export income for SEZ units under the Income Tax Act for the first 5 years.
6. In the manufacturing sector, barring a few segments 100% FDI is allowed.

8.13.1.2. Challenges in Special Economic Zones (SEZs)

SEZs cause potential revenue losses because of the various tax exemptions and incentives. Many traders are interested in SEZ so that they can acquire land at cheap rates and create a speculative market in land and real estate instead of promoting industrial production. There is loss of agricultural land. Lastly, there is no clear exit mechanism for the SEZs developers.

8.13.2. Other Schemes/Initiatives

1. **Export Oriented Units (EOUs):** The Export Oriented Units (EOUs) scheme was introduced in early 1981. The main aim of EOU was to boost exports by creating additional production capacity. EOUs are mainly concentrated in textiles and yarn, food processing, gems & jewelry, computer software, electronics, chemicals, plastics and minerals. Since, it was not very successful so, was replaced by SEZ models.
2. **Single window for custom clearance**: Custom clearances are provided online through a single window to the exporters and importers. It has reduced the clearance time and promoted ease of doing business.
3. **E-filing and e- payment:** Applications for various trade services can be filed online and application fees can be paid through online transfer. To align with the international benchmark, the number of mandatory documents required for the export and import have been cut down to just three.
4. **Niryat Bandhu scheme:** It is a training programme aimed at skill India to boost the export sectors. It helps in achieving international quality standards required for the products.
5. **Services exports from India scheme (SEIS)**: The scheme provides rewards in the form of duty credit scripts to the exporters of the services on their net foreign exchange earnings. These scripts are transferable and can also be used to pay certain central duties and taxes.

8.13.3. Schemes Highlighted by Economic Survey 2021-2022

Economic Survey 2021-2022 has also highlighted various schemes and initiatives taken by the Government to boost exports and to reduce the adverse impact of COVID-19. Some of these schemes are as under:

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1. **Remission of Duties and Taxes on Exported Products (RoDTEP)**: Based on the globally accepted principle that taxes and duties should not be exported, a WTO compliant RoDTEP scheme was launched to replace Merchandise Exports from India Scheme (MEIS). RoDTEP reimburses currently un-refunded Central, State, and Local taxes and duties incurred in the process of manufacture and distribution of exported products. Major components of taxes covered are electricity duty, value-added tax (VAT) on fuels used in transportation/ distribution, mandi tax, stamp duty, etc.
2. **Developing District as Export Hub**: Under this initiative, the focus is to make districts active stakeholders in the promotion of exports of goods/services produced/ manufactured in the district. District Export Promotion Committees (DEPCs) have been set up in each district. Products with export potential (including agricultural, geographical indication (GI) & toy clusters) have been identified in all 739 districts across the country. This scheme would help in diversifying the portfolio of export commodities.
3. **Production-Linked Incentive (PLI) scheme:** PLI scheme extends an incentive of 4% to 6% on incremental sales (over base year) of goods manufactured in India and covered under target segments, to eligible companies, for a period of five (5) years. An outlay of `1.97 lakh crore (US$ 26 billion) was announced in Union Budget 2021-22 for Production-Linked Incentive (PLI) scheme for 14 key sectors. Automobiles and auto components, pharmaceutical drugs, telecom & networking products, electronic/ technology products, etc. are some of the sectors covered under the PLI scheme.
4. **Electronic Platform for Preferential Certificate of Origin (CoO):** In view of the COVID-19 crisis, on-boarding of FTAs/ preferential trade agreements (PTAs) was quickly done to allow electronic issuance to avoid physical movement.
5. **Infusion of capital in EXIM Bank:** Government of India infused capital of `750 crore in Export-Import Bank of India (EXIM Bank) during the financial year 2021-22.
6. **Export Credit Guarantee Corporation of India Ltd. (ECGC)** provides insurance cover to banks against risks in export credit lending to the exporter borrowers. Government has approved capital infusion of `4,400 crore to ECGC Ltd. over a period of five years, i.e. from 2021-2022 to 2025-2026.
7. **Export Promotion Capital Goods (EPCG) Scheme** allows exporters to import capital goods (except certain specified items under the scheme) for pre-production, production and post-production at zero custom duty. In order to increase procurement of capital goods from indigenous manufacturers under the EPCG scheme, the government has reduced specific export obligations from 90 percent to 75 percent of the normal export obligation.
8. The export promotion schemes such as **Trade Infrastructure for Export Scheme (TIES), Market Access Initiatives (MAI), Special Economic Zone (SEZ) scheme, Emergency Credit Line Guarantee Scheme (ECLGS) and Advance Authorization Scheme** continue to provide support to trade infrastructure and marketing.

8.14. MISCELLANEOUS

8.14.1. ECB (External Commercial Borrowings)

The term "ECB" refers to any **money borrowed from a foreign source** to fund commercial activities in a country. In India, the central government allows Indian corporations to use ECBs as a source of financing for both expanding existing capability and making new investments.

ECB includes the following: commercial bank loans, buyers' credit and suppliers' credit from foreign countries, securitized instruments such as floating-rate notes and fixed-rate bonds etc., credit

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from multilateral financial institutions such as World Bank, ADB, AFIC, CDC, etc.

One should not confuse between ECB and FDI though. When foreign money is used to finance the equity Capital it is foreign direct investment, while ECB is like a loan. ECBs have the mandate to be paid back creating liability on borrowers, while in FDI the investor bears the risk.

India's outstanding ECBs at the end of September 2020 stood at US$ 163.8 billion. It is predominantly denominated in US$ (77.2 percent) and accessed mainly by non-financial corporations (74.5 percent).

8.14.2. Deglobalization

Deglobalization is the process of reducing interdependence and integration between national economies around the world. It is characterized by decline in economic trade and investment between countries, rising waves of protectionist policies and trade wars.

8.14.2.1. Indicators of Deglobalization

1. Trade

Global trade is sagging as global demand remains poor and many countries have built import barriers. Measured as a percentage of global GDP, trade increased from 30 percent of GDP in 1973 to 60 percent in 2008. However, after the 2008 financial crisis, global trade started a relative decline. At the end of 2020, it had fallen to 52% of the world GDP.

2. International Flow of Capital

International capital flow reached its peak in 2007 and since then it has been declining. After the financial crisis of 2008, International Capital flow has plummeted to just under 2% of global GDP, down from a high of 21% of global GDP in 2007. Pattern of global capital flow has also changed. These changes have exacerbated the risk of adverse impacts of large and volatile capital flows. This risk is particularly high for **emerging market economies** (EMEs), which tend to be more dependent on foreign capital and less resilient to economic shocks.

3. The flow of people

The **flow of people is slowing**, too. Despite the flood of refugees into Europe, net migration from poor to rich countries decreased dramatically in the last few years. The rise of right-wing conservative politics across the western world has had a strong element of opposition to the flow of immigrants as was seen under Donald Trump in the USA or on the issue of Brexit for the UK and Europe.

8.14.2.2. Reasons Behind Deglobalization

Firstly, global slowdown in the decade after the **global financial crisis** in 2008 intensified protectionist measures. Rise of populist leaders globally re-enforced the trend. **Secondly**, **immigration crisis** further accentuated the security situation at the time of economic slowdown, creating greater legitimacy and support for protectionism.

Thirdly, unequal distribution of benefits of globalization, rising inequalities, job loss and unemployment in developed countries and jobless growth in developing countries are pushing the world towards more intransigent positions in trade negotiations. **Fourthly**, MNCs across the countries and workers from developing countries benefitted the most from the forward march of globalization, leading to the perception that workers from developing countries have stolen jobs from developed countries. This led to demands for stricter visa regimes and relocation of industries.

8.14.3. Countervailing Duties

If a foreign country attempts to subsidize the goods being exported by them, so that it causes domestic production in other countries to suffer, countervailing duties can be applied on imports. Excessive domestic subsidies creates a shift in domestic demand towards cheaper imported goods rather than domestic goods. Countervailing measures impose additional tariffs on such imported goods. This raises the price of these goods and domestic goods again being equally competitive and attractive.

For example, export subsidies given by the Chinese government on electronics products can make the Chinese electronics item priced low in the Indian market. This can be a disadvantage

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for the competing Indian products. To overcome this situation, government of India can impose a countervailing duty on Chinese imports.

8.14.4. Anti-Dumping Duty

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. Anti-dumping duty is a protectionist tariff on such products. The WTO agreement (GATT) allows governments to act against dumping where there is genuine ("material") injury to the competing domestic industry.

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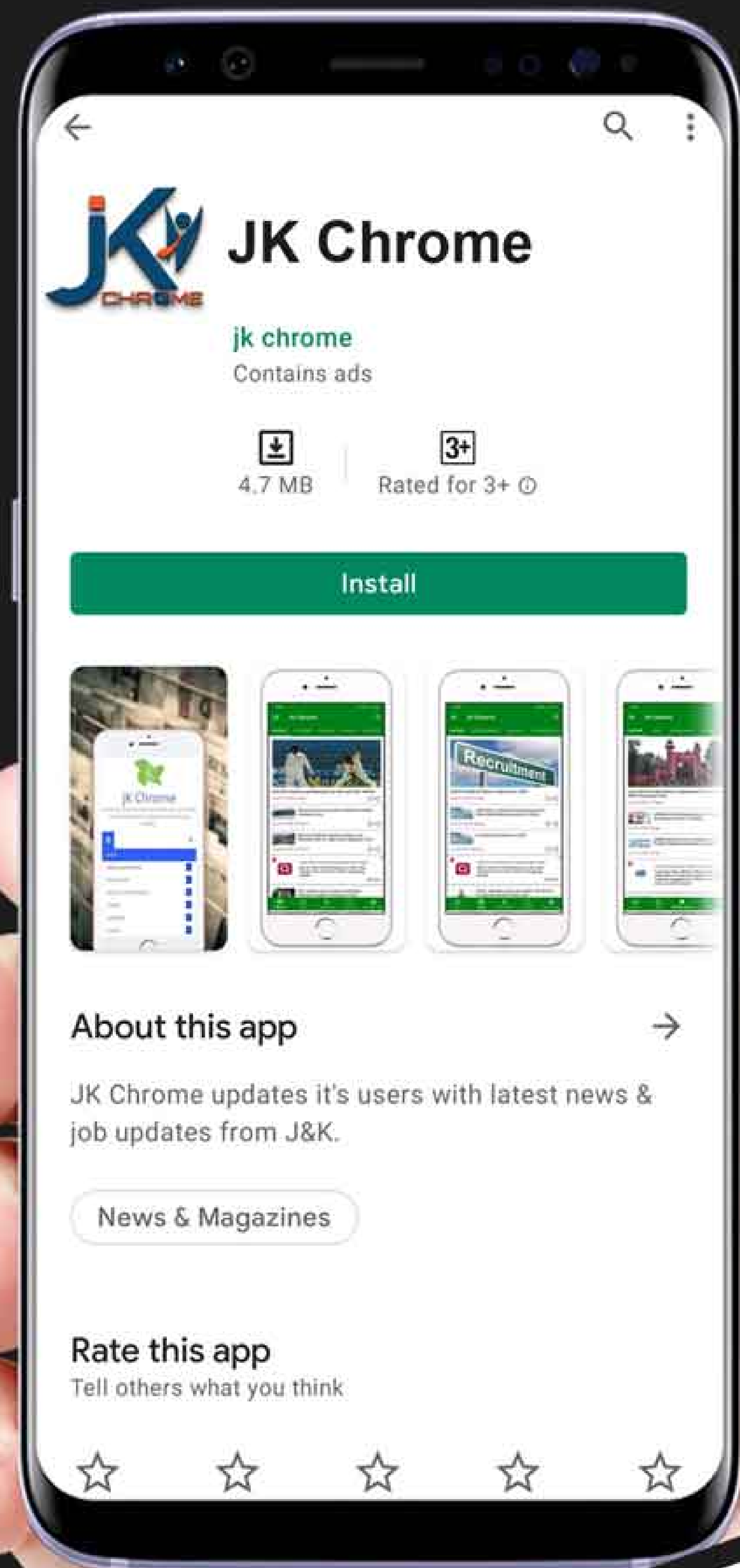

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9 CHAPTER Planning in India

9.1. HISTORY OF PLANNING IN INDIA & ORIGIN OF FIVE YEAR PLANS

India after independence chose to follow a path of planning for social and economic development. Though the planned economic development in India began in **1951** with the inception of **First Five Year** Plan, efforts had begun prior to the independence. Setting up of **National Planning Committee** by Indian National Congress **in 1938**, The **Bombay Plan & Gandhian Plan** in 1944, **Peoples Plan in 1945 etc.**, were some important steps the direction of planned economic development. Similarly, **Sarvodaya Plan in 1950** by Jaiprakash Narayan, envisaged a planned model of development for India, post the independence.

The Planning Commission was formed in **March 1950** with objectives to promote a rapid rise in the standard of living of the people by making a scientific assessment of material, capital and human resources of the country and investigate the possibilities of augmenting them. It was the mandate of the planning commission to formulate a plan for the most effective and balanced utilization of the country's resources. It was supposed to determine priorities and define stages in which the development of the country was to be carried out.

The planning was to be done via 5-year plans, with the **first Five Year Plan (FYP)** launched in 1951. **Growth, modernization, self-reliance, and equity** were the objectives of five-year plans. Because of the limited resources available, each plan decided which of the objectives should be prioritized. In all planning commission formulated 12 FYPs before getting dismantled in January, 2015.

The Planning Commission was dissolved by the government in 2015 and replaced with NITI Aayog (National Institution for Transforming India), a policy Think Tank with an aim to make planning approach more inclusive and bottom-up. After the replacement of Planning Commission with NITI Aayog, the five-year plans have been replaced by various action plans today.

Pre-Independence Planning in India	
The Visvesvaraya plan (1934)	It was the first ever blueprint for Indian economic planning. The architect of Visvesvaraya plane was Mokshagundam Visvesvaraya, a popular civil engineer and ex- Dewan of the Mysore state. The Visvesvaraya plan was an exercise in democratic capitalism (as found in USA) with emphasis on industrialization. The plan aimed to double the national income in one decade.
The FICCI proposal (1934):	The Federation of Indian Chambers of Commerce and Industry which represented the capitalist class, stressed the need for National Planning Commission, for structured and planned economic development of the country. FICCI voiced its support for centralized planning and a greater role of government to achieve full growth potential and make a definitive break from the past.

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The Bombay plan (1944)	It was designed by major capitalists like Purshotamdas Thakurdas, J R D Tata, G.D Birla etc. The plan was also called 'A Plan for Economic Development of India'. Plan was published in 1944-1945 and it had major emphasis on agricultural restructuring and rapid industrialization. It stressed on both heavy industries and basic industries. Further, it stressed upon development of essential consumer goods industry, enhancing the role of MSMEs, and social welfare in order to check prevailing inequalities. Even though it was designed by capitalists, it had adequate provisions for active role of state in social welfare and income redistribution.
Gandhian Plan	It was based upon Gandhian philosophy and was put forward by **Shri S.N. Agarwal of Wardha.** It aimed to create a decentralised economy focused on self-sustaining villages and industrial development. It stressed upon development of agriculture, cottage industries, village industries etc. The Gandhian plan did not agree with the Bombay plan completely.
People's Plan (1945)	The People's plan was prepared by **M.N. Roy**. The plan was based on Marxist Socialism, and aimed to provide all individuals with 'basic necessities of life' Its main focus was on collectivization and the establishment of state-owned industrialization in the agricultural and consumer goods industries.
Planning Advisory Board	In October 1946, a planning advisory board was set up by Interim government, under the chairmanship of KC Neogi. The purpose of the planning advisory board was to make recommendations about co-ordination and improvement of planning, future planning mechanism and to set objectives and priorities for planned development.
The Sarvodaya plan (1950)	It was outlined by Jay Prakash Narayanan. It advocated self-sufficiency by limiting the dependence on foreign goods and technologies. The main focus of the plan was on agricultural and land reforms along with development of small-scale industries. Gandhi's technique of constructive work by community and trusteeship was at the heart of the Sarvodaya plan. It also drew inspiration from the Vinobha Bhave's concept of Sarvodaya. The key was to prepare India for a decentralized Participatory planning, by encouraging creation of self-dependent villages.

Outline of Various Five Year Plans	
First five year plan (1951-1956) Harrod-Domar Model.	Severe food shortage (leading to food grains import), mounting inflation etc., confronted the country at the onset of the first five-year plan. Accordingly, the plan gave priority to agriculture including irrigation and power projects. About 45% of the plan outlay went in favor of public sector undertakings (PSUs).
Second Plan **(1956 - 61)** Target Growth: 4.5% Actual Growth: 4.3% Mahalanobis Plan	The second five-year plan laid emphasis on rapid industrialization with a focus on heavy industries and capital goods. The plan envisaged that a sufficient capacity generation in the capital goods sector will lead to an increase of capacity in the consumer goods sector, by increasing the production levels. Government established steel plants at Bhilai, Durgapur, and Rourkela with joint investment from Russia and Germany. Shortages of both food and capital were felt during this plan.

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Third Five-Year Plan: (1961-1965) John Sandy and Sukhamoy Chakravarty model. Also called Gadgil Yojana Target Growth: 5.6% Actual Growth: 2.8%	The third FYP was unique in the way that it specifically added the development of agriculture as one of the objectives of planning in India. Also, the objective of balanced regional development was adopted for the first time. Further, the plan emphasized on becoming a **self-reliant and self-sustained economy**. The Plan was thorough failure in reaching the targets due to unforeseen events - Chinese aggression (1962), Indo-Pak war (1965), severe drought 1965-66.
Rolling Plans: (1966-1969). Three annual plans rolled. (Plan holiday)	Due to war with China (1962) and Pakistan (1965), the production growth was in turmoil. The average rate of growth of GNP has been of the order of 3.5 per cent per year as against the plan target of 5 to 5.5%. New plans were made and implemented on annual basis, based on changing economic demands.
Fourth Five Year Plan: (1969-1974) Target Growth: 5.7% Actual Growth: 3.3% Based on Allen S Manne and Ashok Rudra model.	The fourth FYP gave special focus to the ideas of growth with stability, keeping the objective of self-reliance at heart. Droughts and the Indo-Pak war of 1971-72 led to double-digit inflations, high fiscal deficits etc. **The plan saw the first move in the direction of nationalization.** To make availability of **finance more inclusive the government Nationalized 14 major Banks in 1969**. A major thrust was given to **GREEN REVOLUTION** under the supervision of M.S Swaminathan. Implementation of Family Planning Programmes were amongst major targets of the Plan.
Fifth five-year plan: 1974-1979 Target Growth: 4.4% Actual Growth: 4.8%	The objectives of the fifth FYP were poverty alleviation and self-reliance. It was formed as Minimum Needs programme under **D.P Dhar.** The famous **Twenty-point Programme (1975)** was launched during the cycle of fifth FYP. During the plan period of this plan, RBI was handed the additional function to stabilize inflation.
Rolling Plan (1978 - 80)	During this period, plans kept changing due to political confrontations and change of government. Janta Govt. put forward a plan for 1978-1983 emphasizing on employment, in contrast to Nehru Model which the Govt. criticized for concentration of power, widening inequality & for mounting poverty. However, the government lasted for only 2 years. Congress Govt. returned to power in 1980 and launched a different plan aimed at directly attacking on the problem of poverty by creating conditions of an expanding economy
Sixth Five-Year Plan: 1980-1985 Target Growth: 5.2% Actual Growth: 5.7%	The sixth plan focused on poverty eradication and started with the popular slogan of 'Garibi Hatao'. The plan gave an impetus to creation of socio-economic infrastructure in rural areas to bridge the regional developmental disparities. A number of schemes and programmes were launched during the life-cycle of the plan such as: National Rural Employment Programme, Restructured Twenty Point Programme, Village and Small Industries Development Programme, Tribal Development Agency, Khadi Village Industries Programme etc. The plan gave special emphasis on economic liberalization. The plan focused on modernization of technology, ensuring continuous decrease in poverty and unemployment through schemes for transferring skills (TRYSEM) and providing slack season employment (NREP), controlling population explosion etc.

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Seventh Plan (1985 - 90) Target Growth: 5.0% Actual Growth: 6.0%	The basic tenets of the plan were growth, modernization, self-reliance and social justice. The Plan aimed at accelerating food grain production, increasing employment opportunities & raising productivity with focus on 'food, work & productivity'. The Jawahar Rojgar Yojna (JRY) was launched in 1989 with the motive to create wage-employment for the rural poor. Target was to modernize economy for productive employment. Government pursued idea of social justice in its schemes. It was the beginning of liberal approach towards private sectors. The plan was very successful as the economy recorded 6% growth rate against the targeted 5% with the decade of 80's struggling out of the' Hindu Rate of Growth. By the end of the plan period, India had a very unfavorable balance of payment situation. Further, the country also reached insurmountably high fiscal deficits.
Two Annual Plans (1990-1992)	Due to political turmoil and worsening economic situation (fiscal imbalances), the Eighth Plan could not take off as per its intended plan cycle. The new government, which assumed power in June 1991, decided to commence the eighth plan for the period 1992-97 and the fiscals 1990-91 and 1991-92 were treated as two Annual plans. The focus during these two fiscal years was on maximization of employment and social transformation.
Eighth Plan (1992 - 97) Target Growth: 5.6 % Actual Growth: 6.8%	Issues such as worsening Balance of Payment position, rising debt burden, widening budget deficits, recession in industry and inflation were inherited as a legacy by the Eight plan. This plan witnessed landmark changes with respect to the restructuring of the economy. The economic reforms had started the process of structural adjustments and macro-stabilization policies. During the plan period of the Eighth FYP, the need for re-defining the role of state in the economy was felt and articulated. Government followed policies for modernization of industries (New Economic Policy, 1991). It gave major thrust on development of Human Resource for productive employment. Also, the eighth plan adopted indicative planning model. Indicative planning model aims to complement and enhance the market (as opposed to replacing it) through coordination between private and public investments through forecasts and output targets. Opening of economy, via the Liberalization, Privatization and Globalization reforms led India to become a member of World Trade Organization (WTO)
Ninth Plan (1997- 2002) Target Growth: 6.5% Actual Growth: 5.4%	The Plan focused on "Growth with Social Justice & Equality". The plan cycle stated with a slowdown in the global economy led by the South East Asian Financial Crisis (1996-97). However, due to the liberalization process started during the previous plans, the economy was out of financial imbroglio. The plan gave special emphasis to 7 identifies Basic Minimum Services viz., health services, safe drinking water, universal primary education, nutritional support etc. It also structured Special Action Plans (SAPs) in areas of agriculture, information technology, and social infrastructure and Water policy. Ninth Plan aimed to depend predominantly on the private sector. Indian as well as foreign (FDI) & State was envisaged to increasingly play the role of facilitator & increasingly involve itself with social sector viz education, health etc. and infrastructure where private sector participation was likely to be limited.

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Tenth Plan (2002 - 2007) Target Growth- 8 % Actual Growth-7.6 %	The objective was growth with emphasis on increasing literacy rates. The plan aimed to double the per capita income in 10 years. The plan fixed 'monitorable targets' for eleven select indicators of development for the center as well as for the states. Several measures were taken to reduce poverty and double per-capita income. The targets included reduction in gender gaps in literacy and wage rate, reduction in Infant & maternal mortality rates, improvement in literacy, access to potable drinking water cleaning of major polluted rivers, etc.
Eleventh Plan (2007 - 2012) Target Growth: 9 % Actual Growth: 8%	The objective of the plan was tp achieve improved standard of living for the citizens and to contribute towards the goals of socio-economic development. It was Planned by **C. Rangarajan,** with a theme of **faster and more inclusive growth.** The plan gave focus to incorporate factors of environmental sustainability. Government pursued Skill development goals and steps to increase agricultural growth rate to 4%. Government also took steps for reducing **Total Fertility Rate (TFR) to 2.1%.**
Twelfth Plan : 2012-2017	It aimed **"Faster, Sustainable, and More Inclusive Growth"** The objective of plan was to give emphasis on **Sustainable Growth**. Health, education and skill development continued to be focus areas in the Twelfth plan. The plan document stressed upon the need to harness private investment in these sectors. The plan document took cognizance for the need of large investments for the development of infrastructure. To this end, PPP model was stressed upon by 12th FYP. Government set the target for time bound electrification of all Indian villages. Several steps were taken to reduce social and gender gap in education. On economic footage, the target was set for penetrating banking services to 90% of households.

Sector Wise Annual Growth rate of GDP at constant price (2004-2005)

	Average 11th plan	**Average 12th plan**
Agri, Forest and Fishing	**3.7**	**4.0**
Mining and quarrying,	**3.2**	**5.7**
Manufacturing	**7.7**	**7.1**
Electricity, Gas and Water supply	**6.1**	**7.3**
Construction	**7.7**	**9.1**
Trade Hotels and Restaurants	**8.3**	**7.4**
Transport, Storage and Communication	**12.0**	**11.8**
Financing, insurance, real state and business service	**11.1**	**9.9**
Industry Total	**7.2**	**7.6**
Service Total	**9.7**	**9.0**

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9.2. NITI AAYOG

National Institution for Transforming India (NITI) Ayog is an institution that serves as a **Think Tank** of the government, providing directional and **policy inputs**. It provides government at the central and state levels with relevant strategic and technical advice across the spectrum of key elements of policy formulation and implementation. NITI Ayog was formed replacing Planning Commission in 2015. However, before going in the details of NITI Aayog further, we need to understand the reason behind dismantling of Planning Commission. The 65-year-old Planning Commission was more relevant in a command economy structure, but with liberalization and privatization it became relatively redundant. With further movement of federal structure to cooperative federalism and competitive federalism, India needed a body with more federal representations which could foster competition as well as cooperation among states and Union for better efficiency.

Specific to the planning process, there was a need to separate as well as energize the distinct 'process' of governance from the 'strategy' of governance. In the context of governance structures, the changed requirements of India, pointed to the need for setting up an institution that would serve as a directional and policy dynamo. With establishment of the NITI Ayog, an important evolutionary change from the past is replacement of a one-way flow of policy from center to state by a genuine and continuing partnerships with the states. NITI Ayog has the necessary resources, knowledge base, skills and, ability to act with speed to provide the strategic policy vision for the government as well as deal with contingent issues. It makes it a truly federal body working in direction of strengthening competitive and cooperative federalism. NITI works in developing an indigenous model of development, imbibing best practices from around the world and molding them as per our own needs and aspirations.

9.2.1. Objectives of NITI Aayog

1. To foster **cooperative federalism** with the States.
2. To establish processes for **forming reliable plans at the village** level and **then aggregating** them **at higher levels** of government.
3. To ensure that the **interests of national security** are incorporated in **economic strategy and policy** in areas referred to it.
4. To pay particular attention to those in our **society** who might be **at risk of not benefiting** enough from economic growth.
5. To provide advice and to **promote collaborations between key stakeholders** and like-minded think tanks, as well as educational and policy research organizations, on a national and international level.

Composition	
Chairperson	**Prime Minister of India**
Vice-Chairperson	To be appointed by Prime-Minister
Governing Council	Chief Ministers of all the States and Lt. Governors of Union Territories
Regional Councils	To address specific regional issues. Regional Council Comprises of the Chief Ministers of States and Lt. Governors of Union Territories in the region. Regional Councils are chaired by the chairperson of the NITI Aayog or his nominee.
Adhoc Membership	Two member in ex-officio capacity from leading Research institutions on rotational basis
Ex Officio member	Maximum of 4 members of the Union Council of Ministers to be nominated by the Prime Minister.
Chief Executive Officer	To be appointed by the Prime Minister for a fixed tenure, in the rank of Secretary to the Government of India.
Special Invitees	Experts, Specialists with domain knowledge nominated by Prime-minister

6. Through a shared group of national and international experts, professionals, and other collaborators, **build an informative, creative, and entrepreneurial support system.**
7. To provide **a forum** for inter-sectoral and inter-departmental **issues to be resolved** in order to speed up the implementation of the development agenda.
8. Maintaining a cutting-edge **Resource Centre** that serves as a repository for research on **good governance** and best practices in sustainable and equitable growth, as well as assisting in their dissemination to stakeholders.

9.2.2. Initiatives of Niti Aayog

1. **Measuring performance and ranking States on the basis of their performance in critical sectors:** NITI Aayog has introduced indices to measure incremental annual outcomes in critical social sectors like health, education, water and Sustainable Development Goals (SDG). The indices are:

Index	Purpose
'Healthy States, Progressive India' **Health Index.** First edition was published in 2018	It measure the health index through various indicators like child mortality rates, sex ratios at birth, immunisation rates, proportion of people living with HIV/AIDS. The major weightage is given to mortality rate, total fertility rate, and sex ratio. The indicators are broadly divided into three domains. Viz. (a) Health outcomes (b) Governance and information (c) Key inputs and processes.
District Hospital Index (Best Practices in the Performance of District Hospitals)	To measure and monitor the performance of hospitals with a focus on outputs and outcome. The assessment framework covers 10 Key Performances Indicators across the domains of Structure and Output.
Composite Water Management Index, 2018	The CWMI is envisioned to bring about much-required improvements in water resource management and conservation in India in a coherent and collaborative manner. The index will measure both the overall progress made by the states in water management and the incremental improvement in performance across time. The index is expected to promote the spirit of 'competitive and cooperative federalism', and at the same time ensure sustainable and effective management of water resources. The index comprises nine themes with 28 different indicators viz. groundwater and surface water restoration, major and medium irrigation, watershed development, participatory irrigation management, on farm water use, rural and urban water supply, and policy and governance.
School Education Quality Index (SEQI), 2019	To evaluate the performance of States and Union Territories (UTs) in the school education sector. It aims to bring outcomes focus to education policy by providing States and UTs with a platform to identify their strengths and weaknesses and undertake requisite course corrections or policy interventions. The indicators are categorized into two domains viz. Outcomes (Learning, Access, Infrastructure and facilities, Equity) and Governance processes aiding outcomes.
Index for Sustainable Development Goals (SDGs), launched in 2018	It has the twin mandate to oversee the adoption and monitoring of the SDGs in the country, and also promote competitive and cooperative federalism among states and UTs. The index represents the articulation of the comprehensive nature of the Global Goals under the 2030 Agenda while being attuned to the national priorities. It gauges progress of states and UTs on the expansive nature of the Goals, including health, education, gender, economic growth, institutions, climate change and environment. The SDG India Index 2020-21, developed in collaboration with the United Nations in India, tracks progress of all states and UTs on 115 indicators that are aligned to MoSPI's National Indicator Framework. These 115 indicators incorporate 16 out of 17, and cover 70 SDG targets.

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India Innovation Index. launched in 2019.	The index attempts to create an extensive framework for the continuous evaluation of the innovation environment in all states and UTs. The innovation inputs are measured through five enabler parameters (human capital, investment, knowledge workers, business environment, safety and legal environment) and the output through two performances (knowledge output and knowledge diffusion).
Export Competitiveness Index. Launched in 2020.	The primary goal of the index is to instill competition among all Indian states to bring about favorable export-promotion policies, ease the regulatory framework to prompt subnational export promotion. The index aims to enable the States and UTs to benchmark their performance against their peers and analyze potential challenges to develop better policy mechanisms to foster export led growth at the subnational level. The index ranks the states and UTs on four main pillars viz., policy, business ecosystem, export ecosystem, export performance.

2. **Sustainable Action for Transforming Human Capital-Education (SATH-E):** It was launched in 2017. The vision of the program is to initiate transformation in the education and health sectors. The program addresses the need expressed by many states for technical support from NITI Aayog. It aims to identify and build three future 'role model' states for health systems. The three chosen states will be assisted in designing a robust blueprint, evolve a structure for program governance, set up monitoring & tracking mechanism and provide support to the state institutions to achieve the end objectives.
3. **Ek Bharat Shrestha Bharat:** It was conceptualized to make our country united, strong and promote excellence in all walks of life by means of long-term inter-state engagements through cultural exchanges and education. All States and UTs will be covered under the programme. There will be pairing of States/UTs at national level and these pairings will be in effect for one year. District level pairings will be independent of the state level pairings. It will connect people through exchanges in culture, tourism, language, education trade etc.
4. **Development Support Services to States (DSSS) for Development of Infrastructure**: NITI Aayog launched (DSSS) for Infrastructure Projects', with the vision to achieve transformational and sustained delivery of infrastructure projects. The key objective behind the initiative is to create PPP success stories and reboot infrastructure project delivery models so that a sustainable infrastructure creation cycle can be established. The DSSS initiative involves providing project-level support from concept plan to financial closure to States/UTs. is to establish a Centre-State partnership model and reignite and establish Private Public Partnership across infrastructure sectors.
5. **Transforming of 115 identified Aspirational Districts:** It was launched in 2018 to ensure that India's growth process remains inclusive. It is an initiative to rapidly transform 115 identified districts that have shown relatively lesser progress in key social areas and have emerged as pockets of under-development, thereby posing a challenge to ensure balanced regional development. The broad contours of the programme are convergence (of central and state schemes), collaboration (of central, state level 'prabhari' officers and District Collectors). The aspirational districts programme promotes productive competition among districts through monthly delta ranking. The program focuses on the strength of each district, identifying low-hanging fruits for immediate improvement and measuring progress on a monthly basis (through delta ranking). The ranking is based on the incremental progress made across 49 key Performance Indicators (KPIs) under 5 broad socio-economic themes- Health and Nutrition, Education, Agriculture and Water

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Resources, Financial Inclusion and Skill Development and Infrastructure.

6. **Promoting Inclusive Growth:** To leverage the pivotal role of Panchayati Raj Institutions (PRIs), NITI Aayog recommended restructuring of the Rashtriya Gram Swaraj Abhiyan (RGSA). RGSA has since become a centrally sponsored scheme from 2018-19 to 2021-22 to address the challenges faced by the States.

7. **Enhancing Productive Efficiency With Long-Term Vision:**

   a. **Three Year National Action Agenda and the Strategy for New India:** NITI Aayog prepared a Three-Year Action Agenda covering the period from 2017-18 to 2019-20. The framework allows better alignment of the development strategy with the changed reality of India. It is aligned to the predictability of financial resources during the 14th Finance Commission award period.

   b. **Seven Year mid-term strategy:** The seven-year mid-term strategy aims to convert a broader vision into implementable policy.

   c. **Fifteen Year long term vision:** It combines national social goals and international Sustainable Development Goals. It expands beyond the traditional Plan mandate to include internal security, defence etc.

8. **Development support to the North East:** A Committee was constituted under NITI Aayog to examine and suggest a road map for a new industrial policy for the North Eastern and the Himalayan States. The Department of Industrial Policy and Promotion (DIPP) prepared North East Industrial Development Scheme (NEIDS) 2017, based on the committee's recommendation. NEIDS aims to catalyse the industrial development in the North Eastern region including Sikkim. The scheme covers new units in manufacturing and services sector, providing for Central Capital Interest Incentives.

   a. **NITI Forum for North East:** It was constituted to identify various constraints in the way of accelerated, inclusive but sustainable economic growth in the North East Region of our country, and also to recommend suitable interventions for addressing the identified constraint.

9. **Island Development Agency (IDA):** It was set up in June 2017. It undertakes reviews on the progress relating to holistic development of identified islands. The agency is chaired by the Home Minister of India.

10. **Health & Nutrition Sector Reforms**

    a. **National Nutrition Strategy:** The Aayog formulate the National Nutrition Strategy that provides the rationale and roadmap for policy makers to bring nutrition to the Centre of the stage in India's Development Agenda. It focuses on inter-sectoral convergence and identifies priority districts to tackle malnutrition and meet the country's nutrition needs and targets.

    b. **POSHAN Abhiyaan**: It was launched on the occasion of International Women's Day 2018. It directs the attention of the country towards the problem of malnutrition and addresses it in a mission-mode. The flagship programme of the government of India aims to improve nutritional outcomes for children (0-6 year's age), pregnant women and lactating mothers. Poshan abhiyaan strives to reduce the level of stunting, under-nutrition, anaemia and low birth weight by 2%. 2%, 3% and 2% respectively.

11. **Driving India's Energy Sector**

    a. **Renewable Electricity Roadmap 2030:** The report was brought out by NITI Aayog with support of CII, Shakti Sustainable Energy Foundation and RAP in 2015. The report talks about the current scenario of renewable energy in India and what needs to be done for its accelerated deployment to address energy security concerns.

    b. **Draft National Energy Policy (NEP):** It was unveiled in 2017. The four key

objectives of the new energy policy are ensuring access to energy at affordable prices, improving energy security& reducing dependence on fossil fuels, promoting greater sustainability & ensuring sustained economic growth.

12. Cross Sectoral Interventions

a. **Task Force on Employment and Exports:** In September 2017, NITI Aayog constituted a high-level Task Force on employment and exports. To address the challenge of creating well-paid, formal sector jobs the task force made seminal suggestions such as: (i) addressing issues related to logistics, export credits and trade facilitation, (ii) Identifying key macroeconomic factors constraining exports and suggesting methods to address these constraints, (iii) a comprehensive plan of action to boost India's export in labor-intensive sector, (iv) assessing the effectiveness of existing schemes to promote exports etc.

13. Partnerships with National and International Organisations

a. **SAMAVESH** – It is a programme launched by the NITI Aayog to link together various lead Knowledge and Research Institutions to catalyse development processes, enhance institutional capacity development and enable a field level interface with the community for mutual enrichment. The network will enable efficient knowledge sharing and information exchange among all partners to fulfil their role in transformative policy reform so as to achieve sustainable and more inclusive development in line with sustainable development goals as well as 15-year vision, 7-year strategy and 3 year action plan of NITI Ayog.

b. **Champions of Change** – Two workshops of young CEOs and young entrepreneurs were organized to make policy making responsive to stakeholder consultations.

14. Promoting Entrepreneurial Ecosystem

a. **Atal Innovation Mission:** It is a flagship initiative of the Government of India to promote and create a culture of innovation and entrepreneurship in the country. AIM's objective is to develop new programmes and policies for fostering innovation in different sectors of the economy. It creates an umbrella structure to oversee the innovation and entrepreneurship ecosystem of the country.

b. **Atal Tinkering Labs (ATLs):** Atal Innovation Mission has established Atal Tinkering Laboratories (ATLs) in schools across India. The objective of this scheme is to foster curiosity, creativity and imagination in young minds; and inculcate skills such as design mindset, computational thinking, adaptive learning, physical computing etc.

c. **Atal Incubation Centres (AIC):** AIM intends to support the establishment of new greenfield incubation centres called Atal Incubation Centres (AICs) that would nurture innovation start-ups in their pursuit to become scalable and sustainable business enterprises. AIM will support these AICs in creating world-class incubation facilities across the country with the state-of-the-art physical infrastructure coupled with the availability of sectoral experts for mentoring. Under the Atal Incubation Centres (AIC) program, more than 100 institutions have been selected for setting up incubators around the country, in a mix of tier 1, 2 and 3 cities.

d. **Women Entrepreneurship Platform:** NITI Aayog launched the Women Entrepreneurship Platform (WEP) for providing an ecosystem for budding and existing women entrepreneurs across the country. As an enabling platform, WEP is built on three pillars viz. ichaashakti (motivation), gyanshakti (knowledge) and karmashakti (support). It aims to help women realize their entrepreneurial aspirations, scale-up innovative initiatives and chalk-out sustainable, long-term strategies for their businesses.

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15. Reforms In Agriculture

a. **Model Act on Agricultural Land Leasing Act:** NITI Aayog formulated a Model Agricultural Land Leasing Act, 2016 to recognize the rights of the tenant and safeguard interest of landowners. An act to permit and facilitate leasing of agricultural land, to improve agricultural efficiency and equity, access to land by the landless and semi-landless poor, occupational diversity and for accelerated rural growth and transformation. The model act proposes to legalize land leasing to promote agricultural efficiency, equity and power reduction. Further, the act provides for the landlord to lease the land with mutual consent for agriculture and allied activities. The act makes provision strengthening the infrastructure for institutional loan, insurance and disaster relief so that the lease holder may invest more in agriculture. The model act also makes a provision of "Special Land Tribunal" to amicably resolve the dispute between the landlord and lease holder.

b. **Agricultural Marketing and Farmer Friendly Reforms Index:** NITI Aayog developed the first ever 'Agriculture Marketing and Farmer Friendly Reforms Index' to sensitise States about the need to undertake reforms in three key areas of agriculture market, land lease and forestry on private land. Seven indicators have been developed by NITI in this regard. The indicators highlight competitiveness, efficiency, and transparency in agricultural markets. Also, the indicators also measure the opportunities for farmers to benefit from modern trade and commerce.

16. Other major achievements of NITI Ayog: NITI Ayog has constituted a **Committee of Chief Ministers on Digital Payments** to promote transparency, financial inclusion and a healthy financial ecosystem nationwide. To incentivize the use of digital payments across all the sections of the society Niti Ayog launched Lucky Grahak Yojana and Digi Dhan Vyapar Yojana.

Niti Ayog has created a **Sub-Group of Chief Ministers** (CMs) on rationalization of **Centrally Sponsored Schemes (CSSs)**. Based on the recommendations of this sub group existing CSSs have been rationalized into 28 umbrella schemes. On the same lines sub group of CMs have been made on Skill Development and Swachh Bharat Abhiyan. Further, to promote cooperative and competitive federalism, Niti Ayog has come out with indices to measure incremental annual outcomes in critical social sectors like health, education and water with a view to nudge the states into competing with each other and at the same time sharing best practices and innovation.

Niti Ayog has created a **Task Force on Elimination of Poverty in India**. The report of this task force primarily focusses on issues of measurement of poverty and strategies to combat poverty. The task force has impressed upon the need for employment intensive rapid growth and effective implementation of anti-poverty programs. Further, Niti Ayog has initiated a transforming India lecture series. It recognizes knowledge building and transfer as the enabler of real transformation in States. The lecture series aims to bring cutting edge ideas in development policy to Indian policy makers.

Also, as a measure to reform and overhaul the medical education ecosystem in India, Niti Ayog has **recommended scrapping of the Medical Council of India** and envisaged a **National Medical Commission** in its place to create a robust education infrastructure. In addition, Niti Ayog along with Institute for Competitiveness, releases the India Innovation Index, which examines the innovation capabilities and performance of the states and union territories. The innovation inputs are measured through five enabler parameters viz. Human Capital, Investment, Knowledge Workers, Business Environment, Safety and Legal Environment. Knowledge Output and Knowledge Diffusion were identified as performance parameters.

Further, Niti Ayog has come with a **National Strategy for Artificial Intelligence** to harness the benefit of AI in various sector. Niti Ayog has decided to focus on five sectors that are envisioned to benefit most from AI in solving societal needs viz. healthcare, agriculture, education, smart cities/infrastructure, and smart mobility

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and transportation. Also, to give a boost to the infrastructure development in the country, Niti Ayog has developed the Asset Monetization Pipeline. The strategic objective of the programme, according to Niti Ayog, is to unlock the value of investments in brownfield public sector assets by tapping institutional and long-term capital, which can be leveraged for public investments.

As a part of the larger movement for balancing the human needs with environmental conservation, Niti Ayog launched an **electric vehicle awareness portal called 'e-AMRIT' at COP26**. It will act as the one-stop destination for all information on electric vehicles. It will also act towards raising awareness towards adoption of electric vehicles, their purchase, investment opportunities and policies in this regard etc. Further, **Development Monitoring and Evaluation Office (DMEO)** as an attached office of Niti Ayog has been mandated to actively monitor and evaluate the implementation of schemes, programs and initiatives of the government. It leads to track performance, determine outcomes, thus promoting evidence-based policy making.

9.2.3. Challenges in NITI Aayog:

NITI Aayog was formed with a vision to take lead the country on a developmental path through creative thinking, public-private partnership, optimum utilization of resources and utilization of youth power of the nation seven years after its formation, the performance of NITI Aayog has not been able to please its detractors. Some experts are of the opinion that NITI Aayog has led to centralization of ideas, shifting the theatre of activity from ministries to the Aayog. It is also argued that, in absence of powers to allocate funds, the body has limited relevance for states, especially when different parties are in power at the union and state. It is opined from some quarters that NITI Aayog as a think tank should maintain a respectable distance from the government. However, alleged uncritical praise of the government-sponsored schemes and programs reduces its veracity. Moreover, it is believed that NITI Aayog has been entrusted with too many functions for a think tank, and thus runs the risk of crumbling under its own pressure.

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10 CHAPTER Taxation

10.1. INTRODUCTION

Taxes are compulsory **payments made by taxpayers** (individuals or legal entities) **to the government** in order to generate funds for undertaking development work, finance government spending and pay for public goods/services. Tax is also the **'glue' that binds the taxpayers and the government together** as it makes the government accountable to the taxpayers. A failure to pay along with evasion or resistance to taxation, is punishable by law. It is a part of the fiscal policy.

10.1.1. Some Basic Concepts

1. **Impact of tax:** The impact of tax is on the person who bears the financial burden of tax (pays the tax money) in the first instance.
2. **Shifting of tax:** Shifting of a tax refers to the process by which the monetary burden of a tax is transferred from one person to another. Whenever there is a shifting of taxation, the liability to pay tax may be transferred forward or backward. When the seller shifts the tax to the consumer it is called forward shifting. When the seller or producer chooses to bear the burden of taxation himself/herself, due to a fear of fall in demand, in that case the tax is said to be shifted backward.
3. **Incidence of Tax:** Incidence of tax refers to the money burden of a tax on the person who ultimately bears it.
4. **Progressive Tax:** It is a system of taxation where the tax rate rises with the rise in tax payer's incomes. The rationale is that tax should impose a relatively larger burden on the wealthy.
5. **Proportional Tax:** It is a system of taxation where the tax rate is fixed at some rate irrespective of the level of taxpayer's income.
6. **Regressive Tax**: It is a system of taxation where tax rate does not decrease with decrease in taxpayer's income.
7. **Specific tax:** Specific tax is a type of tax where specific **duties are levied per physical unit** of the commodity. It is a fixed amount of tax placed on a particular good. It is also referred to as a per-unit tax, and the tax depends on the quantity sold (not the price). For example, it is laid as ₹ X per TV, as cloth per meter, as oil per liter, as fertilizer per tonne etc.
8. **Ad Valorem tax:** Ad Valorem in Latin literally means "according to the value". Hence, an ad valorem tax is a **tax based on the value** of an item. The most common ad valorem taxes are property taxes levied on real estate. It is usually levied as a percentage of the total value of a commodity.

Laffer Curve

Laffer curve depicts the **relationship between taxation rates and resultant tax revenue**. As per this curve, the tax revenue increases with increasing tax rates only up to a certain point. After this, there is disincentive for the people to work/produce more and higher incentive for tax evasion, that leads to decreasing tax revenues. In other terms, lower tax rates increase money in hand.

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This stimulates more business and more revenue due to raising aggregate demands. So, according to this curve the government should optimize its tax structures in such a way that the tax slabs are neither too low nor too high. This optimal tax rate ensures that the government gets sufficient revenue to finance its activities while there is incentive for people to work hard and produce more.

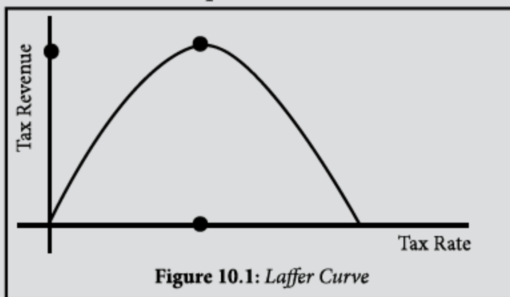

Figure 10.1: *Laffer Curve*

10.2. TYPES OF TAXES: DIRECT TAX AND INDIRECT TAX

The taxes can be broadly classified into two types: (1) Direct taxes and (2) Indirect tax

10.2.1. Direct Tax

Direct taxes are those taxes that have to **be paid by the person on whom they are levied**. In this type of tax, the impact of tax and the incidence of tax are on the same person and there is no possibility of shifting of tax. Income tax, property tax, corporation tax, etc. are direct taxes as they are imposed on and paid by the same person.

Merits of Direct Taxes	Demerit of Direct Taxes
1. The **administrative cost** of collection of these taxes is **low**.	1. The direct taxes are generally not shifted and therefore, they are **painful** to the taxpayers.
2. The taxpayer is **certain** to how much he/she is expected to pay, and similarly, the state is certain as to how much it has to receive as income from direct taxes.	2. It is inconvenient for tax payers as they have to **devote time, money and effort** in ensuring tax compliance, tax filing and tax saving investments.
3. They are considered **more equitable** as they fall more heavily on rich men (**progressive** tax) than on the poor.	3. The direct taxes may **not fall with equal weight** on all classes.
4. It recycles wealth and reduces **inequalities** because of progressive nature.	4. The rate of direct tax is **arbitrarily fixed** by the government and they may not be determined on the basis of ability to pay.
5. It is **elastic**. In case of any contingency, the government can increase revenue by raising direct taxes.	5. Burden of direct taxes **falls more heavily on the honest**. People/entities can deal in cash or manage their books in order to avoid direct taxes.
6. As it directly connects the taxpayer and the government, it helps in **development of a civic sense.**	6. High level of direct tax **disincentivizes investment and enterprise**. High direct taxes also incentivizes individuals and businesses to shift to low tax regime countries.

10.2.2. Indirect Tax

Indirect taxes are the taxes where the **impact** is on a person who can **shift** the burden of taxation so that the **incidence** is **on another person**. In common understanding, indirect taxes are those taxes which are levied on commodities and services which are paid by people through their consumption expenditure. Custom duties, sales tax, services tax, excise duties, etc. are indirect taxes as these taxes are levied on companies but ultimately paid by the customers who buy their products.

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Merits of Indirect Taxes	Demerit of Indirect taxes
1. Usually, they are paid in small amounts and at intervals instead of in one lump sum, and hence the burden of these taxes is **not felt** very much by the taxpayers.	1. Indirect taxes are generally **regressive** in nature as they fall more heavily upon the poor than the rich (same rate charged for rich and poor).
2. Indirect taxes can be **elastic**, i.e., the revenue from them can be increased, whenever the government may desire to do so, provided that these taxes are imposed on those articles for which the **demand is inelastic.**	2. Elasticity of indirect taxes depends on inelasticity of demand. Goods with **inelastic demand are essential goods** like toothpaste, soap, oil etc. which are used by both rich and poor (higher burden on poor).
3. Indirect taxes are generally **difficult to be evaded** as they are included in the price of the commodity.	3. The **administrative cost** of collecting such taxes is generally **heavy,** because they have to be collected from millions of individuals in small amounts.
4. Indirect taxes can be made **progressive** by imposing **heavy taxes on luxurious goods** and exempting articles of common consumption.	4. Indirect taxes **discourage savings,** because indirect taxes are included in price, and therefore people have to spend more on essential commodities. This leads to a diminished investment potential of the economy in the future.
5. Through indirect taxes **every member** of the community can be **taxed**. Thus, bonding everyone with the government.	5. The income from indirect taxes is said to be **uncertain,** because the taxing authority cannot accurately estimate the total yield from different taxes as the demand for different goods is influenced by so many factors.

Direct Tax	Indirect Tax
Incidence and impact of tax fall on the same person.	Incidence and Impact of tax fall on two different persons.
It is levied on the income. Eg – Income tax, Corporate tax etc.	It is levied on goods and services. Eg- GST etc.
It is progressive in nature as higher taxes are levied on persons earning higher income.	It is non-progressive in nature i.e., all persons (rich and poor) bear the same taxes on goods and services, irrespective of their capability to pay.

10.3. CLASSIFICATION OF TAXES BASED ON FAIRNESS

10.3.1. Proportional Tax

A Proportional tax is one in which the **rate of taxation remains constant** even as a tax base changes. The concept of proportional tax is shown in the following table

Tax Base	Tax Rate (constant)	Amount of Tax
Rs 10,000	10%	1000
Rs 20,000	10%	2000
Rs 30,000	10%	3000
Rs 40,000	10%	4000

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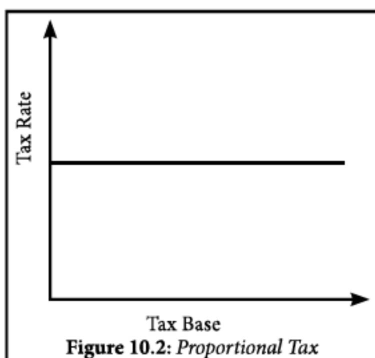

Figure 10.2: *Proportional Tax*

10.3.2. Progressive Tax:

A Progressive tax rate is one in which the **rate of taxation increases as the tax base increases.** In simple terms, the rich are taxed higher than the poor. The best example is the income tax slab based rates in India.

Tax Base	Tax Rate	Amount of Tax
Rs 10,000	10%	1000
Rs 20,000	15%	3000
Rs 30,000	25%	7500
Rs 40,000	40%	16000

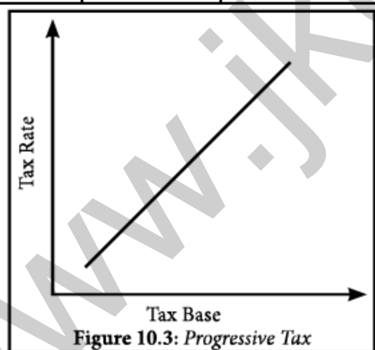

Figure 10.3: *Progressive Tax*

10.3.3. Regressive Tax

A Regressive tax is one in which the rate of taxation decreases as the tax base increases. This is the opposite of progressive taxation. Regressive taxes tend to reduce the tax burden of the people with a higher ability to pay. They shift the relative burden increasingly to those with a lower ability to pay. Such a model of taxation is usually used to promote growth in small scale industries to increase the size of industries. **Example**, the **Production Linked Incentive (PLI scheme)**, where the more you produce, the more rebate you get on taxes.

Tax Base	Tax Rate	Amount of Tax
Rs. 10, 000	10%	Rs. 1,000
Rs. 20,000	7%	Rs. 1,400
Rs. 30,000	5%	Rs. 1,500
Rs. 40,000	4%	Rs. 1,600

Figure 10.4: *Regressive Tax*

10.3.4 Degressive Tax

Degressive taxes are **mildly progressive** but are not very steep. On the basis of equity, these taxes are called degressive. In degressive taxation, a tax may be slowly progressive up to a certain limit, after that it may be changed at a flat rate.

Tax Base	Tax Rate	Amount of Tax
Rs. 10,000	10%	Rs. 1,000
Rs. 20,000	11 %	Rs. 2,200
Rs. 30,000	12%	Rs. 3,600
Rs. 40,000	13 %	Rs. 5,200
Rs. 50,000	13%	Rs. 6 ,500

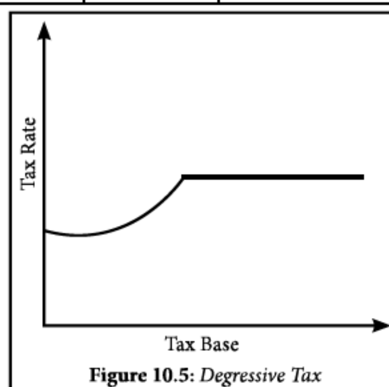

Figure 10.5: *Degressive Tax*

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10.4. CHARACTERISTICS OF A GOOD TAX SYSTEM

Adam Smith was the first economist who prescribed the general principle of taxation or rules of taxation. They are now considered as the characteristics of a good tax system. Adam Smith's canon of taxation includes.

1. **Canon of Equity:** This canon is based on the concept that rich people should pay more taxes than the poor. Hence, a tax system should contain progressive tax rates based on the taxpayer's ability to pay, bear burden of taxation and sacrifice.
2. **Canon of Certainty:** According to Adam Smith, "the tax which each individual is ought to pay has to be certain and without arbitrariness. The time, the manner and the amount to be paid must be clear to the contributor and to every other person". In other words, a more predictable tax system has better compliance.
3. **Canon of Convenience:** Tax should be collected in a convenient manner from the taxpayers so as to ensure more compliance. For example, it is easier to pay the tax when it is deducted at source; at the time of paying salaries rather than asking to pay separately.
4. **Canon of Economy:** This canon suggests that the administrative cost of tax collection should be minimum so that the tax system is efficient.

To these four canons, economists like **Bastable** have added a few more which are as under:

1. **Canon of Elasticity:** Taxation should be elastic in nature, in the sense that more revenue is automatically fetched when income of the people rises. This means that the taxation must have built-in flexibility.
2. **Canon of Productivity:** This implies that a tax must yield sufficient revenue and not adversely affect production in the economy.
3. **Canon of Simplicity**: This suggests that tax rates and tax systems ought to be simple and comprehensible. They should not be complex or beyond the understanding of the taxpayers.
4. **Canon of Expediency**: This suggests that a tax should be determined on the ground of its economic, social and political expediency. For instance, a tax on agricultural income is exempted because it may not be socially justifiable considering the already low wages of agri-laborers.

10.5. TAXATION IN INDIA

India has a well-developed three tier taxation structure based on three levels of government: central, state and the local government (such as panchayats and municipalities).

Constitutional Provisions Pertaining to Taxation in India	
Articles	**Provisions**
Art 265	It states that no tax shall be levied or collected except by the authority of law. It means, all the taxes that are being charged need to be backed by the law passed by parliament or state legislatures.
Article 246 (SCHEDULE VII)	It **distributes legislative powers including taxation** between the Parliament and the State Legislature. Schedule VII provides for the **three lists:** 1. List – I: It provides for areas on which only parliament is competent to make laws. 2. List – II: It provides for areas on which only a state legislature can make laws. 3. List – III: The areas on which both the Parliament and the State Legislature can make laws concurrently.
Article 246(1)	Parliament has exclusive powers to make laws with respect to any of matters enumerated in List-I of Seventh Schedule

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Article 246(3)	It provides that the State Governments has exclusive powers to make laws for the State with respect to any matter enumerated in List-II of Seventh Schedule of Constitution (i.e., State List).
Article 246 A	1. Parliament and the legislature of every state have power to make laws with respect to goods and services tax imposed by the union or by such state. 2 Parliament has exclusive power to make laws with respect to goods and services tax where the supply of goods or services takes place in the course of inter-State trade or commerce.
Article 248	It mentions that the residual powers of Legislation are vested in the parliament. It means that Parliament has exclusive power to make any law with respect to any matter not enumerated in list II and III.

Important taxes within **Union jurisdiction**, as specified in List I of the Seventh Schedule of the Indian Constitution, include	Important taxes within **State jurisdiction**, as specified in List II of the Seventh Schedule of the Indian Constitution, include:
1. Income Tax other than agricultural income.	1. Land Revenue
2. Duties of customs including export duties.	2. Taxes on Agricultural Income
3. Corporation Tax.	3. Taxes on lands and buildings
4. Estate duty in respect of property other than agricultural land.	4. Taxation on the Consumption of Sale of electricity
5. Taxes other than stamp duties on transactions in stock exchanges and future markets.	5. Tolls
6. Taxes on the sale or purchase of newspapers and on advertisements published therein.	6. Taxes on luxuries: on entertainments, amusements, betting and gambling
7. Taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.	7. Stamp Duty
8. All residuary types of taxes are not listed in any of the three lists of Seventh Schedule of Indian Constitution.	8. Taxes on vehicles suitable for use on roads

The 73rd and 74th constitutional amendment acts have provided **enabling provision** for panchayats and municipalities to levy taxes. As per discretion of a state, it may by law authorize a Panchayat (or Municipality) to levy, collect and appropriate taxes, duties, tolls etc.

Few important Taxes in India	
Direct Tax	Indirect Tax
Income tax Corporate Tax Capital Gain tax Wealth Tax	Custom Duty Stamp Duty GST Central GST State GST Integrated GST

10.6. IMPORTANT DIRECT TAXES IN INDIA

10.6.1. Income Tax:

Under the schedule VII of the Constitution of India, the Union Government has the power to levy a tax on **any income other than agricultural income**. The government imposes a tax on taxable income of all persons in India who are individuals, Hindu Undivided Families (HUF's), companies, firms, LLP, association of persons, body of individuals, local authority and any other artificial juridical person.

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Income slabs	General category (non-senior citizens)	Senior citizens (60 and above years of age, but below 80 years)	Very senior citizens (80 years and above of age)	Alternative/ simplified tax Regime
0 to Rs. 2.5 L	Nil	Nil	Nil	Nil
2.5L to 3.0 L	5%	Nil	Nil	5%
3.0L to 5.0L	5%	5%	Nil	5%
5.0L to 7.5L	20%	20%	20%	10%
7.5L to 10L	20%	20%	20%	15%
10L to 12.5L	30%	30%	30%	20%
12.5L to 15.0L	30%	30%	30%	25%
Above 15L	30%	30%	30%	30%

10.6.1.1. Income Tax Slabs

Income tax slab refers to the **different income brackets** on which **different rates of taxation** are charged to ensure **progressive** system of taxation. This means that people in higher income slabs are taxed more and those at the lower income slabs are taxed less or even given tax holidays. These tax slabs are changed as per discretion of the union government in the budget.

Individual taxpayers in India are categorized into 3 groups in India

1. Individuals below the age of 60 years (including residents as well as non-residents)
2. Resident Senior citizens above 60 years but less than 80 years of age.
3. Resident Super senior citizens above 80 years of age.

Alternate simplified tax slabs (introduced in budget 2020) is for those people who do not claim any exemptions. The latest Tax slabs as per Budget 2022-2023 is as follows:

Apart from above taxes, there are

1. Health and Education cess of 4% on all income tax.
2. Surcharge on super rich individuals earning over 50 lakhs annually.

10.6.1.1. Cess and Surcharge

A cess is a **tax on tax** levied by the **central government** for a **specific purpose**. Usually, cess is expected to be levied till the time the government gets enough money for that specific purpose. For example, a cess for financing primary education – the education cess is to be spent only for financing primary education and not for any other purposes.

Surcharge is an **additional charge** imposed on the tax already being levied. Generally, surcharge is levied for a **certain period of time**. Surcharge is not tied to any specific usage. For instance, surcharge is levied on super rich in India at following rate (as on March 2022):

Income	Rate
5L to 1 cr.	10%
1 cr. – 2 cr.	15%
2 cr. - 5 cr.	25%
Above 5cr.	37%

Comparison Between Tax, Cess and Surcharge		
Tax	**Surcharge**	**Cess**
Collections go into the Consolidated Fund of India directly	Collections go into the Consolidated Fund of India directly	Collections go into the Consolidated Fund of India directly
The collected fund can be used for any purpose.	The collected fund can be used for any purpose.	The collected fund can be used only for the specific purpose.

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Revenue is part of divisible pool and is shared by the Union government and the state government.	Not part of divisible pool; No such sharing.	Not part of divisible pool; No such sharing.
Taxes are mandatory contributions levied on individuals or corporations.	Surcharge is imposed on the tax payable or on the total value of service.	Usually, cess is calculated on the tax amount. But some cess like Krishi Kalyan cess, are calculated on the total value of service.

10.6.2. Corporate Tax

Corporate tax is a direct tax paid by the **companies** registered under Companies Act in India. It is **based on the net profit** that the company makes in a financial year. The rate at which the tax is imposed, as per the provisions of the Income Tax Act, 1961 is known as the Corporate Tax Rate. Both **domestic** as well as **foreign companies are taxed** in a country. A domestic company is taxed on its universal income, but a foreign company is only taxed on the income earned within India.

10.6.3. Wealth Tax

Wealth Tax is a direct tax based on the current market value of assets that one owns. As per the Indian tax laws, every individual and hindu undivided family (HUF) whose net wealth (assets less liabilities) exceed ₹ 30 lakhs were required to pay wealth tax. The wealth tax was **abolished from Union Budget 2016 – 2017**.

10.6.4. Minimum Alternate Tax (MAT)

MAT was introduced specifically to **target those companies** which **make huge profits but pay no/ minimal tax** by taking advantage (misusing) of the various deductions and exemptions allowed under the Income Tax Act. After its introduction, companies need to pay a **minimum fixed percentage of their profit as MAT**. MAT is payable under the Income Tax Act, 1961. MAT is applicable to all companies, public, private and foreign companies operating in India.

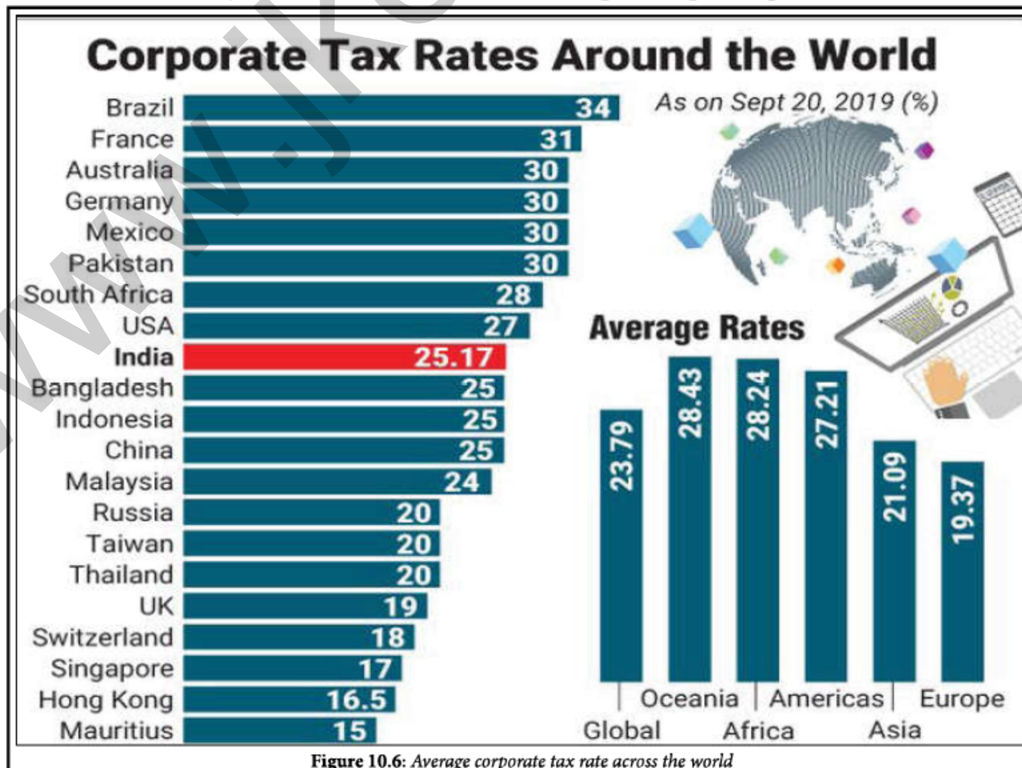

Figure 10.6: *Average corporate tax rate across the world*

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10.6.5. Dividend Distribution Tax (DDT)

DDT is a tax **levied on dividends distributed** by companies out of their profits among their **shareholders**. The DDT is taxable at source and is deducted at the time of the distribution. With effect from the assessment year 2021-22, a domestic company is not required to pay dividend distribution tax on any amount declared, distributed or paid by such company by way of dividend. Also, the dividend received from domestic company is now taxable in hands of the shareholders of the company.

10.6.6. Capital Gains Tax

Capital gains are the profit made over the **purchase and sale of a capital asset**. The gain is arrived at by reducing the purchase price from the sale price. The tax payable on such gain is termed as the Capital Gains Tax. The rate of tax on such gains depends whether the gains made are short term or long term.

Long Term Capital Gains Tax is the tax levied on capital assets owned for more than **36 months** (at the time of sale). However, the duration is 12 months for certain assets like: equity mutual funds, zero coupon bonds etc.

Short Term Capital Gains Tax is the tax on profits earned from capital assets that are held for 36 months or less. However, there are some exceptions to this segregation. For example, in case of land, building, house etc. properties the span is 24 months. Thus, if such assets are owned for a duration of 24 months, they would be treated as long term capital assets and taxed accordingly.

10.7. INDIRECT TAX IN INDIA

Perhaps the most important indirect tax in India is the Goods and Service Tax (GST). We will discuss GST in detail in Section 10.8. Other important indirect taxes in India are:

10.7.1. Custom Duty

Custom duty is an indirect tax applicable on **goods transported across international borders**. Hence, it can be divided into **Import Duty** and **Export Duty**. Custom duty is defined under the Customs Act, 1962. The Central Board of Excise & Customs (CBEC), a division of the Department of Revenue of the Ministry of Finance, administers the Custom duty. Import duties are not levied on a few goods including lifesaving drugs/equipment, fertilizers, food grains etc. to keep their cost at lowest possible level for the welfare of the people.

10.7.1.1. Types of Custom Duty

1. **Basic Custom Duty**: It is applicable on most imported goods. The custom duty rates may be standard or preferential as per the source of import (based on trade agreement with the source country).
2. **Countervailing Duty (CVD)**: CVD is an **additional customs duty** imposed on imported products **to neutralize unfair advantages** enjoyed by these products due to benefits like export subsidies and tax concessions in the country of their origin. This promotes a **level playing field** for the domestic industries. The **WTO permits** countervailing duties after the importing nation has conducted an in-depth investigation into the subsidized imports.
3. **Anti-dumping Duty**: It is a **protectionist tariff** that the domestic government imposes on foreign **imports** that it believes are **priced below fair market value**. It reduces the dumping of goods whose prices have been artificially lowered, into the domestic market.
4. **Safeguard duty**: It is a **temporary relief** provided when **imports** of a product **increase unexpectedly** and threaten the existence of domestic players of similar products. For example: India, from time to time, imposes safeguard duty on import of solar cells and modules from China, Thailand, Vietnam etc.

10.7.2. Central Excise Duty

Central Excise Duty is an indirect tax levied at union level on **goods manufactured in India**. It is a kind of indirect tax which a retailer or an intermediary collects from consumers and then pays to the government. After the introduction of the **GST regime** in India, the Central Excise Duty got **majorly subsumed** under it. However, it is still levied on some products like petroleum, etc. The

authority responsible for collection of central excise duty is the Central Board of Excise and Customs (CBEC).

Excise duty on alcohol, alcoholic preparations, and narcotic substances is collected by the state government and is called **"State Excise" duty.**

10.7.3. Sales Tax

Sales tax is a form of indirect tax imposed in the **sale and purchase of goods** within India. It is an indirect tax as the seller of the goods can recover sales tax from the purchaser. Sales tax is charged at **both the levels of government viz. state and union** (however collected by states). After the introduction of the **GST regime,** sales tax has been **subsumed** under it (except for some exemptions like alcohol etc.).

10.7.4. Service Tax

Service tax is a form of indirect tax charged by the government of India on **specific service transactions** carried out by the service provider. It is indirect in the sense that it is the final consumers (not the service provider) who had to pay the service tax. Service Tax was introduced under the Finance Act, 1994 and as of now has been **subsumed under the GST** regime.

10.7.5. Value Added Tax

Value-Added Tax (VAT) is a type of indirect **tax levied on goods and services for value added** at every point of production or distribution cycle, starting from raw materials and going all the way to the final retail purchase. Under VAT, the amount of value addition is first identified as each stage, and then tax is levied on the same. The end consumer has to pay the complete VAT while the buyers at earlier stages of production receive reimbursements of tax they had paid (Input Tax Credit). **Similar to sales tax, each state has its own VAT laws** for proper implementation and levying. VAT has been as of now **subsumed** under the ambit of **GST**.

10.8 GOODS AND SERVICES TAX (GST)

Goods and Services Tax is an **umbrella indirect, multi-stage, destination-based/consumption-based tax levied on every value addition**. Through GST, most of the indirect taxes imposed by the center and the states have been clubbed into one single tax to create **'one country and one Indirect tax'**. In GST, the tax is levied at the point of sale. In case of intra-state sales, both Central GST (CGST) and State GST (SGST) are charged on goods and services. Tax on Inter-state sales is charged under Integrated GST (IGST).

Earlier, multiple taxes on goods and services created a **complex and confusing** tax structure that led to higher cost and **inefficiencies**. **Single tax system** is **easy** to understand for taxpayers as well as for administrators. It has resulted in **better tax compliance, broadened the tax base** and **promoted formalization** of the economy.

GST came into effect by the **101st constitutional amendment Act** 2016 and has been implemented from 1st July, 2017.

10.8.1. Products which are not under GST

The following product types and related taxes are not covered under GST:

1. **Alcoholic beverages** for human consumption
2. The full range of **petroleum products,** including crude oil and motor spirits

Articles	Provision related to GST in the Constitution
Article 269 A	Central, State and Integrated GST have been defined. It also discusses how the revenue is shared between Centre and the States.
Article 246 A	(1) Parliament and the legislature of every state have power to make laws with respect to goods and services tax imposed by the Union or by such State. (2) Parliament has exclusive power to make laws with respect to goods and services tax where the supply of goods or services takes place in the course of inter-State trade or commerce.
Article 279-A	Provides for the establishment of GST council

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Taxes that were Subsumed Under GST	
State Tax	**Central Tax**
1. State Value Added Tax/Sales Tax 2. Entertainment Tax (Other than the tax levied by the local bodies) 3. Octroi and Entry Tax 4. Purchase Tax 5. Luxury Tax 6. Taxes on lottery, betting, and gambling.	1. Central Excise Duty 2. Additional Excise Duty 3. Service Tax 4. Additional Customs Duty (Countervailing Duty) 5. Special Additional Duty of Customs

including aviation turbine fuel (ATF) and high-speed diesel (HSD).

3. **Electricity**

VAT on petroleum products contributes to nearly 33 percent of state revenues and Centre also earns significant excise duty income on the generation of petroleum products from crude oil. In many states, the revenue from state excise taxes imposed on alcohol brings in 25 percent of total revenue. These are large sources of state revenue, so were not included in the GST regime initially.

10.8.2. Key Concepts of GST

"GST is a comprehensive, **multi-stage, destination-based tax** levied on every **value addition**". These key terms are discussed below:

1. **Multi Stage**

There are **multiple change-of-hands** an item goes through along its **supply chain** from manufacturer to final sale to the consumer. Let us consider the following case:

a. Purchase of raw materials
b. Production or manufacture
c. Warehousing of finished goods
d. Sale to wholesaler
e. Sale of the product to the retailer
f. Sale to the end consumer

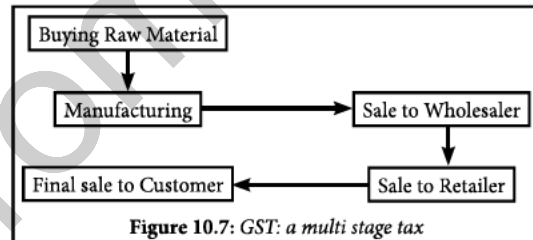

Figure 10.7: *GST: a multi stage tax*

2. **Value Addition**

GST is **levied on the value additions** i.e., the monetary worth added at each stage to achieve the final sale to the end customer.

Refer table 'GST levied on Value Addition' Understanding the cascading effect and how GST, a value added tax, can reduce cascading effect.

Note: Even though the tax collected decreases in GST, it ensures every producer comes into the tax net so that producers can claim the input tax credit. This increases the formalization and thereby the total revenue.

3. **Destination Based**

Destination based means that it is imposed on **final consumption**. Consider a product

'GST levied on Value Addition'			
Stage of Value Addition	**Cost**	**Taxation (specific type) @10%**	**Taxation (value added) (GST) @10%**
Wheat milled 1 Kg	50	5	5
Wheat made into bread	100	10	5 (value addition was Rs. 50)
Bread made into Sandwich	200	20	10 (Value addition of Rs. 10)
Total tax collected		₹35	₹20

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manufactured in Maharashtra and sold to the final consumer in Karnataka. Since Goods & Service Tax is levied at the point of consumption, in this case, Karnataka, the entire tax revenue will go to Karnataka, and not Maharashtra.

10.8.3. Components of GST

There are 3 taxes applicable under this system: Central GST, State GST & Integrated GST.

1. **CGST:** Collected by the Central Government on an intra-state sale (Eg: transaction happening within Maharashtra)
2. **SGST:** Collected by the State Government on an intra-state sale (Eg: transaction happening within Maharashtra)
3. **IGST:** Collected by the Central Government for inter-state sale (Eg: Maharashtra to Tamil Nadu)

10.8.4. Tax Structure after GST

There is a **dual GST** with center and state simultaneously levying equal tax on common base. CGST is levied by the center and SGST is levied by the state (UGST is levied by Union territory). IGST is levied on inter-state sale of goods and services. Import of goods or services is treated as inter-state supplies and is subject to Integrated Goods & Services Tax (IGST) in addition to the applicable customs duties.

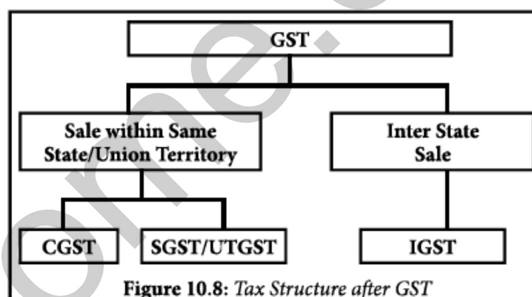

Figure 10.8: *Tax Structure after GST*

Transaction	New Regime	Old Regime	Revenue Sharing
Sale within the State	CGST + SGST	VAT+ Central Excise or Service Tax	Revenue is shared equally between the Centre and the State. **Example:** Consider that a businessman A from Maharashtra had sold goods to B in Maharashtra. The GST rate is 18% comprising of CGST rate of 9% and SGST rate of 9%. In such case, the dealer collects Rs. 1800 of which Rs. 900 will go to the Central Government and Rs. 900 will go to the Maharashtra Government.
Sale to another State	IGST	Central Sales Tax + Excise or Service Tax	There is only one type of tax (central) in case of the inter- state sales. The Center will then share the IGST revenue based on the destination of goods. IGST ensures that the SGST component accrues to the destination/consuming State although the tax is paid in the originating State. **Example:** Consider that a businessman A from Maharashtra had sold goods worth Rs. 1, 00,000 to B in UP. The GST rate is 18%, referring to 18% IGST. In such a case, the dealer has to charge Rs. 18,000 as IGST. This IGST will go to the Centre.

10.8.5. Benefits of GST

The benefits of the GST are discussed below

For Business and Industry	1. A robust and comprehensive IT system providing online services such as registrations, returns, payments, etc. makes compliance easy, cheaper and transparent. 2. GST increases certainty and ease of doing business. GST makes doing business in the country tax neutral, irrespective of the choice of place of doing business.

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	3. A system of seamless tax-credits throughout the value-chain and across boundaries of States, ensures that there is minimal cascading of taxes. This reduces hidden costs of doing business. 4. Reduction in transaction costs and improved ease of doing business improves competitiveness of domestically produced goods in the international market. Thus, businesses gain new markets.
For Government	1. GST is simple and easy to administer. It creates a unified common market for India. GST has a better control on leakage. 2. GST streamlines the taxation process through harmonization of laws, procedures and rates of tax between Centre and States and across States. 3. Uniform SGST and IGST discourages tax evasion by eliminating rate arbitrage between neighboring States. 4. GST has helped in expanding the tax base and enhancing the taxpayer's confidence. This has helped in making tax buoyant. 5. GST has also promoted regularization in the unorganized sector.
For consumer	1. It brings down the total tax burden consequently reducing the prices of goods and services. 2. It benefits the common man as a good number of products and services of common use are exempt from tax or are charged at 5% or less. 3. GST has ensured a uniform price rate throughout the country. 4. It has made interstate movement of goods and services easier by eliminating taxes like Octroi duty etc.

10.8.6. Tax Slab under GST

Goods and services are divided into **five tax slabs** for collection of tax - 0%, 5%, 12%, 18% and 28%. However, petroleum products, alcoholic drinks, and electricity are not taxed under GST (they are taxed separately by the individual state governments, as per the previous tax regime). The GST rate slabs are **decided by the GST Council**.

HSN Code

HSN (Harmonized System of Nomenclature) is a code used for **systematic classification of goods all over the world**. HSN Code (also known as HS code) was developed by World Customs Organization (WCO). In India, HSN Code has 6 or 8-digit uniform codes that classify more than 5000 products and are accepted worldwide. It is also used for identifying the applicable rate of GST on different products. Manufacturers, importers and exporters in India have been using this system for a long time.

10.8.7. E-way bill

E-way bill is an **electronic document** that contains **details about movement of goods** and has to be carried by transporters for any consignment above **Rs. 50000**. It can be generated from the **Goods and Services Tax Network (GSTN)**. Its validity varies depending on the distance that the goods have to travel. Goods that are moved inside a state need no e-way bill if the distance is up to 10 km. The limit has now been increased to 50 km.

Some goods that are out of the e-way bill's ambit include perishable items such as meat, milk and milk products and fruits and vegetables. Other items that don't need an e-way bill are gold and silver jewelry, cooking gas cylinders, raw silk, wool and handlooms. It ensures **minimal physical interaction** with the concerned departments and **hassle-free movement** of goods within and outside a state.

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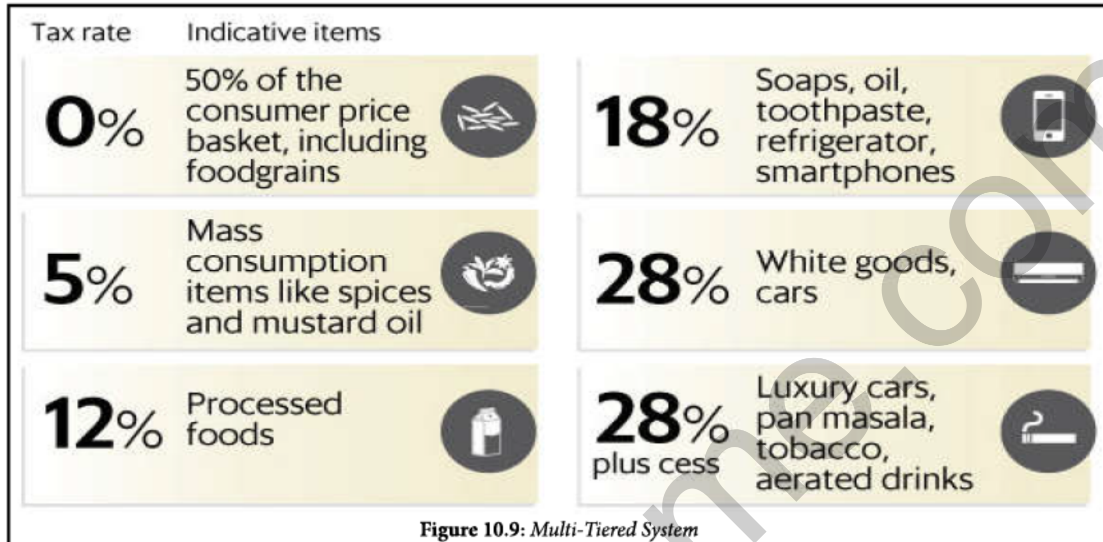

Figure 10.9: *Multi-Tiered System*

10.8.9. GST Network

The GST Network (GSTN) is a non-profit **organization** established to **manage the entire IT system** of the GST portal. GST portal is used by the government to track every financial transaction and provides taxpayers with all services from registration to filing taxes and maintaining all tax details. Initially, in GSTN, Central Government held 24.5% of shares, state governments held 24.5% of shares and the remaining 51% were held by non-government financial institutions. However, later it was made a wholly owned government company having equal shares of state and central government.

10.8.10. National Anti-Profiteering Authority

Profiteering means **unfair profit** realized by traders by manipulating prices and adjusting tax rate. In the context of the Goods and Services Tax (GST), profiteering means that traders are **not passing on the benefits of tax rationalization to customers** i.e., traders are not reducing the prices of the commodities when the GST Council has reduced the tax rates of commodities and services.

The NAA has been constituted under Section 171 of the Central GST Act, 2017. NAA's main function is to ensure that traders are not realizing unfair profit by charging high prices from the consumers in the name of GST and passing on the benefits to the customers. The responsibility of the NAA is to **examine and check profiteering activities and recommend punitive actions** including cancellation of licenses.

NAA comprises of a chairman and four technical members. NAA works with a standing committee, screening committees in every state and the Directorate General of Anti-Profiteering in the Central Board of Indirect taxes & Customs (CBIC). The orders of the NAA can be appealed against only in the high court.

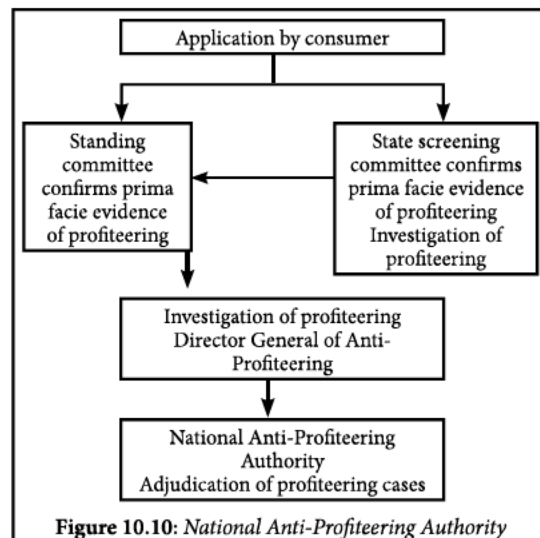

Figure 10.10: *National Anti-Profiteering Authority*

10.8.11. GST Council

Goods & Services Tax (GST) Council is a constitutional body created under Article 279-A (inserted through 101 Constitution Amendment Act). The GST council **makes recommendations** to the Union and State Governments **on issues related to Goods and Service Tax,** such as the goods and services that may be subjected or exempted from GST, model GST laws etc. As per Article 279A (1) of the constitution, the GST Council was constituted by the President. The council consists of the **Union Finance Minister (as the Chairperson),** the Union Minister of State in-charge of revenue or finance, and the Minister in-charge of finance or taxation or any other Minister nominated by each State Government. Secretary (Revenue) acts as the ex-officio secretary to the GST council.

10.8.10.1. Quorum and Decision-Making

For a valid meeting of the GST Council**, at least 50 % of the total number** of the members should be present. Every Decision made during the meeting should be supported by at least **75 percent of the majority of the weighted votes of the members who are present and voting** at the meeting. The votes of Central Government have the weightage of one third of the total votes. The votes of State Government have the weightage of two thirds of the total votes cast in the meeting.

10.8.11. GST Compensation

As per the GST (Compensation to States) Act, 2017, states are **guaranteed compensation for revenue loss** on account of implementation of GST for a transition period of **five years** (July 2017 - June2022). The compensation is calculated based on the difference between the current GST revenue of states and the protected revenue estimated at an annualized **14% growth rate from the base year of 2015-16**. Any shortfall has to be compensated from the receipts of compensation cess imposed on selected commodities that attract a GST of 28 percent. At present, the cess levied on sin and luxury goods, such as tobacco, pan masala, aerated water, certain automobiles etc., flow into the **compensation fund**.

States are **demanding** continuation of GST compensation for states **beyond June 2022.** Pandemic caused a slowdown in economic activities, resulting in reduced GST collections. Further, expenses of states increased on account of more expenditure on health, income support for vulnerable sections and other subsidies during the pandemic. There were also instances of delay in payment of compensation from center to state. According to Ministry of Finance, as of April 2022, compensation of ₹ 78,704 crore was pending for the year 2021-22 due 'inadequate balance' in the compensation cess collections fund. All this has put stress on the state's finances. However, no decision has been taken on extension of GST compensation (till April 2022).

To pay GST compensation to the states in order to secure their protected revenue, central government took loans. GST council has decided to **continue levying compensation cess for an extended period up to March 2026.** It will enable the Centre **to repay the loans** taken to compensate states for GST collection shortfalls during FY21 and any shortfall arising in FY22.

10.8.12. Composition Scheme

Composition scheme is an alternative method of tax levy under GST designed to **simplify compliance** and reduce compliance costs for **small taxpayers**. The business or person who has opted to pay tax under this scheme can **pay tax at a flat percentage of turnover** every quarter, instead of paying tax at normal rate every month. To be eligible for the composition scheme, the registered taxpayer must provide a declaration on the GST portal before the beginning of each financial year. Businesses with **annual turnover up to Rs. 1.5 crore** can opt for this scheme. Further, businesses with inter-state supplies, manufactures of ice cream, pan masala, tobacco, and e-commerce players cannot opt for the composition scheme.

10.9. TAX-GDP RATIO

Tax to gross domestic product (GDP) ratio shows the **tax revenue as a proportion/percentage of a country's GDP**. It represents a government's **ability to finance its own expenditure** without relying on borrowings. A **higher tax to GDP ratio** means that the government is able to cast its fiscal net wide and that the economy's tax buoyancy is

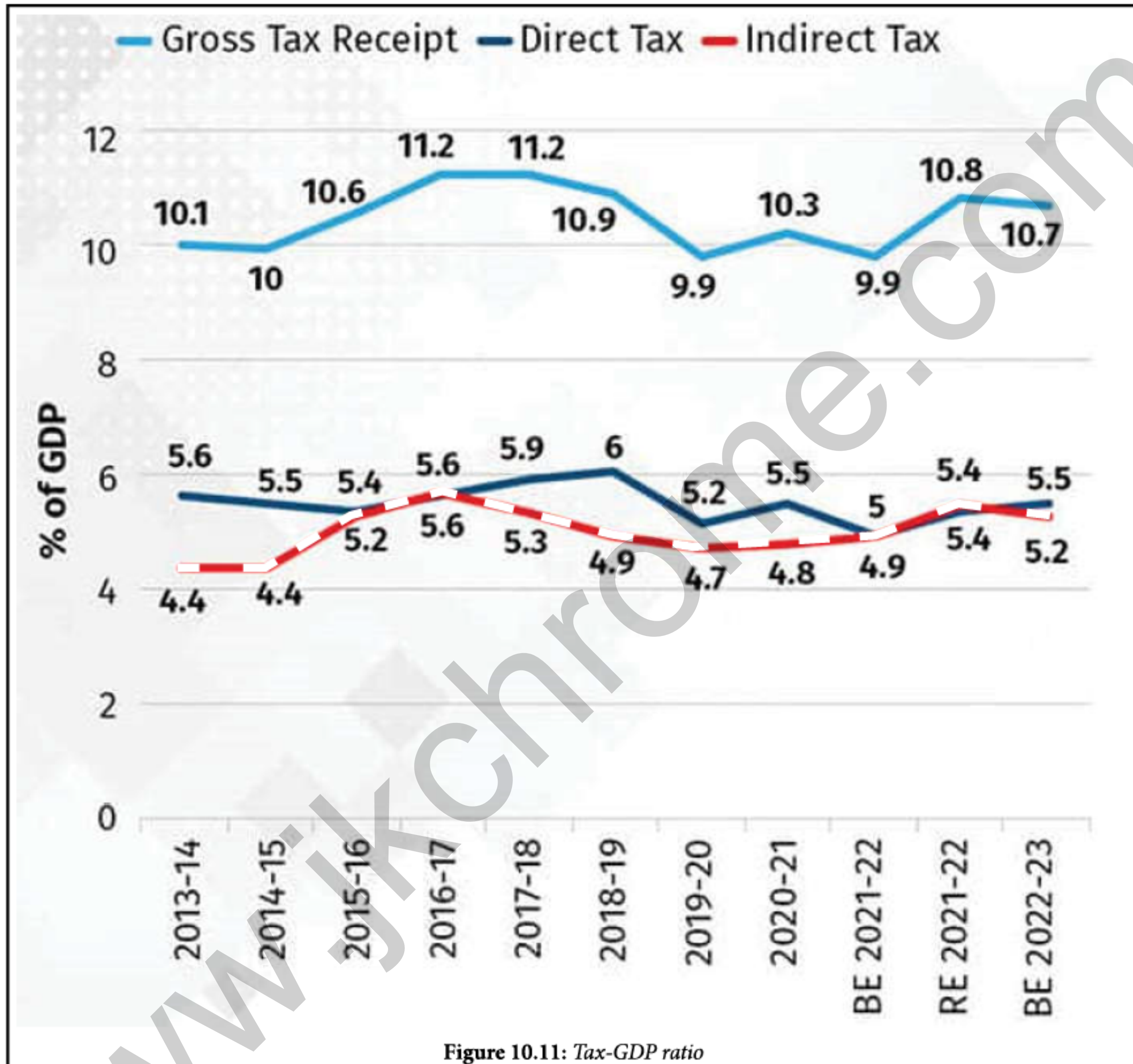

Figure 10.11: *Tax-GDP ratio*

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strong as the share of tax revenue rises in sync with the rise in the country's GDP. On the other hand, **lower tax-to-GDP ratio** constrains the government spending on infrastructure and puts pressure on the government to meet its fiscal deficit targets.

India's Tax to GDP ratio has hovered around **10-11%**. It is far lower than the average OECD ratio, which is 34 per cent. India's tax-to-GDP ratio is lower than some of its peers in the developing world. Despite seeing higher growth rates, India has struggled to widen the tax base. **Low formalization, large number of exemptions, low per capita income and high tax evasion** has been cited as reasons for low Tax to GDP ratio in India.

10.9.1. Income Tax Payment in India: Case Study

1. During the 2019-20 financial year, 5.78 crore individuals filed returns disclosing income of financial year 2018-19.
2. Out of these, 1.03 crore individuals showed income below Rs 2.5 lakhs & 3.29 crore individuals disclosed taxable income between Rs.2.5 lakh to Rs.5 lakh.
3. Out of 5.78 crore returns filed during this financial year, 4.32 crore individuals disclosed income up to Rs 5 lakh.

4. The Finance Act, 2019 exempted individual taxpayers having income up to Rs 5 lakh from paying income tax. Therefore, 4.32 crore individual taxpayers, having income up to Rs 5 lakh, were not liable to pay tax.
5. Hence, only around 1.46 crore individual taxpayers were liable to pay income-tax.
6. Further, around 1 crore individuals disclosed income between Rs. 5-10 lakh and only 46 lakh individual taxpayers have disclosed income above Rs.10 lakh.

10.10. Reforms In Tax Administration

1. Faceless Assessment Scheme 2020

Faceless Assessment Scheme is based on the idea that **automated random allocation of cases** across Income Tax teams with dynamic jurisdiction and **elimination of face-to-face contact** between the income-tax authorities and the taxpayer can lead to an **efficient, non-discretionary, unbiased single window system of assessment**. It establishes a **National Faceless Assessment Centre (NFAC)** in Delhi, headed by Principal Chief Commissioner of Income Tax, as the sole point of contact between the Income Tax department and the taxpayer. All notices or communications to and from the taxpayer, and internal communications related to assessment process within the department are routed through the NFAC.

2. Taxpayers' Charter

Taxpayers charter is a set of written **commitments** by the Income Tax **department** and **obligations** of the **taxpayers**. Taxpayers Charter is for building trust between the taxpayer and the income tax department. The Charter seeks to bring in transparency in the department and at the same time ensure tax compliance from taxpayers.

3. Aadhaar – PAN linkage

Linking of the Aadhaar number with the PAN card is part of the government drive against black money. It is also part of the Digital India initiative in which all government records are to be digitized.

4. Project Insight

Project Insight, launched in 2017, is an income tax department initiative to **monitor high value transactions** in order to **track tax evasion**. To implement the project, the government signed a contract with Information Technology major L&T InfoTech Ltd. The project added to the list of efforts made by government to curb black money like Operation Clean Money (e-platform to analyse large cash deposits made during the demonetization window - 9 November to 30 December 2016).

5. Refining Tax Structure

A simplified tax structure has **optimum** number of tax **slabs** and tax **rates**, minimum **concessions** and deductions, broad tax **base** etc. This **encourages tax compliance** and leaves low scope for tax avoidance or evasion. Government efforts towards this direction are:

a. New simplified regime for Income tax payment.
b. Steps to bring down effective corporation tax to 25% by eliminating concessions and deductions.
c. GST to replace a large number of state and union level indirect taxes.
d. Withdrawal of retrospective taxation amendment in IT act (made in 2012) to create an investor friendly tax ecosystem.

10.11. MISCELLANEOUS

10.11.1. Tax Evasion and Tax avoidance:

When a person/entity **deliberately does not pay** his/its true tax liability, it is termed as tax **evasion**. Tax evasion is **illegal**. On the other hand, tax **avoidance** is the use of **legal methods** to **minimize** the amount of tax owed by an individual or a business to the government.

10.11.2. Black Money:

Black money is an amount/ income that is **not disclosed to the tax authority**. It can be generated from legal as well as illegal activities.

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Steps taken by Government to curb Black money in India

1. **Prevention of Money Laundering Act (2002):** It was enacted for the purposes of preventing the offence of money laundering and the confiscation of property derived from the proceeds of such offence. Under the PMLA Act, the Enforcement Directorate is empowered to conduct a Money Laundering investigation.
2. **Benami Transactions (Prohibition) Amendment Act (2016):** The word benami transaction refers to any transaction made by a person without using his name or by employing the name of a third person. Benami transactions have the motive of disguising the real ownership for the purposes of tax avoidance, parking unaccounted money etc. The Benami Transaction (Prohibition) Act, 1988 was introduced to prohibit benami transactions and to recover property held as benami. However, the rules, regulations and procedures for the implementation of the law could not be framed, rendering it ineffective. Also, it lacked the provision for confiscation of property. To plug in the loopholes the government enacted the Benami Transaction (Prohibition) Amendment Act, 2016
3. **Undisclosed foreign Income and Asset (Imposition of Tax) Act, 2015:** The Act gave a one-time opportunity to Indian residents to declare undisclosed foreign income and assets. The only requirement was to pay tax at a rate of 30 % along with a penalty of 30% on the declared foreign income or assets. In case of non-declaration, the provisions included slapping of tax at the rate of 30% along with a penalty equal to three times the amount of tax evaded or 90% of the undisclosed income or the value of the asset. The Act provides for punishment of jail for 3-10 years for the willful evasion.
4. **Income declaration Scheme 2016:** It was launched to give an opportunity to people with unaccounted income or assets to come clean by paying 45% tax on such wealth.

10.11.3.Digital Service Tax

Digital service taxes (DSTs) are taxes **imposed on multinational firms based on their digital activities** in a particular jurisdiction. The central government in its Finance Bill of 2020-21, imposed a 2% digital service tax on trade and services by **non-resident e-commerce operators** with a turnover of over 20 million rupees or more. DST expanded the scope of equalization levy (introduced in 2016) that only applied to digital advertising services. Austria, Italy, Spain, Turkey, UK etc., too have adopted a digital services tax regime apart from India. The US has objected to digital services taxes stating that they are against tech companies like Apple, Amazon, Google and Facebook.

10.11.4. Transfer Pricing and Advance Pricing Agreement

Transfer Pricing and Advance Pricing Agreement: Transfer pricing is a **practice of accounting** and taxation in cases where **goods or services are sold/bought between related legal entities** (may be situated in different countries) within an enterprise. It ensures that the transaction between 'related' parties is at a price that would be comparable if the transaction was occurring between unrelated parties.

Advance Pricing Agreement is an **agreement** between a **taxpayer and tax authority** to **determine** the transfer pricing **methodology** for accounting international transactions between related parties in future. The agreement helps in removing uncertainty and addressing complex transfer pricing issues in a fair and transparent manner.

10.11.5.Double Taxation Avoidance Agreement (DTAA)

Double taxation is a situation where **income** generated from a single transaction is **taxed in more than one jurisdiction**. To address the issue of double taxation and encourage investment, countries sign DTAA among themselves. Though

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signed with good intentions, DTAA can create three interrelated problems: **Treaty shopping, Round tripping and BEPS (Base erosion and profit shifting)**.

10.11.6. Treaty Shopping, Round Tripping and BEPS (Base Erosion and Profit Shifting)

Treaty shopping is a situation where a person attempts to indirectly **access the benefits** of a tax agreement between two jurisdictions **without being a resident of one of those jurisdictions**. For example: A person (P) in country X wants to invest in India. India and X do not have any tax treaty. Instead of directly investing in India, P starts a company in country Y, and then he invests in India though this company. India and Y have a tax treaty. Thus, P can take advantage of tax treaty between India and Y without being a resident of either Y and India.

Round-tripping refers to a series of transactions that involve **circulation of money across jurisdictions** culminating in its **return to the jurisdiction of origin**, usually as a foreign investment. Round tripping financing generally includes transactions that do **not have substantial commercial purpose** other than obtaining tax benefit, engaging in money laundering etc. Round tripping, from RBI perspective, is a situation where one is investing in an overseas company that has an investment or holding in an Indian company. For example, If an Indian firm creates a shell firm (where no production is taking place) in country Y and invests its money through this shell firm in Indian shares, this is called round tripping. Here, the money originated in India and is invested in India through a foreign channel to avoid tax.

BEPS is a **tax avoidance strategy used by multinational corporations** where they shift their profits earned in one country to another country with a low rate of taxation. It effectively means that MNCs do business in one country, earn profit there but pay taxes in another country that has a low tax regime.

10.11.7.GAAR (General Anti Avoidance Rules)

GAAR is an anti-tax avoidance law under the Income Tax Act, 1961 of India. GAAR was introduced in India through Finance Act, 2012 (applicable from assessment year 2018-19). GAAR is specifically aimed at cutting revenue losses that happen to the government due to aggressive tax avoidance measures practiced by companies. GAAR is based on the **doctrine of 'substance over form'** in which the real **intention of parties** is seen when they enter into an agreement. As per the provision of IT Act, GAAR would apply to an arrangement entered into by the taxpayer which may be declared to be an **impermissible avoidance arrangement** (IAA). For an arrangement to be declared as IAA, it should follow certain conditions such as: (a) The main purpose of entering into such arrangement is to obtain tax benefit, (b) It results into misuse of the provisions of IT Act or creates rights/obligations which are not ordinarily created between person's dealing at Arm's Length Price, (c) the transaction is not carried out in a bona-fide manner etc. Under the GAAR, the onus is on the government to declare an arrangement as IAA. If the revenue authority considers that the arrangement is an IAA, the assessee will be given an opportunity to be heard.

Other Steps taken by Government to curb Tax Avoidance

1. **Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI")**: It seeks to implement a series of tax treaty reforms to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises. It came into force in 2018. India has signed the convention.
2. India has also signed the Inter-Government Agreement (IGA) on **Foreign Account Tax Compliance Act** (FATCA) with the United States.
3. **Automatic exchange of Information:** It is an arrangement for exchange of information between countries **without having to request it**. It can reduce global tax evasion. It is to be carried out under the Common Reporting Standard (CRS) of OECD.

India has become a signatory of the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information in 2015.

4. India introduced core elements of the **Country-by-Country reporting requirement** in the Indian Income Tax Act, 1961 through Finance Act 2016, effective from 1 April 2016.
5. **Place of effective management (POEM) regulation**: In 2017, Central Board of Direct Taxation issued guidelines for determination of POEM. POEM is a place where **key management and commercial decisions are made**. It is a **measure against shell companies** that carry artificial transactions to park funds on tax free jurisdictions.

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11 CHAPTER
Banking System in India

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11.1. INTRODUCTION

A bank is a financial institution which is licensed by the regulator (like Reserve Bank of India) to accept deposits and extend loans. As financial intermediaries, banks act as important drivers of economic development. Banks encourage people to save. Through the coordinating function between savings and investments, banks help the process of capital formation and credit growth. It also introduces people to various financial products like insurance and helps in financial inclusion. Financial inclusion refers to making financial products and services accessible and affordable to all individuals and businesses, regardless of their position in socio-economic strata.

11.2. FUNCTIONS OF BANKS

Banks, being the financial institutions, perform different types of functions that can be classified into two main categories:

11.2.1. Primary Functions

1. **Accepting Deposits:** The commercial banks are mainly dependent on public deposits. There are two types of deposits/accounts i.e., **demand deposit and time deposit. Demand deposit** refers to those deposits from which an amount can be withdrawn anytime by writing a withdrawal slip or a cheque at the bank counter or from ATM centers using debit cards. For example, savings account, current account. Demand deposit accounts pay little or no interest, as a trade-off for the funds being so readily available. **Time Deposit** refers to those deposits that are made for a certain committed period of time. For example, Fixed Deposits. The money deposited under this account cannot be normally withdrawn before the expiry of the agreed period. The rate of interest offered under time deposits is higher than what is offered under demand deposits.

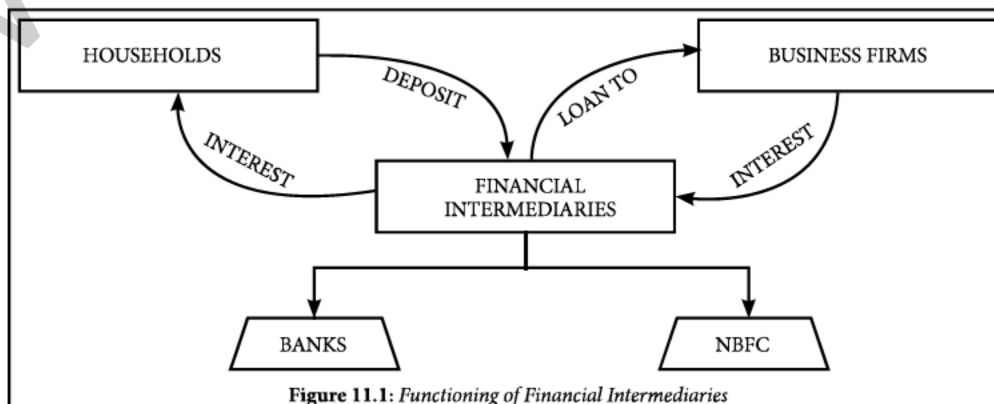

Figure 11.1: *Functioning of Financial Intermediaries*

2. **Advancing loans:** A bank lends a certain percentage of cash lying in deposits to the borrowers as loans. It extends loan at a higher interest rate than what it pays to its depositors (for keeping their money with the banks). The difference between the interest rate charged from the borrowers and that paid to the depositors is called bank spread. Cash Credit, Call Loans, overdraft etc., are some ways in which a bank extends a loan.
3. **Credit creation**: The creation of credit is one of the most important primary functions of the banks. The banks perform this function by advancing loans and purchasing securities. A bank actually does not provide cash directly for a loan; rather, it opens a deposit account from where the borrower can withdraw and pay the money later. This account will be used to create another credit in future. In simple terms, while creating a loan a bank automatically creates the deposits first (which in turn will help in creating credit).

11.2.2. Secondary Functions

The secondary functions of a bank can be divided into banking agency functions and general utility functions.

1. **Banking Agency Functions:** Commercial banks act as agents of customers by performing various functions such as collecting and clearing cheques and dividends, acting as trusty, attorney, correspondent and executor, making the payments of various obligations of customers, such as telephone bills, accepting tax proceeds and tax returns, etc.
2. **General Utility Functions:** Commercial banks provide some utility services such as providing a money transfer facility, accepting payments for various bills e.g., phone bills, gas bills, water bills, providing merchant banking facilities for investing in stock market, Providing Locker Facilities etc.

In the initial days most banks used to serve rich families and industrial houses and this narrowed the growth of the banking system (thin deposit rates as there were very few customers). The poor and marginalized were not been adequately served by the banks, as the banks were driven by the sole motive of maximizing profits. So, to promote rapid growth in various sectors like agriculture, small industries and to develop all backward areas, the banks were nationalized during the Prime Ministerial tenure of Mrs. Indira Gandhi. Under the Banking nationalization Act (1969), 14 banks were nationalized and another 6 banks were nationalized in 1980.

From 1993-94 onwards, we can see a policy reversal, where Public Sector Banks are being liberalized and role of private banks started

Brief History of Indian Banking

Year	Banks	
1770	First bank of India as Bank of Hindustan (Under British rule)	
1806	Bank of Bengal	All 3 were called presidential Banks.
1840	Bank of Bombay	
1843	Bank of Madras	
1921	The three presidency banks were merged into a new agency, called the Imperial Bank of India in 1921.	
1934	The Reserve Bank of India Act was enacted Reserve Bank of India was set up in 1935. During the period of **Great Depression** (1928 to 1934), a large number of **small banks failed** due to their loans going bad. To check the bank failures and to cater to the requirements of agriculture, the **Reserve Bank of India Act, 1934** was enacted and the Reserve Bank of India was set up in 1935.	
1955	The State Bank of India was formed in 1955, with nationalization of Imperial Bank of India.	

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increasing so as to build more efficient and bigger banks for supporting the growing India. The process of liberalization, privatization and globalization which began in 1991, led to increasing participation of the private sector in Indian banking. To this end, the HDFC bank was among the first financial institutions in India to receive an "in principle" approval from the Reserve Bank of India (RBI) to set up a bank in the private sector.

Banking Structure in India		
Commercial Banks		**Cooperative Banks**
1. Public sector banks 2. Private Banks 3. Foreign Banks	Universal Commercial Banks.	Rural/ Urban
4. Differentiated Banks: RRB, Small finance Bank, Payment Bank		

Difference between Scheduled Banks and Non Scheduled - Banks		
	Scheduled banks	**Non-Scheduled banks**
Definition	They are included in the Second schedule of the RBI Act, 1934.	Not included under the schedule of the RBI act, 1934.
Requirements	Minimum paid up capital and other norms to be followed as per RBI guidelines	Need not comply with RBI guidelines.
CRR	CRR to be maintained with RBI	CRR required but can maintain with themselves
Returns	All returns of the banks have to be submitted as specified by RBI	Not applicable
Membership of the clearing house	Automatically becomes a member	Cannot become a member
Borrowing from RBI	Can borrow	Cannot borrow
Examples	SBI, HDFC, ICICI etc.	Manipur State Cooperative Bank Ltd., Costal Local Area Bank Ltd. and various other local banks or small-scale banks

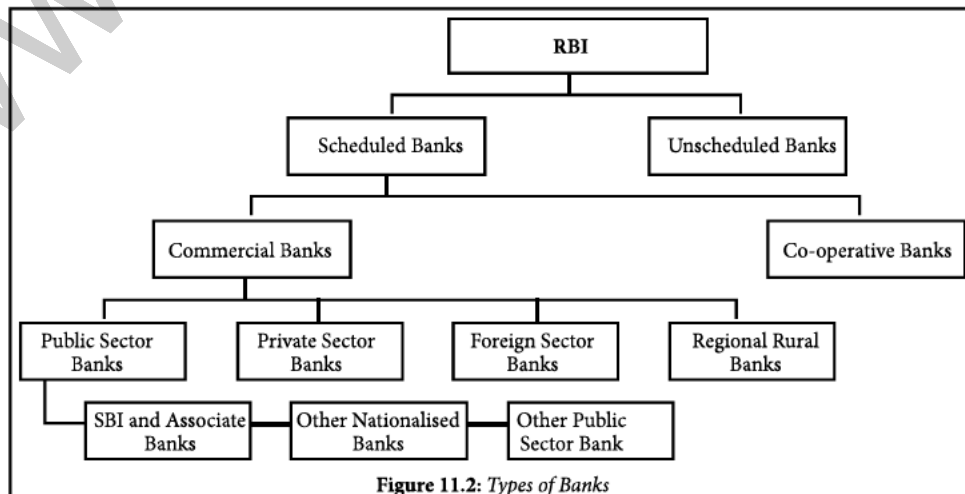

Figure 11.2: *Types of Banks*

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11.3. VARIOUS TYPES OF BANKS IN INDIA

11.3.1. Differentiated Banks and Universal Banks

RBI grants two kinds of banking licenses – Universal Bank License and Differentiated Bank License. **Differentiated Banks (niche banks)** are created to **serve the needs of particular segments** of the population. Small Finance Banks and Payment Banks are the examples of differentiated banks in India. Custodian Banks and Wholesale and Long-Term Finance banks (WLTF) are newly proposed differentiated banks as they are set to provide to the niche sector of long-term finance. Universal Banks are large banks that operate an extensive network of branches and provide many different services. ICICI is an example of a universal bank.

11.3.2. Commercial Banks

Commercial Banks are organized under the Banking Companies Act, 1956. Their main **objective is profit**. Commercial banks comprise the following:

11.3.2.1. Public Sector Banks

Public Sector Banks or PSBs are those banks where the direct holding of the Central/State Government or other PSBs is 51% or more.

11.3.2.2. Private Banks

The Narasimham Committee on Financial Sector Reforms in 1991 recommended the creation of private banks for bringing in more efficiency in the sector. Based on these recommendations, licenses were issued to 10 private banks. In 2001, RBI again issued new rules for the licensing of new banks in the private sector based on the Narasimham Committee I report which had envisioned 4 tiers in the banking structure of India:

Tier-1: International banks (3-4 banks)

Tier-2: National level (8-10 banks)

Tier-3: Regional level

Tier-4: Rural banks

11.3.2.3. Foreign Banks

As per the Organization for Economic Cooperation and Development (OECD), a foreign bank is a bank with head office outside the country in which it is located. Foreign banks in India can either directly operate through branch presence or they can set up a wholly Owned Subsidiary with near "national treatment".

11.3.2.4. Small Finance Banks (SFBs)

They are niche banks to further financial inclusion based on the recommendation of the external advisory committee of the Reserve Bank of India. It is primarily concerned with basic banking activities of acceptance of deposits and lending to unserved sections. It can sell forex to customers, sell mutual funds, insurance and pensions. Also, SFBs are allowed to provide remittances as well as issue credit and debit cards. It can also convert into a full-fledged bank. However, there are few functions that SFBs are restricted to perform. They cannot extend large loans, cannot float subsidiaries and deal in sophisticated financial products.

They have to maintain CRR and SLR as per RBI'S norms. They **have to extend 75% of its credit towards Priority sector lending obligations**. At least 50 per cent of its loans should be up to Rs. 25 lakhs only.

11.3.2.5. Payment Banks

These banks were setup with an objective to further financial inclusion by providing small savings accounts and payment services to the underserved populations by minimizing the costs. They were recommended by the Nachiket Mor Committee on financial inclusion.

They will not lend to customers and will have to deploy their funds in government papers and bank deposits only. People can only deposit an amount of up to Rs.1,00,000/- (now raised to 2,00,000/- rupees) and cannot apply for loans or credit cards under their account. However, payment banks are allowed to issue debit cards. Further, payment banks are allowed to distribute products such as mutual funds, insurance and third-party loans and can provide remittance services.

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Difference Between Payment Banks and Small Finance Banks		
Features	**Payment Banks**	**Small Finance Banks**
Minimum paid up capital requirements	100 crores	200 crores
Max account balance	2 lakhs	No such limit
Deposits	Can accept	Can accept
Lending task	No lending allowed. No credit cards issued.	Do both deposit as well as lending functions of the banks. Can issue credit cards.
Deployments of funds	75% of total deposits should be invested only in Govt. Securities and rest of deposits in other banks or in cash	75% lending via PSL. 50% loan portfolio should be < 25 lakhs each.

Difference Between Universal Scheduled Commercial Banks and Payment Banks		
Parameters	**Universal Scheduled Commercial Banks**	**Payment Banks**
CRR, SLR maintenance	Have to maintain	Need to maintain CRR Required to invest a minimum 75% of its "demand deposit balances" in Statutory Liquidity Ratio (SLR) eligible Government securities/treasury bills with maturity up to one year.
Deposit	No limit	2 lakhs
Loan	Can give loan	Cannot give loan

India Post Payment Bank (IPPB)

IPPB is a wholly-owned subsidiary of the Department of Post, with 100 percent Government of India equity. It is governed by the Reserve Bank of India (RBI). It offers services through both physical and digital platforms. The **maximum limit on deposits** is Rs 2 lakh. It **can issue debit cards and ATM cards, but cannot issue credit cards and cannot loan money.** It provides social security payments like MGNREGA wages, direct benefit transfer and gives access to third-party services insurance, mutual funds. The account holders of IPPB are issued a QR Code based biometric card with a unique QR code.

11.3.2.6. Regional Rural Banks (RRB)

They are special types of banking institutions which focus on ensuring adequate credit for agriculture and other rural sectors. They were set up on the basis of the recommendations of the **Narasimham Working Group (1975) which led to Regional Rural Banks Act, 1976**. They are a joint venture between the Central government (50%), State government (15%), and a Commercial Bank (35%). There is a requirement that 75% of their total credit should be given under Priority sector lending. **Prathama Grameen Bank in Moradabad was the first RRB set up in 1975.**

11.3.2.7. Local Area Banks (LABS)

Government wanted to set up new private local banks with jurisdiction over two or three contiguous districts to enable the mobilization of the rural savings by local institutions and make them available for investments in local areas. They were introduced in 1996. They are established as commerical banks in the private sector and

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registered under the Companies Act 2013. They are regulated by the RBI and PSLs (Priority Sector Lendings) are applicable to them like commercial banks. They cannot establish branches in more than three districts and majority of the branches should be in rural areas.

11.3.3. Cooperative Banks

It was initially set up to supplant indigenous sources of rural credit, particularly money lenders. Today they mostly serve the needs of agriculture and allied activities, rural-based industries and to a lesser extent, trade and industry in urban centers.

11.3.3.1. Recent Changes with the Regulatory Framework of Cooperative Banks

There have been several instances of fraud and financial irregularities including the recent issues like failure of Punjab & Maharashtra Cooperative (PMC) in 2019. All these issues have flagged the poor monitoring in these cooperative banks. Therefore, few changes were made under the Banking Regulation (Amendment) Act, 2020:

1. The RBI may supersede the board of directors of a multi-state-co-operative bank for up to five years under certain conditions (protection of depositors, public interest etc.)
2. The act allows the central bank to initiate a scheme for reconstruction of a bank without placing it under a moratorium.
3. The changes in the new act will not in any way affect the existing powers of the state registrars of co-operative societies under state laws.
4. The co-operative banks will be allowed to issue equity, preference or special shares at face value or at premium. However, prior approval from the RBI is mandatory for such issuance.
5. The act allows cooperative banks to open new places of business or change the location of the banks without the permission from RBI.
6. The act mentions that RBI may exempt a cooperative bank or a class of cooperative banks from certain provisions of the act.

11.4. NBFC (NON-BANKING FINANCIAL COMPANY)

Difference Between Scheduled Commercial Banks and Scheduled Cooperative Banks		
	Scheduled Commercial Banks	**Scheduled Cooperative Banks**
Registered under	Companies Act, 1956	Cooperative Societies Act of 1912
Regulated by	RBI	**Dual regulation**: 1. RBI for banking functions 2. Registrar for Cooperative Societies (RCS) for administrative functions
Regulated under	Banking regulation Act of 1949	Banking regulation Act of 1949 along with Banking Laws (Application to Cooperative Societies) Act, 1965.
Level of operation	At a single level	Operates at 3 levels: 1. State level 2. District level 3. Village level
Voting rights	Depends on shareholding of the member	One member one vote
Objective	To provide financial services and to earn profits out of it	Works on the principle of cooperation and maximization of benefits for all members primarily.

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A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956. NBFCs engage in the business of loans and advances, acquisition of shares/stocks/bonds/ securities issued by government or local authorities. NBFCs do not include any institution whose principal business is that of agricultural activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. Currently, there are close to 10,000 NBFCs spread across the country. The entire NBFC sector is about 25 percent of the assets of the banking industry. Based on their liability, **NBFCs have been classified into 2 broad categories** viz. Deposit-taking NBFCs (NBFC-D) (Need to register with RBI) and Non-deposit taking NBFCs (NBFC-ND). **Based on their primary function, they are also classified as** Asset Finance Company (AFC), Investment Company (IC) and Loan Company (LC).

Difference Between Banks and NBFC

Parameters	Banks	NBFC
Registration	Banking Regulation Act	Companies Act
Supervision	RBI	Depends on the category 1. RBI- deposit taking NBFC 2. SEBI- venture capital fund, merchant bank, stock broking firms 3. IRDA- insurance company 4. National Housing Bank- housing finance company 5. Min. of Corporate Affairs under Companies Act, 1956- Nidhi company 6. Chit Funds Act, 1982- chit Fund Company
Deposit	Time and Demand deposit	Only Time deposit
Issuing Cheque book	Can issue cheques as per Payment and Settlement Act 07	Cannot Issue
Reserve Ratio	They have to maintain as per RBI guidelines.	Do not have to maintain but those who are taking time deposits have to maintain 15% SLR.
Loan rate	MCLR	Variable
Depositor Money	cannot deposit depositors' money in the share market	can deposit depositors' money in the share market unlike banks
Priority Sector Lending	Have to maintain	Not required

11.4.1. Recent Development in NBFC Sector

NBFCs are facing many problems nowadays, viz. liquidity crunch due to slow down in fundings because of conflict between RBI and government on the matter of providing easier fund flows to NBFCs. This was aggravated by a series of defaults like that of Infrastructure Leasing and Financial Services (IL&FS).

In January 2021, RBI proposed a 4-tier structure for tighter regulation of NBFCs. It has also proposed the classification of Non-Performing Assets (NPAs) of base layer NBFCs from 180 days to 90 days overdue. Earlier in 2020 RBI announced various measures to provide liquidity support to NBFCs.

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4-Tier Structure for Tighter Regulation of NBFCs

According to RBI, the regulatory and supervisory framework of NBFCs should be based on a four-layered structure: Base Layer, Middle Layer, Upper Layer and a Top Layer.

1. **NBFC-Base Layer (Lower Layer)**: It requires least regulatory intervention. It can consist of NBFCs which are currently classified as non-systemically important NBFCs.
2. **NBFC- Middle Layer**: It will consist of systemically important NBFCs (NBFC-ND-SI), deposit taking NBFCs (NBFC-D), housing finance companies, IFCs, IDFs, SPDs and core investment companies. It will have a stricter regulation regime as compared to the base layer.
3. **Upper Layer:** This layer will consist of NBFCs which have large potential of systemic spill-over of risks and have the ability to impact financial stability. The regulatory framework for NBFCs falling in this layer will be bank-like, albeit with suitable and appropriate modifications.
4. **Top Layer:** Ideally this layer will be empty. If certain NBFCs lying in the upper layer are seen to pose extreme risks as per supervisory judgment, they can be put to higher regulatory/supervisory requirements

11.4.2. Ombudsman Scheme for NBFCs

The RBI launched 'Ombudsman Scheme' for non-banking financial companies (NBFC) for redressal of complaints against them which will provide a cost-free and expeditious complaint redressal mechanism relating to deficiency in the services by NBFCs covered under the Scheme.

11.5. RESERVE BANK OF INDIA

RBI was established on April 1, 1935, in accordance with the provisions of RBI act 1934 (on the recommendation of the Hilton Young commission). It was established as a private shareholders' bank with a share capital of 5 crore and it was nationalized on January 1, 1949. RBI functions as the central bank of India. Initially headquartered in Calcutta it was later shifted to Mumbai in 1937. It has four zonal offices- Delhi, Mumbai, Calcutta and Chennai.

A central bank basically differs from commercial banks in a number of ways like a central bank does not work with a motive of making profit, while commercial banks aim to earn profits. It acts in public interest so as to regulate the banking and financial system of the country. A central bank does not perform ordinary commercial functions such as accepting deposits from the general public in the country. A central bank has the sole authority to issue currency while commercial banks cannot. Every country has only one central bank while there can be a number of commercial banks functioning in a country.

11.5.1. Functions of RBI

1. RBI is the **sole authority to issue currency notes** of various denominations except one-rupee notes which are issued by Ministry of Finance.
2. RBI is considered as the **banker to the government,** it maintains the account of the central government and all the states. It lends to the government as well as manages the government's borrowing programme. All financial transactions of governments are undertaken through RBI (Shrikrishna committee has suggested transfer of public debt management function from RBI to a new agency called Public Debt Management Agency).
3. It is considered as a **Bankers' bank**. Banks have to maintain accounts and reserves with the RBI. It advises banks on financial matters. It provides an inter-bank clearance facility for settlement of their mutual claim. It lends to the banks in the good as well as bad times. That's why RBI is known as a lender of the last resort (it aids eligible commercial banks during temporary liquidity problems).
4. It regulates banks as well as NBFC (partially). It issues licenses to new banks.
5. It acts as the **supervisors of payment system**. In that capacity it sets norms for transfer of

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funds domestically as well as internationally. Instruments of transfer of funds are cheques, draft, postal orders, NEFT, RTGS, IMPS are under its purview.

6. It is the **custodian of foreign reserves** of the country.
7. It regulates **convertibility norms as per Foreign Exchange Management Act (FEMA)**, 1999. It also helps in stabilizing the exchange rate of rupees.
8. It is concerned with **Publication of monetary data like** monetary policy report, financial stability reports.
9. RBI plays an important role in **promoting economic development** of the country. For example: promoting financial inclusion, ensuring compliance of PSLs targets etc.
10. It **regulates money supply** in the economy through the instrument of monetary policy (thus playing a significant role in keeping inflation within a healthy range).

Various Sections of RBI in News		
Section	**Why in News**	**Explanation**
Section 35 A, Banking Regulation Act, 1949	In 2019, RBI placed several restrictions on Mumbai-based Punjab and Maharashtra Cooperative (PMC). Bank couldn't issue loans or open any fixed deposit accounts until February 2020. RBI imposed the said restriction under Section 35A of the Banking Regulation Act, 1949.	This section vests power in the RBI to give directions to banks and can take action, to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company. Section 56 of the act is applicable to cooperative societies.
Section 7 of the RBI Act 1934	The central government has used Section 7 of the Reserve Bank of India Act, 1934, for the first time in 2018.	It empowers the central government to give directions to the RBI to serve the larger public interest after consultation with the Governor of RBI. These **directions can lead to transfer of powers from RBI** to the Central Board of Directors. The board will exercise all powers and do all acts and things which may be exercised or done by the Bank. The **board comprises of** a Governor, Deputy Governors to be appointed by the Centre (not more than four), four Directors to be nominated by the Centre and one government official nominated by the Centre.
Section 47 of the RBI Act	**In 2019,** Union Finance Minister Nirmala Sitharaman informed Lok Sabha that transfer of surplus reserves from the RBI to the government in future would depend on net income and other financial parameters of the RBI besides the recommendations of the expert committee on excess capital.	As per this section, profits or surplus of the RBI are to be transferred to the government, after making various contingency provisions, public policy mandate of the RBI, including financial stability considerations.

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11.6. ECONOMIC CAPITAL FRAMEWORK

The RBI has developed an Economic Capital Framework (ECF) to provide an objective, rule based, transparent methodology for determining an appropriate level of risk provisions (capital kept aside to cover risks) under Section 47 of the RBI Act, 1934. It was developed in 2014-15, and was operationalized in 2015-16. It reflects the capital that an institution requires or needs to hold as a counter against unforeseen risks or losses in the future. RBI keeps 27 % of its assets as reserve while other central banks like the US keep only 14%. Thus, the government believes that RBI is sitting on much higher reserves than it actually needs to tide over financial emergencies that India may face.

In 2018, The Reserve Bank of India (RBI), in consultation with the central government, had constituted a Committee under Dr. Bimal Jalan to review the economic capital framework. The committee recommended:

1. RBI to maintain the Contingency Risk Buffer (CRB), which is the country's fund to handle financial stability within the range of 5.5% to 6.5% of the RBI's balance sheet. The total economic capital should be maintained between 20.8% to 25.4% of the RBI's balance sheet. Previously it was 28.1% to 29%. Thus, the Surplus Distribution Policy of RBI was finalized. Further, following these recommendations, RBI decided to transfer Rs 1.76 lakh crore in dividend and surplus reserves to the government in august 2019
2. It also said the RBI's accounting year of July-June can be brought in sync with the fiscal year of April-March from the financial year 2020-21.
3. The report has also removed the interim payout structure in general circumstances. The payment of an interim dividend may then be restricted to extraordinary circumstances.
4. The committee recommended a review of the ECF after five years.

All the recommendations of the panel have been accepted by the RBI.

11.7. PRIORITY SECTORS LENDING (PSL)

Priority sectors mean those sectors which are considered important for the development of the basic needs of the country and are to be given priority over other sectors. Through PSLs provisions banks are encouraged to provide these sectors with adequate and timely credit. This is done to ensure their holistic and comprehensive growth.

In July 1966, the All-India Rural Credit Review Committee recommended that the commercial banks should play a complementary role in extending the rural credit. However, the definition for PSL was only formalized based on a Reserve Bank of India (RBI) report in the National Credit Council in 1972.

These sectors include: Agriculture, Micro, Small and Medium Enterprises (MSME), Export Credit, Education, Housing, Social Infrastructure, Renewable Energy (recently added), Startups (recently added) etc., among others.

In September 2020, RBI released revised PSL guidelines by expanding the scope of priority sector lending **to include start-ups funding up to Rs 50 crore**, and **loans to farmers for installation of solar plants** and compressed biogas plants. It has defined farmers with land holding of up to one hectare as marginal farmers, and farmers with a landholding of more than one hectare and up to 2 hectares as small farmers.

To ensure continuous flow of credit to the priority sector the compliance of the bank is monitored on a quarterly basis. If banks fall behind their stipulated priority sector lending targets then they have to allocate the balance amount to the Rural Infrastructure Development Fund, established with NABARD and other such funds with NABARD, NHB, SIDBI etc., as decided by the RBI from time to time.

Priority Sectors Lending Requirement				
Category	**Domestic commercial banks & foreign banks with 20 branches and above**	**Foreign banks with less than 20 branches**	**Regional Rural Banks**	**Small Finance Banks**
Total Priority Sector	40 per cent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposure (CEOBE) whichever is higher should go to priority sector.	40 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector	75 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher should go to priority sector	75 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher should go to priority sector
Agriculture	18 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher; out of which a target of ***10 percent is prescribed for Small and Marginal Farmers (SMFs)** **Will be implemented in a phased manner*	Not Applicable	18 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher; out of which a target of ***10 percent is prescribed for Small and Marginal Farmers (SMFs)** **Will be implemented in a phased manner*	18 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher; out of which a target of ***10 percent is prescribed for Small and Marginal Farmers (SMFs)** **Will be implemented in a phased manner*
Micro Enterprises	7.5 per cent of Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure, whichever is higher	Not Applicable	7.5 per cent of is higher Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher	7.5 per cent of is higher Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher
Advances to Weaker Sections	12 percent *of ANBC or CEOBE, whichever is higher. ***Will be implemented in a phased manner***	Not Applicable	15 percent* of ANBC or CEOBE, whichever is higher ***Will be implemented in a phased manner**	12 percent* of ANBC or CEOBE, whichever is higher ***Will be implemented in a phased manner**

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11.7.1. Priority Sector Lending Certificates (PSLCs)

PSLCs are a mechanism to enable banks to achieve the priority sector lending target and sub-targets by purchase of these instruments in the event of shortfall. This also incentivizes surplus banks as it allows them to sell their excess achievement over the prescribed targets, thereby enhancing lending to the categories under priority sectors.

11.8. FINANCIAL INCLUSION (FI)

It is a method of offering banking and financial services to individuals. It is giving financial services to all regardless of their income or savings, thus including everyone in society. As per the committee on financial inclusion, it may be defined as the process of ensuring access to financial services and timely adequate credit where needed by vulnerable groups such as weaker sections and low-income groups at an affordable cost.

11.8.1 Objectives of Financial Inclusion

It provides banking for the unbanked groups. It ensures universal access to bank accounts (basic no-frills banking accounts) for making and receiving payments. Further, it ensures access to credit at a reasonable cost for those presently excluded. It secures the unsecured by providing universal coverage of insurance and social security.

11.8.2 Financial Inclusion in India

Around 430 million accounts (more than 55% beneficiaries are women) have been opened under the **Pradhan Mantri Jan Dhan Yojana (PMJDY)**. These zero-balance bank accounts have been accompanied by more than 300 million debit cards, a life insurance cover of Rs 30,000 and an accidental insurance cover of Rs 1 lakh. The RBI observed that there has been a 24% improvement in financial inclusion (FI) as measured by RBI's FI-Index between March 2017 and March 2021. However, millions of Indians still remain outside the financial safety net. The government is making concerted efforts to widen the financial inclusion blanket.

Steps taken by Indian Government	
Initiatives	**Purpose**
PM MUDRA YOJANA LAUNCHED IN 2015	Providing loans up to 10 lakhs to the non-corporate, non-farm small/ micro enterprises. These loans are given by Commercial Banks, RRBs, Small Finance Banks, MFIs and NBFCs. Mudra has created three products namely **'Shishu', 'Kishore' and 'Tarun'** to signify the stage of growth / development and funding needs of the beneficiary micro unit / entrepreneur.
PM JAM (JANDHAN-ADHAR-MOBILE) YOJANA Trinity was first proposed in the Economic Survey 2014-15.	The government intended to use these three modes of financial inclusion to implement direct subsidy transfers to the poor.
INDIAN POST PAYMENT BANK Launched in September, 2018.	Aimed at making banking service available at door steps.
NATIONAL STRATEGY FOR FINANCIAL INCLUSION Launched by RBI for the period 2019-2024	It has following state pillars: Universal access to financial services Access to livelihood and skill development Customer protection and grievance redressal Effective coordination among all the stakeholders Providing basic bouquet of financial services

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Banking System in India

NATIONAL STRATEGY FOR FINANCIAL EDUCATION, (2013-18), (2020-25)	It has been launched for a second time by the RBI for the period of 2020-2025. The strategy launched for the second time has recommended a '5C' approach (Content, Capacity, Communication, Community, Collaboration) for dissemination of financial education in the country. It includes emphasis on the development of relevant **Content** in the curriculum in schools, colleges and training establishments. Further, it aims to develop Capacity among intermediaries involved in providing financial services, leveraging the positive effect of **Community**-led model for financial literacy. It has to be achieved through an appropriate **Communication** strategy, and, enhancing **Collaboration** among various stakeholders NSFE also aims to advance the skills of financial service providers and other intermediaries involved in imparting financial literacy.
STAND UP INDIA SCHEME launched by the Prime Minister in 2016	To leverage the institutional credit structure to reach out to the underserved sector of people such as SCs, STs and Women entrepreneurs. The stand-up India scheme makes provision for a collateral free loan (one to SCs/STs and one to a woman entrepreneur) between tens lakhs to one crore, per bank branch. The loan is to be extended for development of a green field project.
ATAL PENSION YOJANA (APY) Launched in 2015	Its objective is creating a universal social security system for all Indians, especially the poor, the under-privileged and the workers in the unorganized sector. APY is open for all bank account holders in the age group of 18 to 40 years. The contribution differs, based on pension and amount chosen.
CREDIT ENHANCEMENT GUARANTEE SCHEME (CEGS) FOR SCHEDULED CASTES Was announced by Govt. of India in the Union Budget of 2014-15	To promote entrepreneurship among SC by providing credit guarantee to banks and other financial institutions that provide Financial assistance to these entrepreneurships.
PRADHAN MANTRI JEEVAN JYOTI BIMA YOJANA. Launched in 2015	Was established to provide life insurance security to the poor and low-income section of the society. It is available to people in the age bracket of 18-50 years. Risk coverage under this scheme is for rupees 2 Lakh in case of death of the beneficiary (due to any reason). The premium under the scheme is rupees 330 per annum.
PRADHAN MANTRI SURAKSHA BIMA YOJANA (PMSBY) **Launched in 2015**	It intends to provide an affordable insurance scheme for the poor and underprivileged people in the age group of 18 to 70 years with a bank account. The risk coverage under the scheme is rupees 2 lakh for accidental death and full disability and rupees one lakh for partial disability. The premium for the scheme is 12 rupees per annum.
SUKANYA SAMRIDDHI YOJANA Launched as a part of the 'Beti Bachao Beti Padhao' campaign in 2015.	It is a small deposit scheme for girl child. It provided an interest rate of 8.4% and tax benefits to every account opened under it for July-September 2019. The Sukanya Samriddhi Account can be opened at any Post office or branch of authorized commercial banks in the country. The permissible contribution under the scheme ranges from rupees 250 to rupees 1.5 Lakh in a financial year.

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11.9. MEASURING THE FINANCIAL POSITION OF A BANK

11.9.1. Bank Run

It is a situation where in a large number of customers withdraw their holdings from a bank simultaneously (based on low credibility of the bank) causing the collapse of the bank. This situation arises when there are concerns about the bank's solvency. This may arise when a bank has mismanaged its assets and liabilities or failed to have sufficient liquidity for the short to medium term.

For example, if a bank XYZ has invested all its deposits in a huge long-term loan and if a situation arises that this loan turns into NPA, the bank may not be in a position to honor its daily withdrawals. It might lead to a situation wherein the bank will be unable to pay its liabilities, prompting other customers to seek to withdraw their deposits in a short period causing collapse of the bank.

11.9.1.1.Avoiding Bank Run

In order to avoid a situation of bank run, the banks should maintain adequate liquidity to manage day to day liability settlements. Also, there is a requirement to maintain adequate Capital (CAR/CRAR) to handle risks of loans turning into NPA. Further, all deposits in India are statutorily protected for up to an amount of 5 lakh rupees, under deposit insurance and credit guarantee corporation act. (DICGC). In case of mismatch of assets and liabilities, the government/regulator should step in a timely manner to avoid bank run. For example, during the recent bank run threat of YES bank, RBI stepped in and put daily withdrawal limits (upon depositors) and also tried to recapitalize the bank. Moreover, the regulator should warn such high-risk banks. For example, in India RBI brings such banks under Prompt Corrective Action Framework.

Deposit Insurance and Credit Guarantee Corporation (DICGC) was established under the DICGC Act, 1961, as a wholly-owned subsidiary of the Reserve Bank of India (RBI), for the purpose of providing insurance of deposits and guaranteeing of credit facilities.

After the latest amendment DICGC insures all bank deposits, such as serving, fixed, current, recurring deposits etc., for up to a limit of 5 lakhs rupees. The insurance premium is paid by the insured banks themselves. This means that the benefit of deposit insurance protection is made available to the depositors or customers of banks free of cost. DICGC protects depositor's money kept in all commercial and foreign banks located in India, urban co-operative banks, regional rural banks, local banks etc.

11.9.1.2. 2008 Crisis

In the post 2000s there was a huge appreciation in the costs of real estates (Real estate bubble) in the United States of America. Banks started lending in excess, hoping the bubble may bring good returns. But over a period of time the bubble (the rate of increase in the prices of real estate was reversed) in this sector ceased and there were many unsold real estate properties which in turn led to huge NPAs and bank crisis. As the bubble burst (due to severe fall in demand), the prices of the sector came crashing down and the banks had nothing else other than mortgages which were also becoming less valued. This news about the crisis in the US banks started to spread which led to huge withdrawals. This forced a bank run on many banks like Lehman Brothers. As many of these banks closed their operations, US went into a period of recession and the whole world was affected by it. US Federal bank pumped money into the economy (**expansionary monetary policy**), bought many mortgages and gave liberal credit to other banks. US government also made many tax cuts and started huge public expenditure programs (**Expansionary Fiscal Policy**) to tackle such a situation.

The international experiences of the failure of banks like that of Lehman brothers in 2008 which led to global crisis led to various stakeholders adopting various standards to avoid such incidents.

11.9.2. Capital Adequacy Ratio

Capital adequacy ratio is defined as **the percentage of total capital to the total risk weighted asset**. It is also called Capital to Risk Weighted Assets Ratio (CRAR). It is fixed by the central banks (RBI in India) to prevent

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commercial banks from taking excess borrowed money (leverage from deposits and other sources) and thus avoiding insolvency. As per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12% (a higher requirement compared to that stipulated **by Basel III** at 8%).

$$CAR = \frac{\text{Tier 1 Capital + Tier 2 Capital}}{\text{Risk Weighted Assets}}$$

NOTE

Tier 1 capital

It is the primary funding source of the banks and it is known as the core capital. It **consists of share capital, undistributed profits, and some preference shares** which a bank can use to absorb losses without ceasing business operations.

Tier 2 capital

It is the supplementary capital. It includes revaluation reserves, hybrid capital instruments and subordinated term debt, general loan-loss revenues and undisclosed reserves. It is less reliable than tier 1 and most of the time if tier 2 is used to avoid bank failure it may end up by ceasing the business operations.

Tier 3 capital

Unsecured, subordinated debt makes up tier 3 capital and is of lower quality than tier 1 and tier 2 capital.

11.10. BASEL NORMS

Basel norms are the set of **agreed norms** in an effort to coordinate banking regulations across the globe by the Basel committee of Banking Supervision (BCBS). It focuses on reducing the risks to banks and the financial system.

In general, banks lend to different types of borrowers and each lending carries its own set of risks. This lending comes from the deposits of the public as well as money raised from the market i.e., equity and debt. This exposes the bank to a variety of risks of default and as a result they might get into a situation of financial crisis (2008 subprime crisis). To avoid bank-run/financial crisis, banks should set aside a certain percentage of capital as security against the risk of non-recovery.

Basel committee on Banking Supervision

It acts as a forum for regular cooperation on banking supervisory matters for the central banks of different countries. It was setup by the efforts of Central Bank governors of the Group of Ten countries in 1974.

The committee expanded its membership in 2009 and then again in 2014. Now, the Basel committee on Banking Supervision has 45 members from 28 Jurisdictions, consisting of Central Banks and authorities with responsibility for banking regulation. This committee works under the auspices of Bank of International Settlement (BIS), in Basel Switzerland.

Bank for International Settlements (BIS) is an international financial institution that aims to promote global monetary and financial stability through the coordination of global central banks and their monetary policy efforts. It is often called the "central bank for central banks" .

Till date, the **Basel Committee has issued three sets of regulations** which are known as **Basel-I, II, and III.**

11.10.1. Basel-I

It was introduced in **1988** and it focused almost entirely on credit risk. Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. To overcome an unexpected credit risk, the minimum capital requirement was fixed at 8% of risk weighted assets (RWA).

For example, an asset which is backed by collateral would carry lesser risks (hence, may require lesser provisioning) as compared to loans without collateral (higher risk). Similarly, an asset lent to the government may have lesser risk than the asset lent to private individuals. **India adopted Basel-I guidelines in 1999**.

11.10.2. Basel-II

These guidelines were issued in **2004** and were based on three parameters (three pillars):

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1. **Capital Adequacy Requirements** which require the banks to maintain a minimum capital adequacy ratio of 8% of risk weighted assets.
2. **Supervisory Review** which requires the banks to develop better risk management techniques in all the three types of risks that a bank can face (credit risk, market risk and operational risks).
3. **Market Discipline**, which requires greater transparency in the banks. Banks should mandatorily disclose their CAR, risk exposure and other such risk assessment parameters to the Central Bank periodically.

   India has been working as per Basel II norms and is in the transition period to Basel III norms.

11.10.3. Basel III

Basel III guidelines were released on the backdrop of 2008 financial crisis. It was issued in 2010 as many financial institutions were under-capitalized, over-leveraged and had a greater reliance on short-term funding.

It was based on 3 main parameters:

1. **Capital:** The capital adequacy ratio (CAR) should be at least 8%. In this Common Equity Tier 1 (CET), must be at least 4.5% of risk-weighted assets (RWA). The Tier 1 capital must be at least 6% and total capital must be at least 8.0%.

   Apart from this capital, banks should also maintain a capital conservation buffer of 2.5% and a counter-cyclical buffer of 0-2.5%.
2. **Leverage:** The leverage ratio has to be maintained at a maximum of 3%. The leverage ratio is the ratio of a bank's tier-1 capital to its total assets. In simple terms leverage ratio can be defined as the capacity to meet its financial obligations. It is the proportion of debts compared to its capital.
3. **Enhanced Risk and disclosure:** These include the revised disclosure requirements for credit risk, operational risk, leverage ratio, credit valuation adjustment (CVA), risk weighted assets (RWA) and key prudential metrics.

11.10.3.1. Funding and Liquidity

As per Basel-III there are two liquidity ratios viz. LCR and NSFR.

1. The **liquidity coverage ratio** (LCR) is the ratio of high-quality liquid assets to the debt of the bank. These high-quality liquid assets provide liquidity for at least 30 days of stress in case of uncertainty. It helps to prevent Bank Run like situations.
2. The **Net Stable Funds Rate** (NSFR) is the rate at which banks can raise funding from their off-balance-sheet assets and other activities in medium term (up to 1 year). Hence, NSFR is a measure for medium-term (1 year) resilience.

Basel III norms were to be implemented from March 2019 in India. It was postponed to March 2020 due to economic slowdown. Further, in the light of the coronavirus pandemic, the RBI decided to further defer the implementation to April 2021. (As per new draft master direction on prudential regulations, AIFI are supposed to comply with Basel III guidelines from April, 2022 and the NHBs have to comply with the same from July, 2022)

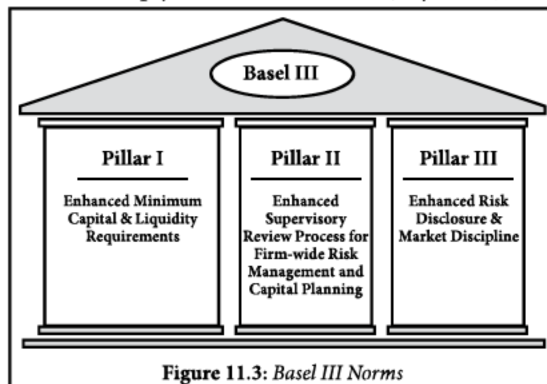

Figure 11.3: *Basel III Norms*

11.11. SWIFT

Society for Worldwide Interbank Financial Telecommunication (SWIFT), founded in 1973, is a **messaging network** that **facilitates safe and secure financial transactions** through a standardised system of codes. Under the laws of its country of origin (Belgium) it is registered as a cooperative and is **owned by its member financial institutions**. As a means to ensure glitch free global financial transactions, SWIFT assigns a **unique 11-digit ID/ code** to each of its member institution. This code

gives the financial institution a distinct ID and is used to identify the bank name, country, city and branch. Though SWIFT is an important part of the global financial structure, it is not and **does not perform the functions of a conventional financial institution**. Presently, the SWIFT network is used by more than 11000 financial institutions in more than 200 countries.

During the Ukraine crisis (2022), 7 Russian banks were banned from using the SWIFT messaging network, as a part of **economic sanctions for Russia's invasion** of Ukraine. In India, the parliamentary committee looking into the Personal Data Protection Bill, 2019, has recommended that **India should strive to build an indigenous alternative to SWIFT payment system**. Data protection in the financial sector is an important concern as Indian citizens are engaged in huge cross-border payments using the SWIFT system.

11.12. NON-PERFORMING ASSETS (NPAS)

Non-performing assets (NPAs) are loans given by a bank or a financial institution wherein the borrower defaults or delays interest or principal payments. According to the RBI norms, any interest or loan repayment delayed beyond 90 days has to be identified as a non-performing asset.

Initially, banks notify a loan as NPA if it is not repaid on time. In order to recover the loan, the bank may even restructure it. The bank may also write off some part of the loan. But in reality, all these assets are a cause of problems at present or a potential cause of economic mismanagement in future. The stressed asset captures all these aspects and hence it is considered as a better indicator of the banking system.

11.12.1. Other Technical Criteria for Defining an NPA Include

1. An account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC).
2. The installment of principal or interest thereon remains overdue for two crop seasons for short duration crops.
3. The installment of principal or interest thereon remains overdue for one crop season for long duration crops.
4. In respect of derivative transactions, if the overdue receivables remain unpaid for a period of 90 days from the specified due date for payment.

11.12.2. Categories of Non-Performing Assets

1. **Sub-standard:** Assets which have remained NPA for a period less than or equal to 12 months.
2. **Doubtful:** An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months or more.
3. **Loss assets:** Those assets considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value.

Related Concepts

Restructured Loans: To reduce the NPAs and to increase the possibility of loan recovery, a bank can make certain relaxations to the borrowers. Such loans after relaxation are known as restructured loans. Restructuring can be extended in the way of extending the time period of repayment, reduction in interest rates etc. Even though restructured loans are not classified as NPA they come under the broad category of Stressed Assets as they are not the standard asset (those assets which are regularly repaid).

Written Off Assets: A write-off is an accounting action that reduces the value of an asset. In other words, those non-collectable assets which are not expected to play a role in the future income to the balance sheet of the banks are removed from the balance sheet by the process of write-off. It doesn't mean that the borrower is pardoned or exempted from paying the loan. A write-off is different from a write-down, where an asset's book value is partially reduced but is not totally eliminated.

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For example: A man "X" failed to pay ₹ 1 lakh due to the bank. Initially, the bank's balance sheet will have a column of receivables which will mention this 1 lakh with interest. Based on this receivable, the bank will plan for new loans or investments in the future worth about ₹ 1 lakh. But if this 1 lakh is not returned for a long period of time and there are very little hopes of getting it, the bank should not plan its asset position having this 1 lakh in receivables. Hence, it's just removed from the receivable books of the balance sheet.

Stressed Assets: Stressed assets are a combination of all assets which are not standard in nature. It is an indicator of the health of the banking system.

Stressed Assets = NPAs + Restructured Loans +Written Off Assets

11.12.3. Reasons for High Non-Performing Assets and Stressed Assets

According to an RBI report, bank NPAs may go beyond 8% by September 2022. The public sector banks have been worst hit with the NPAs crisis. The gross non-performing assets (NPAs) of public sector banks (PSBs) have doubled in the last seven years, from Rs. 2.24 lakh crore in 2014 to Rs. 5.40 lakh crore in 2021.

Though various reasons (as reported by the Government documents since 2013–14) have been cited for the recent upsurge in the NPAs of the PSBs, by now the major ones are being considered as given below:

1. Stressed balance sheets of corporates due to economic slowdown can have spillover effect in bank balance sheets also (twin balance sheet problem). This will lead to a vicious cycle as lower lending to corporates will diminish their productivity, which in turn will reduce their ability to honor their liabilities, aggravating the stressed assets situation of the banks.
2. Lending to unworthy customers (low credit worthiness) without adequate due diligence.
3. Project completion was delayed for various reasons (judicial delays, policy paralysis, economic slowdown, infrastructure bottlenecks etc.).
4. Business failure because of overestimated optimistic projections.
5. Diversion of funds meant for expansion/ modernization. Borrowed funds are not utilized for the purposes which they have borrowed.
6. Willful defaults, siphoning of funds, frauds, misappropriation, etc.
7. Lack of skill on the part of the banks to monitor end use of funds and diversion by the borrower through a web of shell companies.
8. Deficiency in credit appraisal and improper due diligence.

11.12.4. Tackling the NPA Crisis

To resolve the NPA Crisis following steps have been taken in past by the Government:

1. **5/25 Refinancing:** Under this scheme lenders were allowed to extend the tenure of loans to 25 years with interest rates adjusted every 5 years.
2. **Asset Quality Review:** It is a review or assessment of the credit risk associated with an asset, in line with RBI loan classification rules. It enables quicker classification of NPAs and timely identification of other stressed assets and thereby, providing an overall picture of the well-being of the banks.
3. **S4A Scheme (Scheme for Sustainable Structuring of Stressed Assets)**

   This scheme envisages determination of the sustainable debt level for a stressed borrower, and bifurcation of the outstanding debt into sustainable debt and unsustainable debt. The bank hires an independent agency which decides on sustainable management of the company up to a limit where it can generate resources. . The unsustainable debt is converted into equity and preference shares.
4. **Asset Reconstruction Companies (ARCs):** ARCs are specialized financial institutions that buy Non-Performing Assets (NPAs) from banks and other financial institutions.

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This helps banks to concentrate on normal banking activities, cleaning up their balance sheets. They were introduced in India under the SARFAESI Act (2002), as specialists to resolve the burden of NPAs.

Budget 2021-22, envisages Asset Reconstruction Company to be set up by state-owned and private sector banks. Further, there will be no equity contribution from the government. This is being considered as the government's version of a bad bank (which handles the bad assets).

5. **Debt Recovery Tribunal (DRT):** The DRTs and Debt Recovery Appellate Tribunals were established under the Recovery of Debts and Bankruptcy Act (RDB Act), 1993 with the specific objective of providing expeditious adjudication and recovery of debts due to the creditors (Banks and Financial Institutions). The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act passed in 2002 also provides access to banks and financial institutions covered under the act to the DRTs.

6. **Mission Indra Dhanush for Banks:** It is a seven-pronged strategy to resolve issues faced by Public Sector banks.

   a. **Recapitalization of Public Sector Banks:** Bank recapitalization is the term used for infusing capital in state-run banks in order to make them compliant with capital adequacy norms. The process is mainly carried through bank recapitalization bonds. The government issues bonds which are subscribed by the banks. The money collected by the government goes back to the bank in the form of equity capital. The money invested by banks in recapitalization bonds earn them an interest. As the government increases its share of equity holdings, it leads to shoring of bank's capital reserves.

   Recapitalization of ₹ 20,000 crores was proposed in the budget 2021-22. In December 2020, the Government infused Rs 5,500 crore in Punjab and Sind Bank. In April 2021, Government also notified that it would infuse Rs 14,500 crore through recapitalization bonds in four public sector banks by issuing non-interest-bearing bonds to banks.

   b. **Bank Board Bureau:** BBB is a body of eminent professionals, mandated to select and appoint Board members for various financial institutions in the public sector. The BBB is also required to undertake governance activities in these institutions. It will also appoint the non-Executive Chairman of PSBs. BBB helps to formulate appropriate strategies for growth and development of the concerned financial institutions.

   c. **Appointments:** It was decided to separate the post of Chairman and Managing Director. Also, it was decided to appoint a person as non-Executive Chairman of PSBs to ensure appropriate checks and balances.

   d. **De-Stressing PSBs:** More Debt Recovery Tribunals (DRT), ARCs etc., to be set up to fasten the recovery of bad loans of the banking sector so as to make a vibrant debt market for PSBs.

   e. **Accountability:** Under this mission a new framework of accountability for banks will be fixed based on key parameters.

   f. **Governance Reforms:** A set of new reforms will be given by the government to improve the efficiency of the public sector banks when required.

   g. **Empowerment:** Under this, the banks will be empowered to take independent decisions for quicker resolution of NPAs and faster decision making.

11.13. BANK CONSOLIDATION

Merging PSU banks is envisaged to make them able to absorb shocks and generate capital without depending on the state exchequer. The motive

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behind the decision is to modify public sector banks to suit the credit needs of the growing economy that is India. This will also promote better efficiency and reduce duplication of works performed by many public sector banks.

In August 2019, the government announced the merger of 10 public sector lenders into four bigger and stronger banks. With that the number of public sector banks in India came down to 12 from 27 in 2017. The process of mergers is set to continue as and when required.

For Example: the recent merger of Canara Bank with Syndicate Bank, Union Bank of India merged with Andhra Bank and Corporation Bank.

11.14. THE INSOLVENCY AND BANKRUPTCY CODE (IBC)

Insolvency is a situation which arises due to inability to pay off the debts due to insufficient assets. Bankruptcy is a situation wherein application is made to an authority declaring insolvency. Thereafter, a formal proceeding is initiated, so that the assets of the bankrupt organization can be liquidated to pay off the debts.

The Parliament enacted Insolvency and Bankruptcy Code 2016 to provide a uniform, comprehensive insolvency legislation encompassing all companies, partnerships and individuals. It is a one stop solution for resolving insolvencies, which previously was a long process that did not offer an economically viable arrangement. It aims to protect the interests of small investors and make the process of doing business less cumbersome.

The Code specifies a timeframe of 180 days after the process is initiated, plus a 90-day extension — for resolving insolvency (so that any insolvency or bankruptcy is solved within a maximum of 270 days). A major feature of the Code is that **it creates four pillars of institutional infrastructure for administering the bankruptcy procedure:**

1. Insolvency and Bankruptcy Board of India (IBBI) to regulate and oversee the new entities.
2. Insolvency Professionals to conduct the insolvency resolution process.
3. Insolvency Professional Agencies will examine and certify the insolvency professionals.
4. Information Utilities which will collect, collate and disseminate financial information related to debtors.

When an asset becomes stressed, the balance sheet strain causes poor up gradation and investments in the company leading to further decline in the value of assets of the company. So, at least a time bound resolution will save some assets for the bank for those unviable companies.

11.15. PROJECT SASHAKT

It is a **five-pronged strategy** to resolve bad loans, suggested by PNB chairman Sunil Mehta and accepted by the government. The five-pronged resolution route will enable a standard operating procedure to deal with any type of NPA.

i. **SME resolution approach** for dealing with bad loans up to ₹50 crore, involving creation of a steering committee by banks for formulating and validating the schemes, with a provision for additional funds.
ii. **Bank-led resolution** approach for loans between ₹50 crore and ₹500 crores, with the resolution being achieved in 180 days.
iii. **Asset Management Company (AMC)/ Alternative Investment Fund (AIF)** led resolution approach to deal with NPA cases of more than ₹ 500 crore. Alternative Investment Fund will raise resources from banks and institutional investors so that it can bid for the insolvent assets under insolvency and bankruptcy.
iv. **National Company Law Tribunal (NCLT)/ IBC approach** for assets larger than ₹500 crore already before the NCLT and any other assets whose resolution is still pending.
v. **Asset-trading platform** for both performing and non-performing assets.

11.16. PROMPT CORRECTIVE ACTION (PCA) FRAMEWORK

The PCA framework works as an early warning signal for banks in stress. The Reserve Bank of India has specified certain regulatory trigger points for undertaking a prompt corrective action (PCA) framework. These trigger points include: capital to risk weighted assets ratio (CRAR), Net non-performing assets (NPA) and Return on Assets

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(RoA) to Tier 1 leverage ratio. RBI initiates certain structured and discretionary actions in respect of banks hitting such trigger points so that failing of banks is avoided.

11.17. SUPERVISORY ACTION FRAMEWORK (SAF) FOR URBAN CO-OPERATIVE BANKS

The SAF is similar to the Prompt Corrective Action (PCA) based on three parameters such as, when net Non-Performing Assets (NPAs) exceed 6% of net advances, when losses are incurred for two consecutive financial years or losses have accumulated on the balance sheets and when Capital Adequacy Ratio (CAR) falls below 9%.

When such criteria are met, the urban cooperative banks are brought under RBI and RBI can also take action if there are serious governance issues. This is especially relevant in the backdrop of a large number of cooperative banks failing like the Punjab & Maharashtra Cooperative (PMC) Bank crisis and the recently reported nearly 1,000 cases of fraud worth more than ₹220 crore in past five fiscal years.

11.18. DOMESTIC SYSTEMICALLY IMPORTANT BANK (D-SIB)

According to the RBI, some banks become systemically important due to their size, cross-jurisdictional activities, complexity and lack of substitute and interconnection. Banks whose assets exceed 2% of GDP are considered part of this group and these banks are too big to fail. This means that the economic heft of the entity is such that the government cannot afford to let it fail. The state bank of India (SBI), ICICI and HDFC banks are under this category. In order to ensure extra financial prudence, these banks are required to maintain additional capital requirements over and above the standard norms.

11.19. COMMITTEES ON BANKING

Committees on Banking	
Narasimham Committee- I, 1991	1. A 4-tier hierarchy for the Indian banking system with 3 or 4 major public sector banks at the top and rural development banks for agricultural activities at the bottom. 2. A quasi-autonomous body under RBI for supervising banks and financial institutions. 3. Reduction in statutory liquidity ratio. 4. Reaching 8% capital adequacy ratio. 5. Deregulation of interest rates. 6. Full disclosure of banks' accounts and proper classification of assets. 7. Setting up an Asset Reconstruction fund.
Narasimham Committee- II, 1998	The task of the Committee was to review the progress of the implementation of reforms and to suggest a design for further strengthening of the sector. 1. The Committee recommended the merger of major public sector banks. However, the Committee warned against merging stronger banks with weaker banks. 2. Committee recommended Narrow Banking Concept where the banks (especially with high NPA's) were allowed to put their funds in short-term and risk-free assets. 3. It also recommended that government ownership of banks should be reviewed as it hampers the autonomy of banks resulting in mismanagement. 4. The Committee wanted the banks to reduce their NPAs to 3% by 2002. It also recommended the formation of Asset Reconstruction Funds or Asset Reconstruction Companies. The recommendations led to the introduction of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Nachiket Mor Committee, set up in 2013 Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households	1. Universal banking for all Indians above the age of 18 years. To achieve this, a vertically differentiated banking system with payments banks for deposits and payments and wholesale banks for credit outreach. 2. Aadhaar to be the prime driver towards rapid expansion in the number of bank accounts. 3. Adjusted 50 per cent priority sector lending target with adjustments for sectors and regions based on difficulty in lending.
PJ Nayak committee, 2014 To Review Governance of Boards of Banks	1. Repeal the Bank Nationalisation Act (1970, 1980), the SBI Act and the SBI Subsidiaries Act. This is because these acts require the government to have above 50% share in the banks. 2. The government should set up a Bank Investment Company (BIC) as a holding company or a core investment company. 3. The government to transfer its share in the banks to this BIC 4. Until the BIC is formed, a temporary body called the Bank Boards Bureau (BBB) to be formed to do the functions of the BIC. Once BIC is formed, the BBB will be dissolved. 5. The BBB will advise on appointments to the board, banks' chairman and other executive directors.

11.20. RECENT INITIATIVES OF GOVERNMENT

11.20.1. Shadow Bank

A shadow bank is a type of financial intermediary facilitating the creation of credit across the global financial system (carrying out bank-like activities) but outside the regulatory oversight. The shadow banking system may consist of lenders, brokers, and other credit intermediaries who fall outside the realm of traditional regulated banking. Hedge funds, NBFCs etc., are examples of shadow banking in India.

11.20.2. Payment and Settlement System

In India, the payment and settlement systems are regulated by the Payment and Settlement Systems Act, 2007. Accordingly, RBI is mandated to commence or operate a payment system in India. It is an important function of the central bank whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems. By overseeing payment and settlement systems, RBI helps to maintain systemic stability and public confidence in the payment and settlements system.

11.20.3. National Payments Corporation of India (NPCI)

NPCI is the specialized division of RBI, created for operating retail payments and settlement systems in India. It is an initiative of RBI and Indian Banks Association under the provisions of the Payment and Settlement Systems Act, 2007, for creating a robust Payment & Settlement Infrastructure in India. It has been incorporated as a "Not for Profit" Company under section 8 of Companies Act 2013.

11.20.4. Unified Payments Interface (UPI)

Unified Payments Interface is an instant real-time payment system developed by NPCI facilitating inter-bank transactions. The interface is regulated by the Reserve Bank of India.

It can lead to instant money transfers through mobile devices, giving round the clock services. It can be used as a single mobile application compatible with different bank accounts. The UPI app is inbuilt with a robust grievance redressal system.

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11.20.5. Ban on dealing in Virtual Currencies

The Reserve Bank of India prohibited entities regulated by the bank to deal in virtual currencies (VCs) or provide services for facilitating any person or entity in dealing with or settling VCs.

Winter session of the parliament (November 29, 2021-December 23, 2021) had put The Cryptocurrency and Regulation of Official Digital Currency Bill, 2021 for introduction, consideration and passing. It seeks to prohibit all private cryptocurrencies in India while allowing for certain exceptions that promote the technology of cryptocurrency. Also, creates a framework for digital currency that will be issued by the Reserve Bank of India.

11.20.6. Merchant Discount Rate

The Merchant Discount Rate is the cost that a merchant pays to banks for accepting payment from their customers via digital means. This cost is often passed on to the customer.

11.20.7. Gold Investment Scheme

Sovereign Gold Bonds and Gold Monetisation Schemes are gold investment schemes that were launched by GoI in 2015. The scheme aims to reduce the dependence on imported coal by mobilizing the physical gold with households in a productive way, through sovereign gold bonds.

1. **Sovereign Gold Bonds:** These are government securities denominated in grams of gold, issued by RBI. Investors have to pay the issue price in cash and the bonds will be redeemed in cash on maturity. The minimum and maximum investment limits are one gram and four kilograms of gold per person per fiscal year (20 Kgs for trust and other such entities). The tenor of the Bond is for a period of 8 years with an exit option from the 5th year onward.
2. **Gold Monetisation Scheme:** In this scheme, BIS (Bureau of Indian Standards) certified CPTCs (Collection, Purity Testing Centers) collect the gold from the customer on behalf of the banks. The minimum quantity of gold (bullion or jewelry) which can be deposited is 10 grams and there is no limit for maximum deposit. In short, the scheme allows you to deposit your idle gold with a Reserve Bank of India (RBI) designated bank and earn interest on the same just like a bank fixed deposit.

   Gold Saving Account can be opened with any of the designated banks with denominations in grams of gold for short-term period of 1–3 years, a medium-term period of 5–7 years and a long-term period of 12–15 years. The CPTCs transfer the gold to the refiners. The banks will have a tripartite/bipartite legal agreement with refiners and CPTCs. The customers will have the option of redemption either in Indian rupee (according to the prevalent price of deposited gold) or in gold.

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12 CHAPTER International Financial Institutions

12.1. INTRODUCTION

The International financial institutions (IFIs) are an important source of external finance as well as its regulation. They are governed by international laws. Most of the IFIs that we see today were formed after World War II (1945) to aid the reconstruction of Europe and to provide frameworks for international cooperation in the management of the global financial system. With the changes in the world economy since 1945, the role and functions of these financial institutions have also changed. Important changes include the failure of the Bretton Woods system and evolution of the global trade regime through various rounds of trade negotiations under GATT and WTO.

Today, there are various types of IFIs. One set of institutions provide credit for developmental finance and direct the funds from countries with surplus financial capital towards those countries which are in dire need of investment, thus functioning like an international bank for countries. The World Bank is an example of such an institution. Another set of institutions help to guide the world's monetary transactions and policies thereby promoting trade among countries. IMF, WTO etc. are among these kinds of institutions. There is also a third set of organizations which help countries to cooperate on global best practices in economic policies like the OECD, Bank of International Settlements (BIS), etc. Lastly, there are smaller versions of the above-mentioned institutions which work for the same purpose but at bilateral or regional levels. Examples include the Asian Development Bank, New Development Bank (BRICS bank), etc.

12.2. WORLD TRADE ORGANIZATION (WTO)

The World Trade Organization (WTO) is an intergovernmental organization that governs international trade. It was established in 1995 as part of the **Marrakesh Agreement**, which was the outcome of **Uruguay round negotiations** spanning across 1986-1994 It replaced the General Agreement on Tariffs and Trade (GATT) that had been in place since 1948. WTO regulates trade between members by providing a mechanism for negotiating trade agreements and a dispute settlement process aimed at ensuring participants' adherence to WTO agreements.

Relevance of WTO	
Multi-lateral agreements	It administers existing multilateral trade agreements, for example Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement.
Dispute settlement and Rules-based System	It settles disputes among its members through its Dispute Settlement Mechanism and prevents 'trade wars'. WTO ensures that global trade is based on a rules-based system.

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Economic Growth and Development	By removing trade barriers, WTO expands and develops market economy, thus, stimulating global growth. WTO membership gives smaller countries immediate access to developed markets at lower tariff rates.
Standardization	WTO and its members set standards for trade in goods and services, including IPR protection. It serves as a platform for negotiations on new global trade agreements like Doha Round negotiations, or standards for post-Doha talks such as on e-commerce.
Democratic Order	Two-thirds of WTO members are developing countries and agreements within the WTO need the approval of all members.

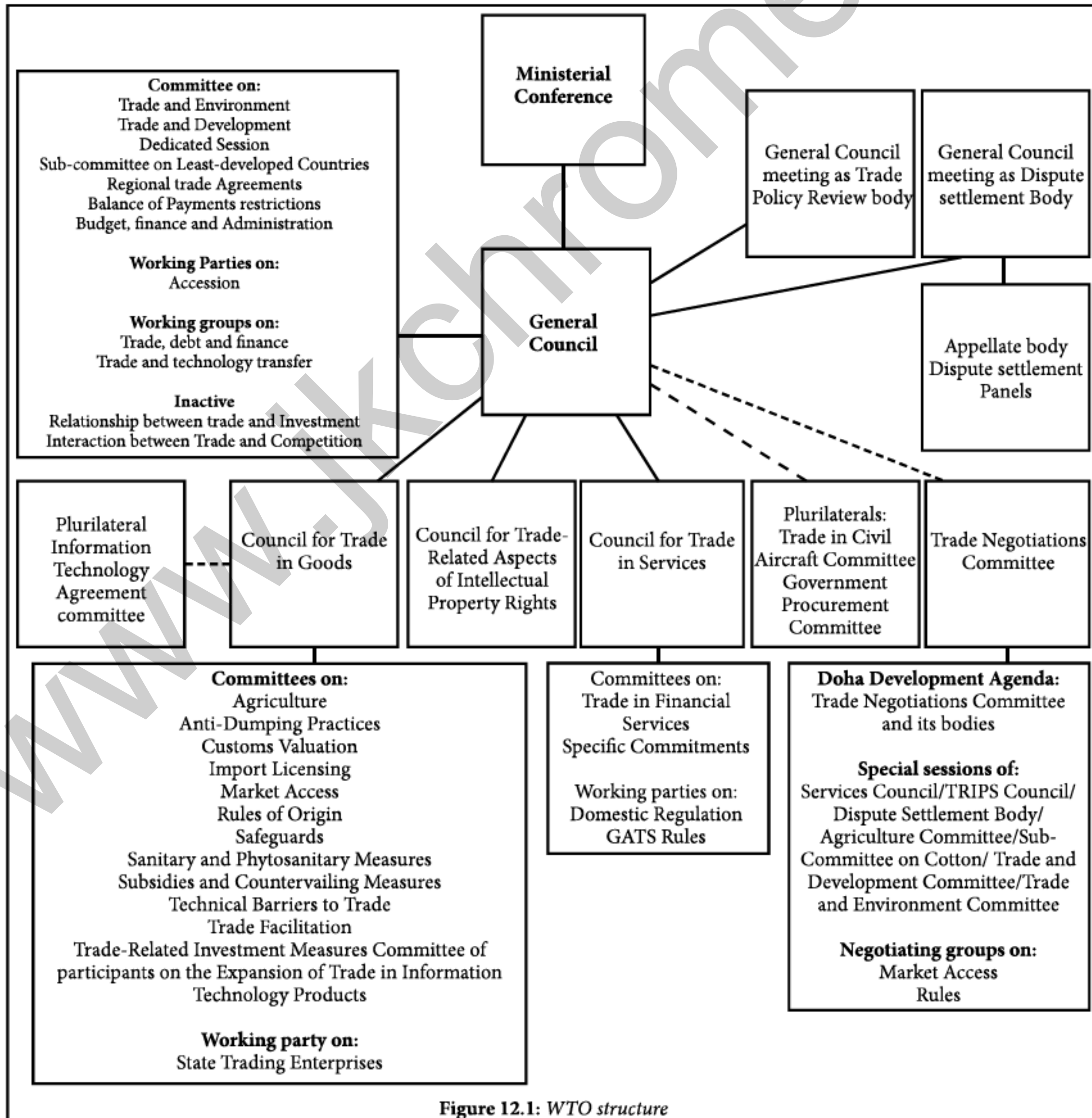

Figure 12.1: *WTO structure*

12.2.1. Challenges Faced by WTO

Over years, many grievances and disputes have come to fore regarding the working of the WTO. WTO is the only international organization dealing with rules governing global trade. But the organization has failed to build consensus among developed and developing countries on important issues like agriculture, services, subsidies etc. as corroborated by the stalemate in Doha talks. Developed countries like the US are pushing for changing the voting process in WTO from consensus to majority vote so as to evade the developing countries' steadfast opposition and blocking of proposals for post-Doha talks. In recent years, bilateral and regional trade agreements like Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership (TTIP) have threatened to undermine the relevance of WTO in a changing world. The **US** has undemocratically **blocked judges** from being **appointed to** the WTO **appellate body**, making its appellate role dysfunctional.

WTO aims at linking domestic and global value chains (GVCs) but developing countries face problems of remodeling, up-skilling and adapting their industries quickly in a small window of opportunity before the capture of their domestic markets by cheap imports. While phenomena like **Dutch disease** threaten to keep such countries stuck in production and export of low value addition primary articles, race-to-bottom is seen in desperation to attract GVCs wherein protective labor laws are done away with to achieve cost competitiveness. WTO is inadequate in checking unfair labor practices in other countries like China which violates basic workers' rights or environmental norms to lower the cost of its exports. Similarly, the glut of imports amidst high employment for countries has undercut support for free trade agreements and globalization in developed as well as developing countries.

An inadequate WTO in face of issues like **forced labor** as seen vis-à-vis Uighurs in China, **race-to-bottom approach** in labor conditions for attracting industries in countries like Bangladesh, and regional or unilateral trade measures like **carbon-border tax** may soon see a reversal in the march of globalization. This would be a setback in achieving Sustainable Development Goals as globalization and reduction of trade barriers has been crucial in lifting millions out of poverty over the last three decades.

Dutch Disease

During 1960's, large reserves of natural gasses were discovered in Netherland. Inflow of foreign funds and export of natural gas resulted in appreciation of Dutch currency. As the Dutch currency appreciated, imports became cheaper and exports became non-competitive. Net result was boom in natural gas sector while other sectors witnessed a slowdown.

Dutch disease refers to **causal relationship** between the **increase** in the economic **development in a specific sector** (for example natural resources) **resulting** in economic **decline in other sectors** (like the manufacturing or agriculture).

12.2.2. Reforms in WTO

Experts have suggested different approaches to reforms in WTO. Some advocate a total overhaul of existing mechanism and a complete rethinking on global trade and economy, arguing for reversal of globalization. Others argue for tinkering with the existing mechanisms to make them workable. As majority of negotiations are usually blocked by dissenting countries, hence guidelines should spell out clear criteria for when a country may use its veto power. Veto usage also needs to be weighed against the interests of all countries in light of WTO's global mandate.

Till deadlock in appointment in appellate tribunal lasts, independent panels could play the role of arbiter, evaluating the competing claims and helping to overcome the political deadlock. The **Multiparty Interim Appeal Arbitration Arrangement (MPIA)** by the European Union and 15 other countries can be a good working solution to avoid the fate of tit-for-tat **tariff wars.**

But ultimately, the appointment process to the dispute settlement body should be made independent of political control.

Plurilateral negotiations should be promoted as they offer the prospect of building **"coalitions**

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of the willing" i.e., like-minded members come together to deliberate a specific issue which is easier and faster to negotiate than multilateral accord like passage of Trade Facilitation Agreements.

To reduce abuse of national-security exemption as justifications for trade restrictions, the national security concerns should be resolved at the political level, rather than at WTO.

WTO should be conferred with penalizing powers to curb willful non-compliance. This would create additional incentives to cooperate and achieve consensus in trade negotiations.

Expanding the Appellate Body panel from **seven judges** to nine, redefining membership of the Appellate Body from **part-time** to full-time, and allotting more resources to the Appellate Body Secretariat will increase the capacity of the Appellate body.

Taking cue from the IMF, negotiations at WTO could be streamlined by delegating most discussions to an executive board of the 20 or so largest trading nations, with the most existential questions reserved for treatment by the full WTO membership. Since the WTO is afflicted with distrust, a good start to acknowledge and address the problem of reform is to use platforms like G20 which have the advantage of limited and effective global membership. Given the intransigence over the issue of subsidy - for agriculture and industry -WTO members should proactively disclose their subsidies, long-term timelines for withdrawal and vision to develop trust and transparency among WTO members.

WTO 2.0 can be built incrementally by providing consensus-based pathways and fixing contentious issues first like the agriculture problem.

12.2.3. Boxes of Subsidies

In WTO terminology, subsidies are identified by "boxes" which are given the colours of traffic lights: **green (permitted), amber (slow down — i.e., to be reduced), red (forbidden).** In agriculture, things are more complicated. The Agriculture Agreement has no red box, although domestic support exceeding the reduction commitment levels in the amber box is prohibited; and there is a blue box for subsidies that are tied to programmes that limit production. There are also exemptions for developing countries.

Green Box	1. The subsidy must **either not distort global trade or cause a minimal distortion**. 2. These subsidies should be **government funded** and must not have the **component of price support.** 3. These subsidies can be given for the purpose **of environmental and regional development** programmes. 4. Greenbox subsidies are generally allowed without limits.
Amber Box	1. These subsidies include nearly all **domestic measures which are liable to distort production** and trade across globe. 2. It includes price support as well as subsidies that **directly lead to an increase in production quantities.** 3. These subsidies are subjected to **De-minimus limits**. De-minimus threshold is generally 5% of the value of agricultural production for developed countries and 10% for the developing countries. (Base of the year 1986). 4. Most of the subsidies given by India falls under amber box.
Blue Box	1. These subsidies **aim to limit the production**. 2. As per WTO, blue box is amber box with conditions. Any support that would normally qualify to be in amber box, is placed in the blue box if the support also **requires farmers to limit production**. 3. At present there are **no limits on spending** on blue box subsidies.

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12.2.4. Important Agreements Under WTO

12.2.4.1. Agreement on Agriculture (AoA)

The WTO AoA provides a framework for the long-term reform of agricultural trade and domestic policies. The AoA aims to create a fairer competition paradigm with minimal distortions.

The AoA has following components:

1. **Market access**: use of trade restrictions, such as tariffs and imports.
2. **Domestic support**: the use of subsidies and other support programmes that may directly influence production thereby distorting trade.
3. **Export competition**: the use of export of export subsidies and other government support programmes that subsidize exports.

12.2.4.1.1. Peace Clause

Article 13 (due restraint) of the AoA also known as the peace clause protects India's food procurement programmes against action from WTO members in case the subsidy ceilings (De-minimus level) are breached. India invokes peace clause in order to meet the domestic food security needs of country's poor and vulnerable population. India does not use peace clause to distort commercial trade or impinge upon food security of others. However, India wants a permanent solution regarding the issue of public stockholding of food grains as a temporary 'peace clause' is a threat to the food security of millions of destitute Indians.

12.2.4.2. Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)

Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) is a comprehensive multilateral agreement on intellectual property (IP). It frames the IP system in terms of innovation, technology transfer and public welfare. TRIPs were negotiated as the part of Uruguay round talks. The Agreement is legally binding and signifies the links between IP and trade and the need for balanced IP system. The TRIPs agreement The TRIPS system was criticised during the covid19 pandemic for over zealous protection of vaccine patents.

12.2.4.3. Agreement on Trade-Related Investment Measures (TRIMs)

Agreement on Trade-Related Investment Measures (TRIMs) applies to measure that affect trade in goods. TRIMs states that no member shall apply a measure that is prohibited by the provisions of GATT. TRIMs enable international firms to operate more easily within foreign markets. It bans practices like local content requirements that may have the effect of promoting domestic companies.

12.2.4.4. General Agreement on Trade in Services (GATS)

The General Agreement on Trade in Services (GATS) provides a **framework of rules governing services trade**, establishing a mechanism for countries to make commitments to liberalize trade in services and also provides a **mechanism for resolving disputes** between countries. The treaty entered into force in January 1995 as a result of the **Uruguay Round negotiations**. The GATS agreement covers four modes of supply for the delivery of services in cross-border trade.

Mode 1	Cross border supply of services
Mode 2	Consumption of services happens abroad
Mode 3	Here the company is required to have commercial presence in the country where the service is delivered
Mode 4	It includes cross-border movement of natural person

India's concerns with the WTO	
Concerns	**Explanation**
Agreement on Agriculture (AoA)	It is based on three pillars: **domestic support**, **market access**, and **export subsidies**. Developed countries consider India's MSP support to farmers, public stockholding of grains and its PDS distribution to be '**market distorting subsidies**' and want their removal. Developed countries are insisting that developing countries take on additional commitments in terms of enhanced market access and reduction in policy space through reduced domestic support. But India demands amendment of AoA for continuation of these measures as a permanent solution to its food security problem beyond the temporary **Peace Clause (Article 13 of AoA)** and for all G33 members. Peace clause, passed in the Bali summit 2013, allowed subsidies beyond WTO limits set in AoA without legal implications till a permanent solution was found.
Domestic content requirement'	US challenged India's 'domestic content requirement' in procurement of Solar cells/ panels for its solar programme in WTO as it allegedly violated core WTO principle of national treatment for imports. WTO ruled in US's favor following which India committed to implement the Dispute Settlement Body's recommendations.
Visa problem and duty hikes on steel and aluminium	India has approached the Dispute Settlement Body of WTO on issues of increase in visa processing fees, high rejection rates and other difficulties faced by the Indian services companies in USA. India has approached the Dispute Settlement Body of WTO on issue of imposition of import duties on steel and aluminium exported from India.
Intellectual property issue	As part of Doha Round, developing countries secured a favor in TRIPS which allowed **compulsory licensing** of patents in certain circumstances. For example **compulsory licensing** for pharmaceutical products. USA wants removal of compulsory licensing and expects a liberal IPR regime which shall allow **evergreening** of patents.
Sanitary and phytosanitary (SPS) issues	India lost a case to USA at the WTO when the latter resisted India's step to block agricultural imports from US citing SPS issues. SPS refers to protective trade measures aimed at ensuring that a country's consumers are being supplied with food that is 'safe' to eat as per appropriate scientific standards. But such strict health and safety regulations are often challenged on grounds of being protectionist measures for domestic producers
Elimination of cotton subsidies	Presently large export subsidies on cotton are provided by some developed countries such as USA. The issue lies in AoA's use of 1986 as base year for determining WTO limits on agricultural subsidy. The higher the subsidies provided during that time, more is the policy space for a country to support its farmers now. As USA was giving large subsidies in year 1986, compared to developing countries, its scope for supporting cotton cultivation through subsidies continues to be high. India as well as the C4 countries (Benin, Burkina Faso, Mali, Chad), demand quick elimination of cotton export subsidies to make the cotton industry in developing countries more competitive.

12.3. THE BRETTON-WOODS INSTITUTIONS

The Bretton Woods Agreement and Framework were developed in 1945 with the primary goals of establishing an effective foreign exchange system based on fixed rates of foreign exchange, preventing competitive devaluations of currencies, and fostering international economic development. The Bretton Woods Agreement formed the foundation of institutions such as the **International Monetary Fund (IMF)** and **the International Bank for Reconstruction and Development** (IBRD). It was expected that countries would adhere to

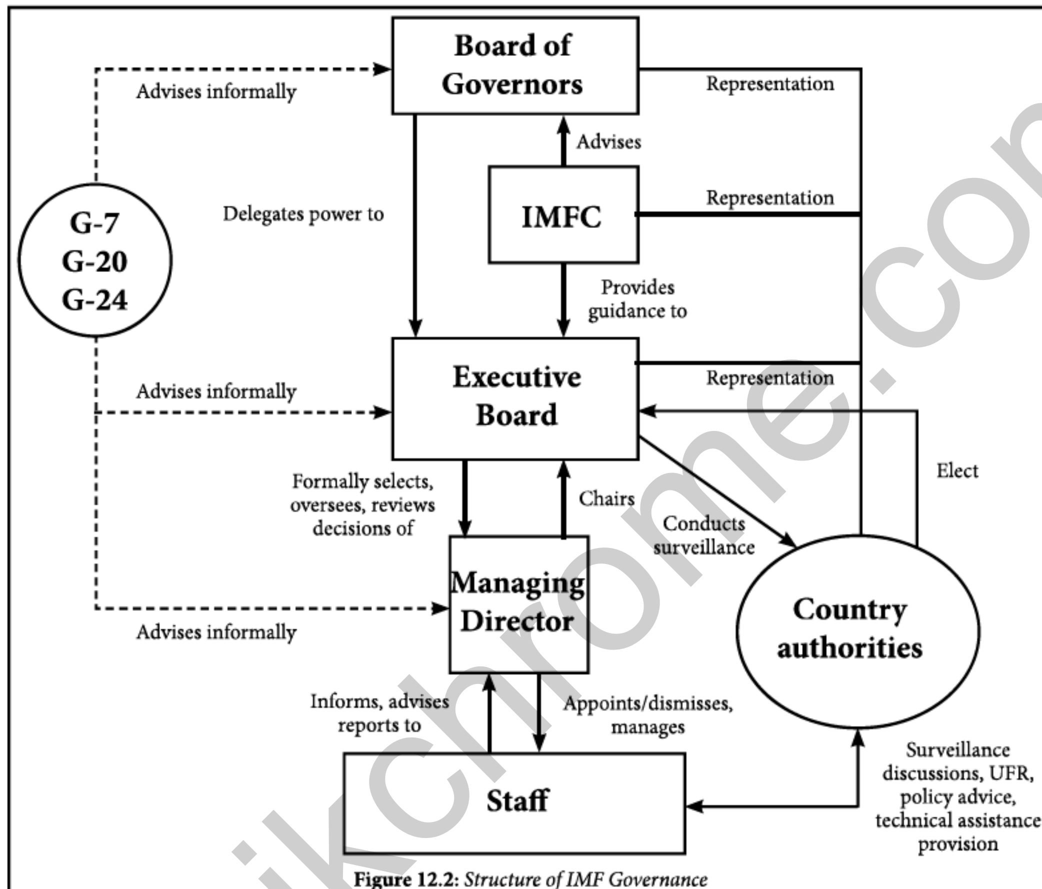

Figure 12.2: *Structure of IMF Governance*

the new economic system based on national monetary reserves which would be supplemented by IMF credits when necessary. IBRD was deemed necessary in the transition to the new economic system as it would expedite the return of war-ravaged countries to normalcy. The Bretton Woods System of fixed exchange rate came to an end in 1970s when the underlying basis of the US dollar – effectively the international reserve currency till that time - was changed from gold-backed currency to a fiat currency. Even though the Bretton Woods system ended, the associated institutions namely, the IMF, World Bank etc. continued to perform their functions as International Financial Institutions. .

12.3.1. International Monetary Fund

The International Monetary Fund (IMF) is today an organization of 190 countries. It was established in 1945 with 29 member countries. The main goal of the IMF is to ensure the stability of the international monetary system. It also seeks to facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. Its headquarter is in Washington D.C. **Global Financial Stability Report** and **World Economic Outlook** is published by the IMF.

12.3.1.1. IMF Quotas

Quotas provide the base for IMF's financial and governance structure. Quotas form the larger source of IMF's funds in the form of **a pooled fund**. An individual country's quota broadly reflects its relative importance in the world economy. Quotas are denominated in Special Drawing Rights (SDRs) which is IMF's unit of account.

IMF quotas broadly provide **4 functions.** The first is **resource contribution** as they determine the maximum amount of financial resources a member is required to provide to the IMF. Second

function is as a determinant of a country's voting power in IMF decisions. Votes comprise one vote per SDR 100,000 of quota plus basic votes (the latter are the same for all members). Third function is to enable **access to financing.** Quotas determine the maximum amount of financing a member can obtain from the IMF. Lastly, quotas determine **SDR allocations** among member countries.

12.3.1.2. How are IMF Quotas Allocated?

When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members of broadly comparable economic size and characteristics. The IMF uses a quota formula to help assess a member's relative importance in the world economy.

The current quota formula is:

(0.50 * GDP + 0.30 * Openness + 0.15 * Variability + 0.05 * Reserves) compression factor,

i.e., a weighted average of GDP (weight of 50%), openness (30%), economic variability (15%), and international reserves (5%), modified by a compression factor.

For the purpose of this formula, GDP is measured through a blend of GDP—based on market exchange rates (weight of 60%)—and on PPP exchange rates (40%). Compression factor reduces the dispersion in calculated quota shares across members.

12.3.1.3. Importance of IMF Quota from India's point of view

India's share increased to 2.75% from 2.44% after a revision in 2010, making it the 8th largest shareholder in the IMF quota system. The quota system is most controversial due to its asymmetric power structure. USA continues to hold the largest share at 17.46%, followed by Japan at 6.48% and China at 6.41%. Today the global financial capital is looking towards developing countries due to their fast-growing economy, but these countries have minimal say in the IMF. The economic slowdown due to Covid-pandemic and related lockdowns have reignited debates on reimagining the IMF, including the current quota system.

Voting rights	Financial contributions from member countries are linked to voting power in the IMF. Thus, higher IMF quota implies more voting rights under the IMF. But the formula is designed in such a way that some countries are over-represented. As IMF quota determines the voting power of any member in IMF decisions, countries that grow economically have tended to become under-represented as their voting power lags behind. As a result, many emerging economies are against the current quota scheme of the IMF.
The size of contingency funds	Quotas determine the size of contingency funds at the disposal of the IMF to lend to countries in need of help, as well as the power of individual countries to influence lending decisions and to tap into the funds themselves. Each IMF member has an unconditional right to borrow up to 25 percent of its quota from the IMF.

12.3.1.4. Special Drawing Rights (SDR)

SDR is an international reserve asset maintained by the IMF to supplement its member countries' official reserves. The value of SDR is based on a basket of five currencies—**the U.S. dollar, the euro, the Chinese renminbi, the Japanese yen,** and **the British pound sterling.**

SDR was created as a supplementary international reserve asset in 1969 in the context of the Bretton Woods fixed exchange rate system amidst shortage of gold and dollar which were preferred foreign exchange assets at that time. But the collapse of the Bretton Woods system in 1973 and the shift of major currencies to floating exchange rate regimes lessened the reliance on the SDR as a global reserve asset. It currently serves as the unit of account of

the IMF and other international organizations. **It is neither a currency nor a claim on the IMF.** Rather, it is a potential claim on the freely usable currencies of IMF members. SDRs can be exchanged for these currencies. But SDR cannot be held by private parties.

12.3.2. World Bank Group

The World Bank Group is a global financial institution which provides loans and financial assistance to low- and middle-income countries. The world bank collectively consists of IBRD and the International Development Association. It owns 5 sub-institutions which make up the world bank group, namely:

1. International Bank for Reconstruction and Development (IBRD)
2. International Development Association (IDA)
3. International Finance Corporation (IFC)
4. Multilateral Investment Guarantee Agency (MIGA)
5. International Centre for the Settlement of Investment Disputes (ICSID)

Currently, 190 countries are members of IBRD and there are 174 member countries in IDA. The world bank started off as IBRD which provided loans for reconstruction of European countries in wake of the destruction caused by the second world war. But due to alternate funding from the Marshall Plan, it shifted attention towards funding infrastructure in non-European countries. In the 1970s, the world bank's coverage for loans expanded from the earlier focus on infrastructure to social services. Focus shifted towards developing countries and funding of NGOs for developmental and environmental causes.

International Bank for Reconstruction and Development (IBRD)	Founded in 1944 as one of the two Bretton Woods institutions, today IBRD is the world's largest development bank. It helps credit-worthy middle-income and low-income countries by providing loans, guarantees, advisory services, and risk management products. More than 60% of the IBRD's portfolio is made up of middle-income countries. IBRD finances investments across all sectors and provides technical support at every stage of a project. It assists governments in augmenting the investment climate of countries. IBRD **deals only with sovereign governments** and not private players. It also assists governments in augmenting the investment climate of countries, removing service delivery bottlenecks, and strengthening institutions and policies. IBRD sources most of its funds from the global financial markets. **India is a founding member** of IBRD.
International Development Association (IDA	It was established in 1960 to assist the world's poorest countries through grants and low-interest. It aims to supplement the work of the IBRD. **India is a founding member.**
International Finance Corporation (IFC)	It was established in 1956. It is the largest international development institution focused on the private sector in developing countries. It promotes economic growth by funding for-profit and commercial ventures aimed at alleviating poverty and advancing development. The IFC offers savings, advisory, and asset management services. It makes loans to companies and private-sector ventures. **India is a founding member** of IFC.
Multilateral Investment Guarantee Agency (MIGA)	It was established in 1988. It guarantees to protect investments against non-commercial risks. It emphasizes on Fragile and Conflict-affected States. It also works towards credit enhancement by extending protection when governments fail to honor financial obligations. **India became a member of the MIGA in 1994.**

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International Centre for Settlement of Investment Disputes (ICSID)	It was established in 1966. It is used to resolve conflicts between investors and governments. It also serves as an administrative register and resolves state-to-state disputes under investment treaties and free trade agreements using various methods like Arbitration, conciliation, or fact-finding for resolving conflicts at the Centre. **India is not a member of the ICSID** because it believes the organization's structure and functioning favours developed countries.

Reports Published by World Bank: Ease of Doing Business (IBRD), World Development Report Global Financial Development Report.

12.4. ASIAN INFRASTRUCTURE INVESTMENT BANK (AIIB)

It is a multilateral development bank that aims to support the building of infrastructure in Asia. It is headquartered in Beijing and began its operations in January 2016. Membership in the AIIB is open to all members of the World Bank or the Asian Development Bank and is divided into regional and non-regional members. As of January 2022, AIIB has 89 countries as its regional and non-regional members and 16 prospective members. Major economies that are not members include Japan, Mexico, Nigeria, and USA. Unlike other multilateral development banks, the AIIB allows for non-sovereign entities to apply for AIIB membership, provided their home country is a member.

12.5. ASIAN DEVELOPMENT BANK (ADB)

ADB is a regional development bank established on 19 December 1966. It is headquartered in Manila, Philippines. It aims to promote social and economic development in Asia through loans, technical assistance, grants and equity investments.

It has 68 members, of which 48 are from within Asia and the Pacific and 19 are from outside the region. Japan and USA hold the largest shares in ADB followed by China, India and Australia. The Bank is also an official United Nations Observer.

India was a **founding member** of ADB in 1966 and is now the bank's fourth-largest shareholder **and top borrower** (2021). ADB commenced operations in India in 1986 and has since committed 229 sovereign loans totaling $38.9 billion.

The report **'Asian Development Outlook'** is published by ADB.

12.6. NEW DEVELOPMENT BANK (NDB)

It is a multilateral development bank jointly founded by the BRICS countries (Brazil, Russia, India, China and South Africa) at the 6th BRICS Summit in Fortaleza, Brazil in 2014 (**Fortaleza declaration**). The Bank formally came into existence in 2015. Its headquarter is located in Shanghai, China. The initial authorized capital of the bank is $100 billion.

The NDB was set up with the purpose to mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging economies. The voting power of each member is equal to the share of its subscribed capital in the NDB. All members of the United Nations are allowed to be members of the bank; however, the combined share of the BRICS countries can never be less than 55%.

12.7. EUROPEAN BANK OF RECONSTRUCTION AND DEVELOPMENT

EBRD is a multilateral development bank set up in 1991 after the fall of the Berlin wall to promote private and entrepreneurial initiative in countries of eastern Europe which had been part of communist bloc and had few private sector enterprises. Today, the bank invests in 38 emerging economies across three continents, according to a set of criteria that aim to make these countries more competitive, better governed, greener, more inclusive, more resilient and more integrated. It remains committed to furthering the development of "market-oriented economies and the promotion of private and entrepreneurial initiative."

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Its largest shareholder is currently USA, while other G7 nations also hold significant stakes and 71 countries have ownership rights in EBRD, Alegria being the latest to have joined in October 2021. In addition, European Union and European Investment Bank are also among the owners of the bank. In 2017, EBRD signed a pact with the International Solar Alliance. India became the 69th shareholder of the bank in 2018.

12.8. THE FINANCIAL ACTION TASK FORCE (FATF)

The Financial Action Task Force (FATF) is an inter-governmental body which develops and promotes global standards against money laundering and terror financing. It was established in 1989 during the G7 Summit in Paris. Its secretariat is located within the headquarter of the Organization for Economic Cooperation and Development (OECD) in Paris.

Currently, the FATF comprises 37 member jurisdictions and 2 regional organizations representing most of the major financial centers in all parts of the globe. Saudi Arabia is the latest country to have come on-board the FATF in 2019.

The objectives of FATF are to set standards and promote effective implementation of legal, regulatory and operational measures, for combating money laundering and terrorist financing and other related threats to the integrity of the international financial system.

FATF publishes the **Global Money Laundering Report**

12.8.1. Role of FATF in Combating Terror Financing

The role of the FATF is to protect the integrity of the financial system, and enhance its transparency in the interest of global security. FATF performs these roles in following ways:

Listing by FATF	
Grey List	Countries that are considered a safe haven for supporting terror funding and money laundering are put in the grey list. The inclusion in the grey-list serves as a warning to the concerned country that it may enter the blacklist if found to be non-cooperating. Pakistan and Myanmar, India's western and eastern neighbor respectively, are among 23 countries which feature on the grey list as on January 2022.
Black List	Countries, which are found to be non-cooperative in global fight against money laundering and terror financing, are put in the blacklist. These countries support terror funding and money laundering activities. The list is officially called the **'Call For Action'** list. The FATF revises the blacklist regularly adding or deleting entries. As of January 2022, North Korea and Iran are the two countries on FATF's Call for Action List.

Role of FATF in Combating Terror Financing	
International Standards	Developing and refining the international standards for combating money laundering and the financing of terrorism and proliferation to ensure that they are up-to-date and effective;
Grey and Black-list	Identifying and engaging with high-risk, non-co-operative jurisdictions and those with strategic deficiencies in their national regimes, and coordinating action to protect the integrity of the financial system against the threat posed by them;
Co-operation with FSRBs	Promoting full and effective implementation of the FATF Recommendations by all countries through the global network of FATF-style regional bodies (FSRBs) and international organizations;

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Co-operation on emerging threats	Responding as necessary to significant new and emerging threats and risks to the integrity of the financial system consistent with the needs identified by the international community, including the United Nations Security Council, the G20 and the FATF itself;
Implementation	Assisting jurisdictions in implementing financial provisions of the United Nations Security Council resolutions on terrorism and non-proliferation;
Engagement with civil society and private sector	Engaging and consulting with the private sector and civil society to foster transparency and dialogue towards more effective implementation of the FATF standards;
Evaluation and Monitoring	Assessing and monitoring member countries through 'peer reviews' or mutual evaluations and follow-up processes, to determine the degree of technical compliance, implementation and effectiveness of systems to combat money laundering and the financing of terrorism and proliferation;
Threat and Risk Assessment	Identifying and analyzing money laundering, terrorist financing and other threats to the integrity of the financial system, including the methods and trends involved; examining the impact of measures designed to combat misuse of the international financial system; supporting national, regional and global threat and risk assessments;

12.9. INTERNATIONAL CRIMINAL POLICE ORGANIZATION (INTERPOL)

It is an intergovernmental organization established in 1923 with the aim to facilitate worldwide police cooperation and crime control in around 194 countries. It is headquartered in Lyon, France. Each of the member countries hosts an **INTERPOL NCB** (National Central Bureau). It connects their national law enforcement with other countries and with the General Secretariat of Interpol. The **Central Bureau of Investigation (CBI)** is designated as the NCB of India.

The Rise of Environmental Crime is published jointly by UNEP and INTERPOL.

12.9.1. Types of Interpol Notices

Red Notice	To seek the location and arrest of persons wanted for prosecution or to serve a sentence.
Yellow Notice	To help locate missing persons, often minors, or to help identify persons who are unable to identify themselves.
Blue Notice	To collect additional information about a person's identity, location or activities in relation to a crime.
Black Notice	To seek information on unidentified bodies.
Green Notice	To provide warning about a person's criminal activities, where the person is considered to be a possible threat to public safety.
Orange Notice	To warn of an event, a person, an object or a process representing a serious and imminent threat to public safety.
Purple Notice	To seek or provide information on modus operandi, objects, devices and concealment methods used by criminals.
INTERPOL–UNSC Special Notice	Issued for groups and individuals who are the targets of UN Security Council Sanctions Committees.

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12.10. BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)

The Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for the prudential regulation of banks. It provides a forum for regular cooperation on banking supervision among the central banks of different countries. BCBS was established by the Central Bank governors of the Group of Ten countries in 1974. The committee expanded its membership in 2009 and 2014. The BCBS now has membership from 28 Jurisdictions through 45 members consisting of Central Banks and authorities with responsibility of banking regulation. The objective of BCBS is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

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13
CHAPTER

Insurance in India

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13.1. INTRODUCTION

Insurance is a mechanism of risk management and protection that safeguards an individual against unexpected losses. Insurance is a **contract** between an insurance policy-holder and an insurer. The policyholder pays a periodic premium or a lump sum to the insurer and the insurer promises to cover losses of the policyholder/ insured entity.

An entity which provides insurance is called an **insurer**, an individual or entity who buys insurance is known as a **policyholder** and the person or individual covered under the policy is called an **insured**. **Insurance policy** is a document/contract which gives details regarding terms and conditions under which the insurer will compensate the insured.

Life insurance covers the life of an insured person and the insurer pays a designated beneficiary a sum of money upon the death of an insured person. **General insurance** is an umbrella term for non-life insurance policies which covers other aspects and assets in a person's life, for example, health, car, home, etc.

13.1.1. How does insurance work?

Working of insurance can be understood on basis of two related features:

1. **Transferring of risk** from one individual to a group
2. **Sharing losses,** on some equitable basis, by all the members of the group.

Insured entities transfer individual risk to a group where every member of the group faces a similar risk. Individuals substitute a large uncertain cost (in case of occurrence of an event insured against) with a small certain cost (premium). The premiums paid are pooled together, out of which the loss sustained by any policy holder is compensated. Thus, risks are shared with others and many pay for the loss of unfortunate few. Insurance can also be understood as an instrument of loss distribution. What could have been a devastating loss for an individual is divided in an equitable manner among all the members of a group.

Insurance protests through pooling of risk. When a large number of homogeneous entities exposed to similar risk are combined, risk is pooled and burden is shared. There is a very minuscule possibility that all the insured entities would simultaneously face the event insured against. It must be understood that insurance does not reduce the possibility of a loss causing event but it reduces the probability of financial loss due to that event. So, insurance, in essence, provides relief from the burden of the uncertain and not from the uncertain itself.

13.2. HISTORY OF INSURANCE IN INDIA

Ancient writings like Manu (Manusmriti), Yagnavalkya (Dharmasastra) and Kautilya (Arthashastra) mention a system of risk sharing similar to modern day insurance. These writings speak of pooling of resources that could be redistributed in times of calamities such as fire, floods, droughts, epidemics and famine, etc. Evolution of the insurance industry in the modern sense can be divided into three phases.

Insurance in India

The first phase started in 1818 with the establishment of **Oriental Life Insurance Company** in Kolkata, the first life insurance company in India. In 1829, the Madras Equitable began providing life insurance services in the Madras Presidency. These companies were operating in India but catered to the needs of the European Community living in India and did not insure the lives of Indians. Gradually, some of the companies later started insurance services for the Indians but they were treated as 'substandard'. So, the Indian had to pay an ad-hoc extra premium. Bombay Mutual Life Assurance Society, started in 1871, was the first company to sell policies at 'fair value' to Indians. This phase was dominated by foreign insurance companies, such as Albert Life Assurance, Royal Insurance, Liverpool and London Globe Insurance etc. Triton Insurance Company, established in 1850, was the first general insurance company in India. This was a British-owned and -operated company. The Indian Mercantile Insurance Company Ltd, established in Bombay 1907, was the first indigenous insurance company.

By the year 1938, more than 100 insurance companies were operating in India but the sector was plagued by frauds and mismanagement of funds. A consultative committee under the Chairmanship of Mr. Sushil C. Sen was set up by the government of India in 1937. Finally, the first comprehensive law, Insurance Act, 1938, was passed to regulate both life and general insurance companies.

The Insurance Act 1938 provided stability to the sector. This legislation resulted in a large number of insurance companies operating in India, and the level of competition was high. However, there were also allegations of unfair trade practices. The **second phase** started with the decision of the government of India to nationalize the life insurance business in 1956 and the general insurance business in 1972. During the second phase, the insurance business in India was a public sector monopoly.

An ordinance was issued on 19 January 1956 for nationalization of the life insurance sector. Life Insurance Corporation (LIC) came into existence under the Life Insurance Act, 1956. The LIC absorbed 245 Indian and foreign insurers. Nationalization aimed at (1) overcoming the inefficiency and malpractices involved during the period of private insurance operations (2) to make life insurance widespread under government control (3) to restore public confidence and to ensure maximum security to the policyholders' capital. At the same time, nationalization also aimed at using the funds available with LIC for development under the five-year plans.

An ordinance promulgated on 13 May 1971 nationalized the general insurance business. 107 insurers were amalgamated and grouped into four companies, namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd and the United India Insurance Company Ltd. The General Insurance Business (Nationalisation) Act, 1972 (GIBNA) paved the way for the Government to take over ownership of these businesses. For this purpose, General Insurance Corporation of India was incorporated to function as the holding company of the four companies, and superintend, control and carry on the business of general insurance on behalf of the Government of India.

With the liberalization, privatization and globalization (LPG) reforms, the importance of private sector in deepening the insurance sector was felt. The process of reopening of this sector began with appointment of a committee headed by former RBI governor Mr R.N. Malhotra in April 1993 to propose recommendations for reforms in the insurance sector. The committee submitted its report in January 1994 and recommended that the private sector should be permitted to enter the insurance industry. Following the recommendations of the committee, in 1999, the Insurance Regulatory and Development Authority of India (IRDAI) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDAI was incorporated as a statutory body in April 2000.

The IRDAI opened up the market in August 2000 to private players with a foreign investment cap of 26% in equity shareholding. In December, 2000, the subsidiaries of the General Insurance Corporation (GIC) of India were restructured as independent companies and at the same time GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002.

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With the private and foreign players' participation, the Indian insurance industry has transformed from a monopoly to a competitive market. To encourage private participation FDI limit has been increased to 49% in 2014, and further increased to 74% in May 2021.

As of December 2021, there are 34 general insurance companies and 24 life insurance companies operating in the country. The insurance sector is huge and is growing at a speedy rate of 15-20% per annum. Together with banking services, insurance services add about 7% to the country's GDP.

13.3. INSURANCE PENETRATION AND INSURANCE DENSITY IN INDIA

Insurance penetration and insurance density are the two parameters used for measuring potential and performance of insurance sector.

Coronavirus pushed life insurance penetration In India to 3.2% in 2020 from 2.82% in 2019. This has brought life insurance penetration in India closer to global average. The significant rise in purchase of life insurance by Indians in 2020 can also be gauged by the fact that 44.3% of total premium collected by life insurers in 2020 was from new policies. It was last time in 2011 when the life insurance penetration was at this level (3.4%). Between 2011 and 2014, life insurance penetration gradually declined to 2.62% in 2014. Since 2014, there has been an upward trend in life insurance penetration in India.

Overall insurance penetration, which includes both life and non-life insurance, was 2.71% in 2001 and has steadily increased to 4.2% in 2020. As of 2020, the penetration of non-life insurance penetration was 1%. While India has now reached close to the international average in terms of insurance penetration for life insurance, in terms of non-life insurance, India lags behind the global average of 4.1%.

Insurance Penetration	Insurance Density
It is the ratio of total insurance premium paid to the GDP in a given year.	It is calculated as the ratio of total insurance premium paid (in USD) to the population in a given year.
Insurance penetration was just 3.76% of the GDP in the country in 2019. (2.71% in 2001)	Insurance density in India was approximately USD 78 in 2019 (USD 11.5 in 2001)
In comparison, insurance penetration in countries like Malaysia and China was 4.72 and 4.30 percent respectively in 2019.	In comparison, insurance density in countries like Malaysia and China in 2019 were much higher at USD 536 and USD 430 respectively
In India, in 2019, insurance penetration for life insurance was 2.82% and for non-life insurance was 0.94%. Globally, insurance penetration for life insurance was 3.35% and for non-life insurance was 3.88% in 2019.	In India, in 2019, insurance density for life insurance was USD 58 and for non-life insurance was USD 19. Globally, insurance density for life insurance was USD 379 and for non-life insurance was USD 439 in 2019.

Trends in Insurance Sector: Penetration and Density in Life Insurance							
Particulars	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Insurance Penetration (in percent)	3.10	2.60	2.72	2.72	2.76	2.74	2.82
Insurance Density (in USD)	41.0	44.0	43.2	46.5	55.0	55.0	58.0

Trends in Insurance Sector: Penetration and Density in Non-Life Insurance							
Particulars	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Insurance Penetration (in percent)	0.80	0.70	0.72	0.77	0.93	0.97	0.94
Insurance Density (in USD)	11.0	11.0	12.0	13.2	18.0	19.0	19.0

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13.3.1. Reasons for low Insurance penetration in India:

1. Low average income results in greater proportion of income being spent on basic needs like food, clothing, housing, health etc., leaving very little for saving and virtually nothing for paying insurance premium.
2. People generally lack financial literacy and are ignorant towards benefits of insurance. People often believe that they have wasted their money in purchasing insurance if a loss does not occur and indemnity is not received.
3. Increased number of private players and multiple schemes/policies offering various benefits for different premiums along with numerous add-ons have created confusion in the general public.
4. Most people continue to view insurance only as a tax saving measure. Since just 2% of the population pays income tax, the number of persons inclined to buy insurance is also low.
5. There is also an element of distrust towards insurers among the public. For example, there seems to be a general perception that insurance comes with lots of terms and conditions that insurance companies misuse to reject even genuine claims.

13.4. SIGNIFICANCE OF INSURANCE

The significance of the insurance sector in a modern economy can be understood at two levels (1) At level of individual and enterprise (2) At national and societal level. Insurance protects enterprises against unforeseen risks such as fire and natural disasters. Individuals require insurance services for financially safeguarding against loss of property, life, health care needs etc. Insurance is assuming increasing importance in face of growing urbanization, declining social bonds and rising cost of health care. Insurance also enables individuals and enterprises to undertake high risk activities that can provide higher returns, thus promoting higher productivity and growth.

Insurance encourages long-term saving, thus provides long term capital for investment in developmental activities like infrastructure projects. It reduces the burden on the government exchequer by covering the needs of society. It helps in mobilization of saving and investing them in productive activities, economic growth and development of the nation. Insurance sector also employs a significant number of workers, helping to lower India's unemployment rate.

13.5. GOVERNMENT SPONSORED SOCIALLY ORIENTED INSURANCE SCHEME

Insurance Scheme	Objective
Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)	PMJJY is a life insurance available to people in the age group of 18 to 50 and having a bank account. It provides a risk coverage of Rs. 2 L against annual premium of Rs.330.
Pradhan Mantri Suraksha Bima Yojana (PMSBY)	PMSBY is a personal accident insurance scheme that covers accidental death, permanent disability, and partial disablement. Scheme is available to individuals in the age group 18 to 70 years and having a bank account. The annual premium of the scheme is Rs.12. Rs.2 lakh is paid to the nominee if the subscriber dies in an accident or if he is fully disabled. If the subscriber meets with an accident and suffers partial permanent disability, then Rs.1 lakh is paid. The annual premium of the scheme is Rs.12
Life Cover under Pradhan Mantri Jan Dhan Yojana (PMJDY)	PMJDY seeks to provide a basic bank account to every family. The bank account comes with a RuPay debit card with a built-in accidental insurance cover of Rs. 1 lakh.

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Pradhan Mantri Jan Arogya Yojana (PMJAY)	Pradhan Mantri Jan Arogya Yojana (PMJAY) is a health insurance scheme that aims to provide health cover of Rs. 5 lakhs per family per year for secondary and tertiary care hospitalization to over 10.74 crores of poor and vulnerable families (approximately 50 crore beneficiaries) from the bottom 40% of the Indian population. It is the largest government-funded health assurance scheme in the world.
Pradhan Mantri Fasal Bima Yojana	Pradhan Mantri Fasal Bima Yojana provides comprehensive insurance cover against failure of the crop thus helping in stabilizing the income of the farmers. It is a scheme of Ministry of Agriculture and Farmers Welfare. It covers a) food crops b) oilseed crops and c) annual commercial/horticultural crops. The prescribed premium is a) 2% for Kharif crops b) 1.5% for crops and c) 5% for commercial and horticultural crops. Balance of actuarial premium is shared equally between State and Central government.

13.6. INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (IRDAI)

The IRDAI as statutory regulatory body established under IRDA Act, 1999. It was formed in response to the Malhotra Committee's recommendations. It has its headquarters in Hyderabad. IRDAI is a 10-member body including the chairman, five full-time and four part-time members appointed by the government of India. Its functions and responsibilities include:

1. Registering and regulating insurance companies
2. Protecting policyholders' interests
3. Licensing and establishing norms for insurance intermediaries
4. Promoting professional organizations in insurance
5. Regulating and overseeing premium rates and terms of non-life insurance covers
6. Specifying financial reporting norms of insurance companies
7. Regulating investment of policyholders' funds by insurance companies
8. Ensuring the maintenance of solvency margin by insurance companies
9. Ensuring insurance coverage in rural areas and of vulnerable sections of society

13.7. DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION (DICGC)

Deposit insurance is a form of insurance that protects money of bank depositors in case of a bank failure or inability of a bank to repay its depositor. Deposit insurance premium is borne entirely by the insured bank. In India, a depositor can claim a sum upto a limit of 5 lakhs as insurance cover in the event of a bank failure (even if the deposit in their account is greater than 5 lakhs).

As premium is paid by the bank, accounts are insured bank-wise. So, the deposits kept in different branches of a bank are aggregated for the purpose of insurance cover and a maximum amount of upto Rupees five lakhs is paid. If an individual has deposits with more than one bank, deposit insurance coverage limit is applied separately to the deposits in each bank.

The Deposit Insurance and Credit Guarantee Corporation (DICGC) provides for the insurance coverage. Deposit Insurance and Credit Guarantee Corporation (DICGC) is a subsidiary of the Reserve Bank of India and provides for the deposit insurance coverage. It was established in 1978 under Deposit Insurance and Credit Guarantee Corporation Act, 1961. The Deputy Governor of RBI acts as its Chairman of DICGC. It is headquartered in Mumbai. It prov**ides insurance covers for all commercial banks, local area banks, regional rural banks, co-operative banks and branches of foreign banks in India.** However, the primary cooperative societies, Non-banking Financial Companies (NBFCs) and mutual funds are not insured by the DICGC.

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DICGC insures all bank deposits such as savings deposits, fixed deposits, current account deposits and recurring deposits. It does not insure Deposits of foreign Governments in India, deposits of Central/State Governments with various banks, inter-bank deposits, deposits of the State Land Development Banks with the State co-operative banks, any amount which has been specifically exempted by the corporation with the previous approval of the RBI.

Reinsurance

Reinsurance is protection that an insurance firm buys from another insurance company to protect itself against the possibility of a major claim. Reinsurance is where a firm transfers its own insurance risks to another insurer. In most cases, the entity that purchases the reinsurance policy is referred to as a **"ceding company" or "cedant"**. The "reinsurer" is the institution that issues the reinsurance policy.

13.8. MISCELLANEOUS

13.8.1. Hedging

A hedge is an investment made to offset potential losses or gains that may be incurred by an associated investment. To hedge, an individual invests in two different instruments that have adverse correlation. In simple terms, it is an investment made in a relatively safer instrument to reduce the likelihood of negative impact of loss from an investment in a high-risk instrument. It is a risk management that does not eliminate the loss, but, decreases the impact of loss.

13.8.2. Bilateral Netting

Bilateral netting refers to offsetting the claims arising from dealings between two parties to determine the net amount payable or receivable from one party to the other.

Bilateral Netting of Qualified Financial Contracts Act, 2020 provides for a legal framework

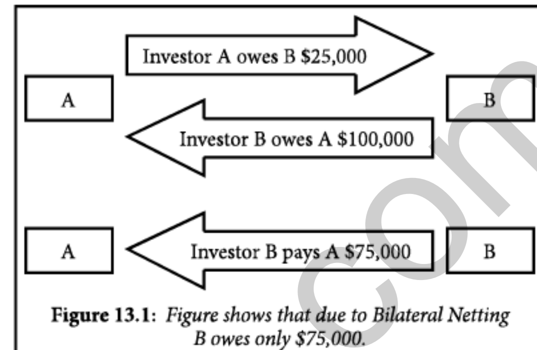

Figure 13.1: *Figure shows that due to Bilateral Netting B owes only $75,000.*

for bilateral netting of qualified financial contracts. This bilateral netting legislation helps in evaluating risks far more on a real-time basis and actual risk assessment happens rather than a notional risk assessment based on the gross figures.

13.8.3. Domestic Systemically Important Insurer (D-SII)

D-SII are insurers of such size, market importance, and domestic and global interconnectedness, whose distress or failure would cause a significant adverse impact on the domestic financial system. Therefore, the stability of D-SIIs is critical for the uninterrupted availability of insurance services in the country.

D-SIIs are perceived as insurers that are 'too big or too important to fail' (TBTF). This perception and the perceived expectation of government support may amplify risk taking, reduce market discipline, create competitive distortions, and increase the possibility of distress in future. These considerations require that D-SIIs should be subjected to additional regulatory measures to deal with the systemic risks and moral hazard issues.

Three insurers have been identified as D-SIIs for the year 2021-22:

1. Life Insurance Corporation of India;
2. General Insurance Corporation of India; and
3. New India Assurance Co. Ltd.

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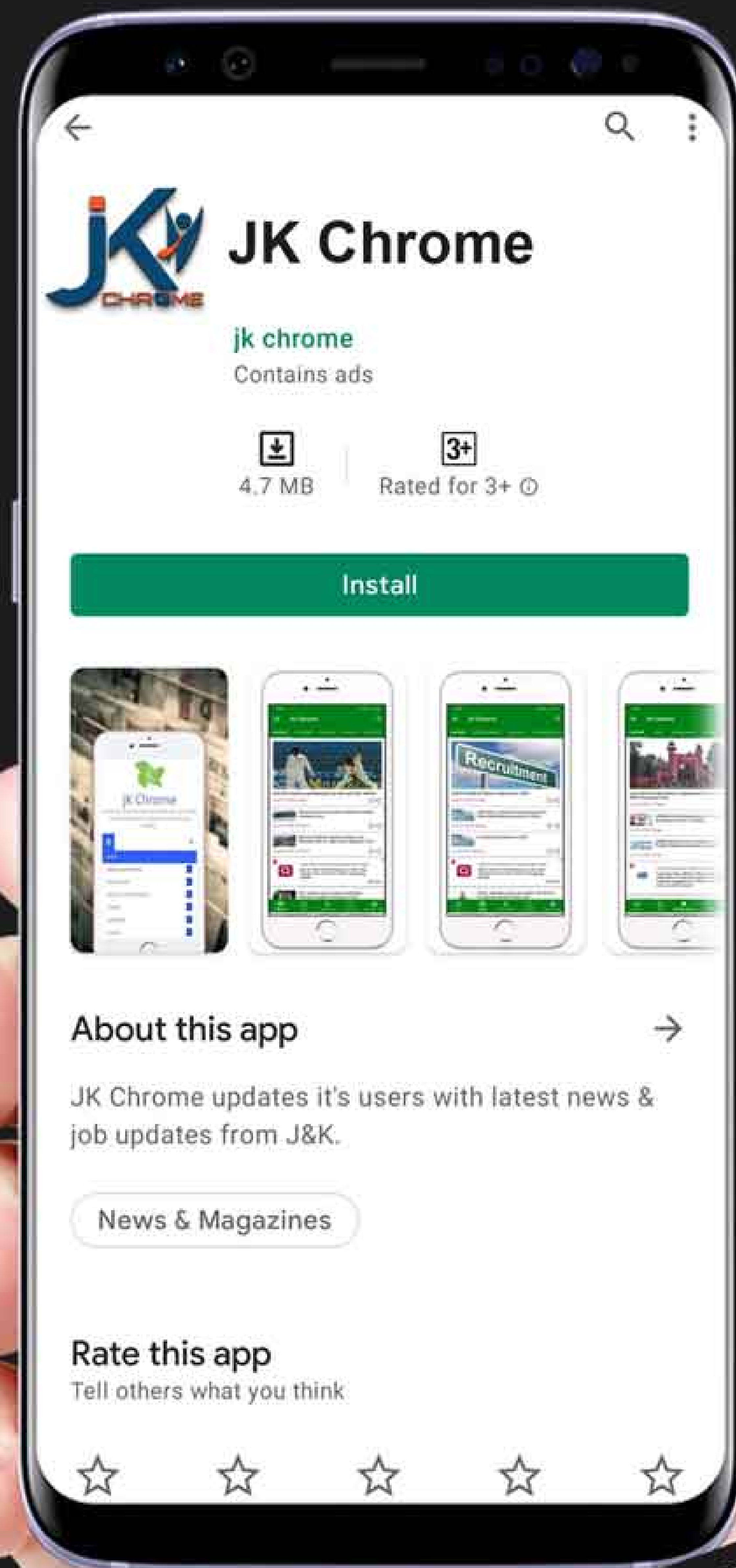

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