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Module I – Commercial and central banking

Introduction to commercial banking

Section 5b of the Banking Regulations Act, 1949, defines banking as

"Acceptance of deposits of money from the public for the purpose of lending or investment".

These deposits are repayable on demand or otherwise, and withdrawable by a cheque, draft, order or otherwise.

Banks are the only financial institutes which can accept demand deposits (Saving / Current) which can be withdrawn by a cheque. In addition, a bank performs the following functions:

- Issuing Demand Drafts & Travelers Cheques
- Collection of Cheques, Bills of exchange
- Discounting and purchase of Bills
- Safe Deposit Lockers
- Issuing Letters of Credit & Letters of Guarantee
- Sales and Purchase of Foreign Exchange
- Custodial Services
- Investment services
- doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

Role of commercial banking

The finance sector is an important factor of rapid development. The role can be explained as follows:

a. Commercial banking aids industrialization by providing liberal trade credit or working capital.
b. Commercial banks through their operations of mobilizing deposits and extending advances help in redistribution of resources across regions.
c. By savings mobilization, commercial banks help in capital formation.
d. Extensive banking sector can improve the banking habits of people.

e. Entrepreneurship can be promoted by commercial banking finance.
f. Commercial banking is looked upon as an agent of economic growth.

Assets and liabilities of Commercial banks

Assets and Liabilities

The assets of a typical commercial bank show Money at call and short notice, bills discounted / purchased, investment in Government securities, shares debentures, bonds and gold, loans and advances, bills received for collection, acceptance endorsement and other fixed assets like furniture and fixtures, land and buildings etc.

The liabilities of a commercial bank include Share capital shown as authorized, allotted, subscribed and paid-up capital, deposits, bills payable, deposits, funds and reserves Borrowings from other banking, acceptance, endorsement, contingent liabilities etc.

Conflicting Objectives of Liquidity and Profitability

Banks are limited companies whose main aim is to create profit to its shareholders. Most of the profit comes out of lending the money, which is received from depositors, out to the customers.

So the more the depositors a bank has, the more it can lend out, thus it can make more profit and pay higher dividends to its shareholders. It follows that the banks try to be as attractive to potential savers as possible. They can offer two things: a high interest rate and a high liquidity. Both are very important, because depositors want to be able to draw their money out any time they want and have profit by receiving interest.

A bank has to maintain liquidity as well as profitability. Liquidity is meant for maintaining the statutory responsibility to the depositors and profitability for its survival.

So, a bank needs to maintain its portfolio in such a manner that it is able to honour the demands of the depositors as well as earn profits out of its deposits and other investments.

Flowing are the factors determining **liquidity**

- *Statutory liquidity ratio:* Statutory liquidity ratio is the part of deposit held by Reserve bank as reserve. With increasing SLR the liquidity decreases.
- *Nature of Business*: The banking activities are spread over traditional functions, non conventional areas, innovative products and activities specific to a region. Liquidity is affected by any of these factors.
- *Banking habits*: The banking habits of people determine the liquidity needs of the bank. Usage of cash or banking instruments determine the demand for cash
- *Liquidity policy of other banks*: As '*neighborhood effect'* the liquidity policy of other commercial banks affects its own liquidity needs.
- *Facility of clearing houses:* An efficient clearing houses and system will enable flow of liquidity to banks.

Following are the factors determining **profitability:**

- *Portfolio management*: A bank invests its funds on various assets to receive profits. This is called the portfolio management. A bank has to manage its portfolio in such a manner that it has the basic liquidity for its responsibility to the depositors yet earn profits.
- *Interest and non- interest incomes*: banks income comprises interest and non interest incomes. The bank has to draw a balance between them so as to maintain a combination of liquidity, returns and security.
- *Level of non performing assets:* The bank has to diversify its lending operations and also keep the non performing assets low. Non performing assets are bad debts. Keeping them low depends on a sound loan appraisal and recovery mechanism.
- *Spread:* The banks shall have healthy distribution of incomes coming form interest and non interest incomes. This can be learnt through. Spread is the difference

between the average ratios of interest income to assets and the average ratios of interest expended on liabilities.

- *Level of Competition:* In spite of these objectives the bank has to face and manage competition in a open market system.

In its operations, a commercial bank has to draw a balance between liquidity and profitability.

Now there is a clash for the bank between these two objectives. If they would want to maximize the liquidity they would keep their assets in cash, which is the most liquid form of assets, but the bank cannot earn any interest on that, so it cannot give any interest to its depositors.

In ***portfolio management***, a bank resolves the conflict of liquidity and profitability

- Due to security reasons of security and liquidity the banks to have some portion of their assets in cash. This money earns no interest.

- The liquidity loss of keeping less cash is compensated by the interest bearing loans at call or short notice (the money can be received back immediately or after a week notice).

- Discount houses deals with bills and so can provide the money immediately by selling some of them.

- Treasury Bills which government issues every month for the period of 91 days and which are very secure and bills issued by other businesses.

- Liquid assets form 9-12 percent of all the assets. They are unprofitable compared to the other type of assets that are less liquid: medium-term loans, investments and advances.

- The main part of banks' assets is advances to its customers. They form more than 50 percent of total assets and are formed from overdrafts and loans of various types.

- Government stocks are another very common type of profitable assets. They are loans to government, who issues interest-bearing bonds (e.g. Exchequer stock, Treasury stock), which banks can then buy.

Banks have to make decisions which proportion of these assets described above to choose to make profits and maintain liquidity. They do not have choice, because great part of their liabilities is controlled by the Reserve Bank of India as eligible liabilities.

Banking Sector Reforms: Narasimham Committee

In 1991, under the chairmanship of M Narasimham, a committee was set up by his name which worked for the liberalization of banking practices.
M. Narasimham (1998) had pointed out; the reforms in the banking sector can be classified into two phases:

1. The first phase consisted of the *curative measures*, which were brought about for making the banking sector more oriented to the market and impart competition to the environment.

2. The second phase consisted of the *preventive measures*, which were brought about to ensure smooth functioning of the banking sector in the long run.

The primary curative measures included the reduction of reserve requirements, interest rate deregulation and lifting of entry barriers. Other important measures introduced in this category included prudential reforms in terms of following capital adequacy norms as well as adhering to well-defined asset classification and provisioning standards.

Supervisory and regulatory reforms were introduced to ensure transparency and adequate risk management practices were made mandatory. The thrust of the preventive measures was primarily on privatization and government

stake was reduced to 30 per cent. The establishment of asset reconstruction companies was envisaged and capital adequacy norms were made more stringent.

Some of the recommendations offered by the committee, in its report submitted in November 1991, are:

1. A reduction, phased over five years in the Statutory Liquidity Ratio (SLR) to 25 percent, synchronized with the planned contraction in Fiscal Deficit.
2. A progressive reduction in the Cash Reserve Ratio (CRR).
3. Gradual deregulation of interest rates.
4. All banks to attain Capital Adequacy o 8 percent in a phased manner.
5. Banks to make substantial provisions for bad and doubtful debts.
6. Profitable and reputed banks be permitted to raise capital from the public.
7. Instituting an Assets Reconstruction Fund to which the bad and doubtful debts of banks and Financial Institutions could be transferred at a discount.
8. Facilitating the establishment of new private banks, subject to RBI norms.
9. Banks and financial institutions to classify their assets into four broad groups, viz, Standard, Sub-standard, Doubtful and Loss.
10. RBI to be primarily responsible for the regulation of the banking system.
11. Larger role for SEBI, particularly as a market regulator rather than as a controlling authority.

As a sequel to the report, the government has acted upon many of the suggestions. These actions include reductions in CRR and SLR, stipulation of capital adequacy norms for banks and announcement of guidelines for new private banks.

The Report of the Narasimham Committee-II, which was submitted to the Government in 1998 made a number of recommendations covering institutional, supervisory, legislative and banking policies aspects. These recommendations relate to capital adequacy, asset quality, non-performing

asset, directed credit, prudential norms, disclosure requirement, system and methods in banks structural issues, rural and small industrial credit, regulation and supervision, legal and legislative framework. Most of the recommendations have been accepted and implemented by RBI. Consideration and examination in respect of some remaining recommendations is going on.

The Committee, recommended that the public sector banks should be encouraged to go the market to raise capital to enhance their capital. The Government has accepted the recommendation of Narasimham Committee for reducing the requirement of minimum shareholding of Government in nationalized banks to 33 per cent without changing the public sector character of banks.

Growth and Performance of banking sector*

Public Sector Banking

Public Sector Banks comprise

- State Bank of India and its associate banks called the State Bank group, and
- 20 nationalized banks

The State Bank of India is India's largest commercial bank and is ranked one of the top five banks worldwide. It serves 90 million customers through a network of 9,000 branches and it offers either directly or through subsidiaries a wide range of banking services.

The Public sector banks play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches.

In order to reach the stipulated capital adequacy norms, substantial capital were provided by the Government to Public sector banks.

Capital Adequacy and Recapitalization of Banks: Out of the 27 public sector banks, 26 Public sector banks achieved the minimum capital to risk assets ratio of 9 per cent by March 2000. Of this, 22 Public sector banks had CRAR exceeding 10 per cent. To enable the Public sector banks to operate in a more competitive manner, the Government adopted a policy of

providing autonomous status to these banks, subject to certain benchmarks. As at end-March 1999, 17 Public sector banks became eligible for autonomous status.

Revival of Weak Banks: The Reserve Bank had set up a Working Group to suggest measures for the revival of weak Public sector banks in February 1999. The Working Group, in its report suggested that weak banks need to be supported on the basis of three factors:

- Solvency (capital adequacy ratio and coverage ratio),
- Earnings capacity (return on assets and net interest margin) and
- Profitability

Public sector banks have large non performing assets. Recognizing that the high level of Non-performing assets in the Public sector banks can endanger financial system stability, the Government in 2001 set up seven more Debt Recovery Tribunals for speedy recovery of bad loans.

Public sector banks

	Operating Profits	Operating expenses	Income
2006-07	42665 (1.8)	43225 (1.8)	187869 (7.7)
2007-08	50307 (1.7)	46663 (1.5)	245872 (8.1)
2008-09	66972 (1.8)	55190 (1.5)	315608 (8.4)

(*) percent to total assets Rs crores

Private sector banks

There were 24 private banks during pre reforms period. As per the recommendations of the Narasimham Committee private sector banks were allowed to start business in India. The private sector banks were allowed as per the capital requirement norms of RBI. The Committee suggested that as pert the spirit of privatization, the new private sector banks shall have all the concessions and facilities of public sector banks.
Presently there are 19 old 8 new private sector banks in India.

Foreign investment in private sector banks is allowed up to 74 percent of paid up capital.

The private sector banks were required to have

1. Minimum net worth of Rs 200 crores
2. Credit rating of AAA for earlier years
3. Capital adequacy greater than 12 percent
4. Non performing assets less than 5 per cent

The private sector banks were to give priority to agro based rural industries

The new private sector banks had to develop innovative services and methods of conducting business to with stand the competition of public sector banks. New private sector banks emerged with excellent financial services, innovative products, created new markets, brought n low cost funds from NRI. In all they showed great efficiency.
In this process the public sector banks were giving away one of their businesses to private sector banks, annually.

New private sector banks

	Operating Profits	Operating expenses	Income
2006-07	10682 (1.8)	12353 (2.1)	48837 (8.4)
2007-08	16632 (2.1)	17302 (2.3)	71199 (9.6)
2008-09	18480 (4.5)	17840 (2.2)	81444 (1.1)

(*) percent to total assets Rs crores

Foreign banks
There are 29 foreign banks operating in India. A foreign bank can be set as a wholly subsidiary if it gets $ 50 mil. Foreign banks helped in strengthening the financial structure and also created competition.

Foreign banks crated competition for the private banks more than the public sector banks. In terms of competition it is public sector versus private and foreign banks. These two sets of banks have different objectives and have dissimilar products. However, there is convergence in terms of technology and conduct of business. In recent times, all the banks are showing similar business objectives.

Foreign banks are known for their state of the art cutting edge technology, innovative financial products and marketing. These banks are responsible in improving the banking habits of people and bringing in credit culture.

	Operating Profits	Operating expenses	Income
2006-07	9619 (3.5)	7745 (2.8)	24968 (9.1)
2007-08	14047 (3.9)	10353 (2.8)	35004 (9.6)
2008-09	20098 (4.5)	12299 (2.8)	45213 (10.1)

(*) percent to total assets
Rs crores

Trends and Performance of banking sector

- Reforms have had a moderately positive impact on reducing the concentration of the banking sector and improving performance
- Banking regulations lowered the profitability and cost efficiency of public-sector banks at the initial stage of the reforms, but such a negative impact disappeared once they adjusted to the new environment.
- Cost efficiency steadily improved over the reform period, and the gap in performance compared with foreign banks has diminished.
- Non-traditional activities have contributed to improved profitability and cost and earnings efficiency of the whole banking sector, including public-sector banks.
- Investment in government securities has lowered the profitability and cost efficiency of the whole banking sector, including public-sector banks. Lending to priority sectors and the public-sector has not had a negative effect on profitability and cost efficiency, contrary
- Foreign banks (and private domestic banks in some cases) have generally performed better than other banks in terms of profitability and income efficiency.

Performance of banks: analysis of important ratios

1. Foreign and private domestic banks are generally more cost-efficient than public sector banks.
The ***ratio of operating expenditure to operating income*** was 72 per cent for foreign banks, 80-85 per cent for domestic banks, and 84 per cent for public-

sector banks. While foreign banks are more cost-efficient, their efficiency level has decreased. Instead, domestic and public-sector banks improved efficiency.

2. In terms of ***earning capacity***, foreign banks are generally better performers. The foreign banks have consistently performed better than private domestic and public sector banks. The inferior performance of domestic banks relative to foreign banks can be attributed to

- Larger share of credit extended to the public-sector,
- More stringent requirements imposed on direct lending,
- Lesser degree of diversification, and
- Lower interest rate margins.

3. The ***contingent liabilities to assets ratio*** of foreign banks (at around 25-30 per cent), has been greater than that of domestic banks and public-sector banks. This indicates that foreign banks are more exposed to high potential losses in cases of default.

The ratio of provisions for Non Performing Assets to assets reports that foreign banks generally allocated greater provisions for Non Performing Assets. Given that more stringent accounting and auditing standards of their mother countries are applied to foreign banks, the foreign banks are more resistant to adverse shocks.

4. Management performance is assessed based on two indicators:

- The ratio of credit to deposits; and
- The ratio of equity and reserves to debt (inverse of leverage).

The first indicator reports that foreign banks attempt to improve their income by expanding their lending operations as compared with other domestic banks. The ratio of foreign banks improved from 56 per cent to 94 per cent between 1995 and 2008, while the two other types of banks maintained the ratio at about 40 per cent over the same

Recent trends in banking sector

The banking sector has just come out of the Global melt down and world financial crisis. There was a change in the mode of operation in terms of expansion and growth

- In 2009-2010 private sector banks have performed better than public sector and foreign competitors in terms of credit growth.

- When the public sector and foreign banks registered a decline in their credit growth rates, private sector banks witnessed a 70 basis points (bps) increase in credit growth..

- There is a revival of loans in the banking industry.

- The private sector banks saw the pace of their credit growth increase to 11.7 per cent during the 2009- 2010 as against 11 per cent a year earlier.

- The private sector banks have extended loans worth Rs 61,211 crore during 2009-2010 as compared to loans worth Rs 52,013 crore in the previous year.

- The foreign banks reduced their loan assets by 1.5 per cent as compared to a growth of 4 per cent in the previous year.

- The foreign banks also witnessed decline of Rs 2,496 crore in the total outstanding loans of foreign banks.

- The credit growth for the Public sector banks slowed down to 19.5 per cent as against a growth rate of 20.9 per cent in2008-09.

- For the banking sector the incremental credit-deposit ratio has also risen steadily in the second half of 2009-10

- The banks have been able to cross the RBI estimate of 16 percent credit growth rate for the year thanks to a record growth in loan disbursals.

New Technologies in banking

Technology in Payment and Settlement Systems

As part of restructuring of the banking sector, special emphasis has been accorded to improvements in payment and settlement systems. Important among them are:

- *Electronic Funds Transfer*
  National Electronic Funds transfer and on-line Payments All inter-bank and intra-bank remittances can now be made on the same day by electronic funds transfer using the National Electronic Funds transfer system introduced by RBI.

- *Centralized Funds Management System*
  The Centralized Funds Management System would enable the funds and treasury managers of commercial banks to obtain the consolidated account-wise, centre-wise position of their balances. The Centralized Funds Management System would enable better funds management by constituent current account holders of the Reserve Bank

- *Structured Financial Messaging Solution*
  Institute for Banking Research and Development of Technology has developed the Indian Financial Net Work (INFINET). At the base of all inter-bank message transfers using the INFINET is the SFMS. SFMS would serve as a safe, secure communication carrier built with templates for transmission of intra and inter-bank messages in fixed message formats, which would facilitate "Straight Through Processing". This would result in the security levels matching those of international standards.

- *Imaging of Instruments*
  A process of capturing the images of the instruments as they are being processed was introduced during the year at the four metropolitan National Clearing Cells managed by the Reserve Bank. Imaging reduces clearing reconciliation differences.

- *Electronic Clearing Services*
  Electronic Clearing Service is prescribed by the Reserve Bank to encourage non-paper based funds movement.

- *Indian Financial Network (INFINET)*
  The INFINET has been operational for almost two years. It started as a closed user group communication network for the banking sector in India, now extended to all banks.

- *Cheque Clearing*
  Magnetic Ink Character Recognition based cheque-clearing indicates general trends the world over in migrating towards electronic funds transfer mechanisms.

- Depository Institutions like National Security Depository Ltd. and Central Security Depository Ltd. provide delivery vs. payment for secondary market deals in equity and debt paper.

Module II – Central Banking

Changing trends in monetary policy

Monetary Policy deals with changing money supply and rate of interest for the purpose of stabilizing the economy at full employment or potential output level by influencing aggregate demand

The RBI makes use of instruments to regulate money supply and bank credit so as to influence the level of aggregate demand for goods and services.

The monetary policy has to balance the objectives of economic growth and price stability.

Economic growth requires expansion in the supply of money so that no legitimate productive activity suffers due to finance shortage. Price stability requires control the expansion of credit so that money supply does not cause inflation.

Changes in the monetary policy can be made anytime during the year. The Central Bank may adopt an *expansionary* or *contractionary* policy depending on the general economic policy of the Government and conditions in the economy.

Monetary policy may also be used to influence the exchange rate of the country's currency.

Monetary management

Maintenance of a sound monetary system is the basic objective of any central bank of a nation - De kock.

Monetary management involves four major issues.

1. Price stability
2. Control over money supply
3. Control of Reserve money creation (RBI credit to government) and
4. Rationalization of administered interest rate.

The pre reforms monetary regime

- Existence of a spectrum of interest rates with built in elements of concessions and cross subsidies to meet the priorities to different sectors.
- Rate of return on government securities was fixed and was lower than market rates.
- Resolution of deposit rates and borrowing rates to maintain the cost of funds in relation to lending ratio.
- Unlimited accommodation through *adhoc* treasury bills to meet budgetary deficits of the central government
- Maintenance of high CRR and SLR of 15 per cent and 38.5 per cent respectively.
- Lack of depth in government securities market on account of application of lower than market coupons and
- Lack of depth and vibrancy in money market.

During transition to liberalized regime of monetary policy, formulation and implementation there were several changes:

- A shift in dependence from direct to indirect instruments of monetary control
- A more transparent way of formulation and implementation, keeping up with time consistency
- Recognition of the absence of trade-off between inflation and unemployment

The monetary policy now has to deal with twin objectives. Monetary policy now aims at striking a fine balance between high growth rate and price stability.

Changing trends in Monetary policy

- Controlled Expansion (1951-72):
  RBIs main concern during this period was to moderate the expansion of credit and money supply in such a way so as to legitimize needs of industry and trade and to curb the use for unproductive and speculative purposes.

- Tight Monetary Policy (1972-1991):
  RBI tightened the monetary policy to curb inflation. In seventies and eighties, large fiscal deficits were incurred. Reserve Bank's credit to the Government increased sharply which caused a rapid growth in money supply. Thus the monetary policy was to neutralize the inflationary effect
- Monetary Policy during reforms (1991 onwards):
  - As part of the economic reforms in 1991 it was decided to reduce the fiscal deficit. Until 1995 the focus of the policy was on ensuring price stability. Since 1995 the policy has been eased to accelerate economic growth. Since 1999, effects of policy were more encouraging
  - Like all emerging economies, India too has been affected by the crisis, and much more than was expected earlier.
  - GDP growth has shown lower industrial production, negative exports, reduction in services activities, and decreasing business confidence.
  - There were some strong points like well-functioning financial markets, good rural demand, lower headline

inflation and comfortable foreign exchange reserves which buffered the impact of the crisis.
- Reduced the repo rate to 4.75 per cent
- Reduced the reverse repo rate to 3.25 per cent
- Kept the CRR unchanged at 5.0 per cent

- *Monetary Policy 2009-10*
    - The thrust of the Reserve Bank's policy stance since mid-September 2008 aimed at providing rupee liquidity, ensuring comfortable dollar liquidity and maintaining continued credit flow to productive sectors.

    - There is scope for banks to further reduce lending rates so as to ensure credit flow for all productive economic activity.

    - In the January 2009 policy review, there was a projected growth for 2008-09 of 7.0 per cent.

    - Keeping in view the global trend in commodity prices and domestic demand-supply balance, WPI inflation is projected at around 4.0 per cent by end-March 2010.

RBI's Short term Liquidity management

The Government of India borrows from public by issue of securities, to finance its deficit. RBI uses government securities to control liquidity in the market in order to influence the interest rates.

RBI may reduce liquidity by selling the securities in the market and may increase liquidity by buying back the securities from the public.

Short term liquidity management refers to injection or absorption of liquidity by RBI through Repos and Reverse Repos.

Liquidity adjustment facility is an instrument of monetary policy through which the repos and reverse repos are auctioned within a corridor of interest

rates in the short run. The corridor of inertest rates refr to narrow range predetermined by RBI.

The second Liquidity adjustment facility announced in 2005 allowed auction twice daily. This reduced dependence on other tools like cash reserve ratio.

Liquidity adjustment facility reduces emphasis on the banks monetary targeting and concentrates on interest rate alone.

Market stabilization scheme
RBI introduced the Market Stabilization scheme in April 2004 to mop up the excess liquidity.

The MSS operates mainly through Treasury bills. The Government will issue T-bills by way of auctions by the RBI in addition to its normal borrowing requirements, for moping up excess liquidity.

The amount raised through this scheme is to be held in a separate account with the RBI and would be used only for the purpose of redemption or buyback of the T-bills

Repo and Reverse Repo are tools available in the hands of RBI to manage the liquidity in the system. It either injects liquidity into the market if the conditions are tight or sucks out liquidity if the liquidity is excess in the system through the Repo and Reverse Repo mechanism, besides a host of other measures.

- RBI, as lender of last resort, provides liquidity to the banks through Repo auction, where RBI purchases securities from banks with an agreement to sell back the securities after a fixed period.

- RBI conducts Repo / reverse Repo auctions daily for overnight funds. Currently RBI is conducting Repo actions thrice daily, as the banks need to maintain their liquidity

- It is the objective of RBI policy that the money market rates should normally move within the *corridor* of the policy rates (currently within the band of 3.25 percent and 4.75 percent).

- The Reverse Repo rate would lay the floor, which is the minimum rate of interest banks can earn on excess funds.

- The Repo rate would lay the upper side of the corridor as the maximum rate of interest at which banks can borrow overnight funds from RBI (RBI has imposed ceiling over call money lending and borrowing by banks. Banks can borrow and lend overnight up to a maximum of 100 percent and 25 percent respectively of their capital funds.

- Negotiated Dealing System is an electronic platform for facilitating dealing in government securities and money market instruments.

Role and performance of Micro finance

Micro finance

Microfinance is defined as *financial services for poor and low-income clients.* In practice, it refers to loans and other services from providers that identify themselves as “microfinance institutions”.

These institutions give very small loans to unsalaried borrowers, taking little or no collateral. These methods include group lending and liability, pre-loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly.

Indian microfinance is dominated by two operational approaches: self-help groups, and microfinance institutions, in addition to a few cooperative forms.

The Indian micro finance industry offers small quantum of finance in the form of loan to the individual or any organization. The industry of micro finance in India facilitates micro finance for the development of the social standard of the rural mass of India. Further, these micro finances are also offered for the development of the semi-urban and urban areas.

The industry of micro finance in India offers these micro finances through different tailor made financial instruments. These micro finances of India are structured with low rate of interest and with easy repayment options.

Micro Finance Institutions are playing an important role as financial intermediaries in micro finance sector. The MFIs operate under various legal forms.

a. NGO MFIs – Registered under Societies Registration Act 1860 and / or Indian Trust Act 1880
b. Cooperative MFIs
c. NBFC MFIs under Section 25 of Companies Act 1956 (Not for profit t)
d. NBFC MFIs incorporated under Companies Act 1956 & registered with RBI

Promotional Support - MFI Bank Linkage

i. Rating of Micro Finance Institutions. In order to identify, classify and rate Micro Finance Institutions and empower them to intermediate between the lending banks and the clients, NABARD had introduced a scheme for providing financial assistance by way of grant to Commercial Banks, Regional Rural Banks and Co-operative Banks to avail of the services of accredited rating agencies for rating of MFIs.

ii. Capital / Equity Support to Micro Finance Institutions (MFIs) a scheme called "Capital / Equity Support to MFIs from MFDEF" was announced under which capital/ equity support to various types of MFIs would be provided to enable them to leverage capital / equity for accessing commercial funds from banks.

iii. Revolving Fund Assistance (RFA) to MFIs NABARD provides loan funds in the form of Revolving Fund Assistance (RFA) on a very selective basis to MFIs.

Self-Help Groups

The SHG model was initiated by the National Bank for Agriculture and Rural Development (NABARD) through the SHG-Bank Linkage Programme in the early 1990s.

Today the SHG model, which links informal groups of women to the mainstream banking system, has the largest outreach to microfinance clients in the world.

According to NABARD, almost 3 million SHGs have linked to nearly 500 banks since the program started, reaching over 11 million households across.

To encourage banks to lend to SHGs, NABARD has provided subsidized refinancing support to banks, although the demand for such refinancing has declines as banks begin to discover that SHG lending is quite profitable, and characterized by default rates (less than 1 percent) that are, in fact, much lower than the rate of default on their regular lending portfolios (11 percent - 12 percent).

SHG Federations

Some NGOs have promoted federations. These apex institutions aggregate savings from SHGs and act as intermediaries between financial institutions and SHGs.

Financing Strategies

Commercial banks, regional rural banks (RRBs) and cooperative banks primarily fund the SHG-Bank Linkage Programme, and NABARD in turn re-finances them. Credit lines to SHGs are critically limited, as they are based on a certain multiple of SHG members' savings accounts within banks. While the cumulative savings of SHGs could serve as a low-cost source of funds for on lending, their potential is limited by the lack of aggregated savings across SHGs. Commercial equity investments are not available to for SHGs due to their informal status

Growth estimates

Assuming the entire poor population of India is potential microfinance clientele, the market size for microfinance in India is in the range of 5.8 to

7.7 crore clients. This translates to an annual credit demand of Rs 230 to 773 billion assuming loan sizes between USD100 and 250.

SHG Bank Linkage Model:
The model involves the SHGs financed directly by the banking agencies viz. Commercial Banks (Public Sector and Private Sector), Regional Rural Banks and Cooperative Banks.

MFI Bank Linkage Model: Under this model, Micro Finance Institutions (MFIs) avail bulk loans from banks for on-lending to SHGs and others small borrowers.

Recommendations for the industry of Micro Finance in India

- Creation of National Micro Finance Equity Fund with an initial subscription of Rs 200 crore
- The fund of the banks towards the equity fund are be treated as weaker section lending under the priority sector and the quantum of the equity fund to be raised to Rs 500 crore by 2012.
- Creation of a special type of non-banking finance companies to facilitate growth of the micro finance business with initial capital of Rs 25 lakh
- The maximum quantum of deposits mobilized by any such MFI must not exceed Rs 5,000 per investor and all such deposits may be covered by Deposit Insurance Credit Guarantee Corporation
- The Reserve Bank of India should facilitate establishing more micro-finance funds
- Subsidy funds should be mobilized from Rural Infrastructure Development Fund, National Bank for Agriculture and Rural Development and also as the profits of commercial banks
- The Reserve Bank of India should establish a permanent working group on micro-finance to monitor and review the progress of resources and also undertake the capacity building initiatives
- The RBI shall facilitate establishing business incubation fund for providing venture capital
- All Non-governmental organization or the self help groups, those who facilitate micro finance should transform themselves into mutually aided co-operative societies, maximum within a period of two years

Composite Credit

SSI units face difficulties in accessing bank credit because of their inability to provide adequate collateral security for loans. Considering this, the Government launched the Credit Guarantee Fund Scheme for Small Industries on 30th August, 2000 to solve the problem of collateral security and impediment to flow of credit to Small Scale Industries (SSI) sector.

Availability of bank credit without the problem of collaterals / third party guarantees is a major source of support to entrepreneurs of Micro and Small Enterprise (MSE). Keeping this objective in view, Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched Credit Guarantee Scheme (CGS) to strengthen credit to the MSE sector. The Government of India with SIDBI set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE).

Objectives:

- To give importance to project viability and secure the credit facility purely on the primary security of the assets financed.

- The lender availing guarantee facility should try to give composite credit to the borrowers so that the borrowers obtain both term loan and working capital facilities from a single agency.

The Credit Guarantee scheme (CGS) seeks to reassure the lender that, if the MSE unit, which availed collateral free credit facilities, fails to repay the lender, the Guarantee Trust will pay the lender up to 75 / 80/ 85 per cent of the credit facility.

The Trust shall cover credit facilities extended, by eligible lending institution(s) in respect of a single eligible borrower not exceeding Rs.50 lakh by way of term loan and/or working capital facilities on or after entering into an agreement with the Trust, to the Micro and Small enterprises, without any collateral security and\or third party guarantees.

Trust shall provide up to 75% of the amount in default of the credit facility extended by the lending institution to an eligible borrower, subject to a maximum guarantee cover of Rs.37.50 lakh

Cumulative credit approved CGTMSE

	Credit(Rs Lakhs)
2000-01	606
2001-02	3558
2002-03	9425
2003-04	21185
2004-05	53862
2005-06	100053
2006-07	170506
2007-08	215220

Module III – Financial markets (Revised)

Financial Markets

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset.

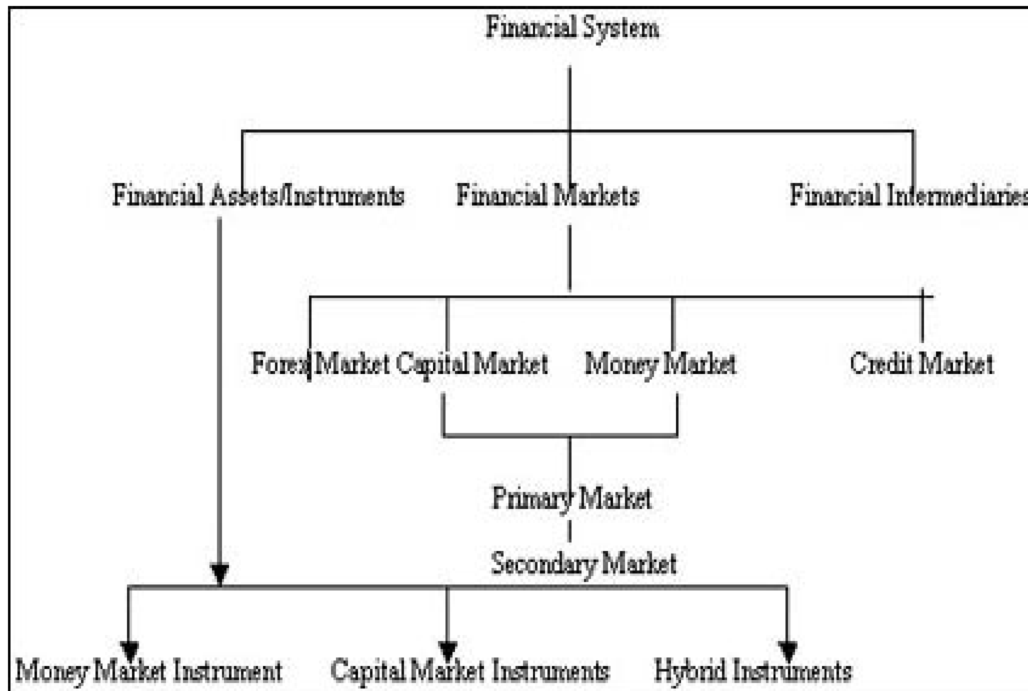
Money Market- The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Capital Market - Capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

Forex Market - The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this

market. This is one of the most developed and integrated market across the globe.

Credit Market- Credit market is a place where banks, Financial Institutions and Non Bank Finance Companies purvey short, medium and long-term loans to corporate and individuals.



Functions of financial system

- *Linkages between depositors, investors, savings and investment :* Financial system bridges gap between the depositors, and investors. The market provides required instruments and arrangements
- *Expansion of financial markets:* A good financial system helps the institutions grow, develop strong infrastructure and improve liquidity.
- *Efficient allocation of resources:* The system canalizes funds to the best use by offering right and competitive reward.

- *Economic development:* The puropose of any system is growth. Healthy financial system helps the industry and agriculture grow.
- *Financial stability*: The system should show stability in terms of returns and safety.
- *Liquidity:* Liquidity is essential fr the industry and also the State mechanism to function.
- *Savings mobilization;* The system should be able to mop up saving from house hold sector. This is possible only when there are wide variety of instruments offering security and return
- *Capital formation:* The generation of capital from household savings is a continuous process which helps the country grow.

Nature and characteristics of Indian money markets

Money market deals with the short term financial requirement of Industry, trade and commerce. The capital markets provide the long term capital needs. The development banks, stock exchanges and other financial intermediaries provide the long term finances. As against this, the money markets provide short term financial resources ranging from a single day to 364 day credit.

In India the money markets have not developed to completely meet the need of the productive sectors. In India unorganized money markets claim as much significance as organized. It is a case of dualism.

The organized money market mostly caters to the needs of the industry, trade and commerce: the agricultural sector remains isolated. Though agriculture happens to be a dominant sector, money markets do not cater as an organized activity.

There is dualism in the money markets as parallel institutions. The organized markets have commercial banks, co-operative banks, regional rural banks, IFCI, IDBI, RBI etc. The unorganized markets are made of local money lenders, *multani* bankers, *nidhis*, chit funds, indigenous bankers etc. Only

organized institutions come under the purview of RBI control and the monetary policy.

Organized money markets:

The organized money markets are made up to of registered financial institutions whose activities are subject to monetary regulations. These financial institutions work under the guidelines issued by RBI. Organized sector is very responsive to the changes in the monetary policy. Being, organized institutions, there is better co-ordination between various agencies and also with RBI.
The strength, operations and transactions determine liquidity in the money markets. There are several policy instruments which can govern liquidity in the organized money markets.
There are several instruments operating in the money markets like treasury bills, trade bills, commercial papers, deposit certificates and other short term instruments.
The organized markets can be further sub divided into

a. Call money market,
b. Treasury bill markets,
c. Repurchase Agreements
d. Commercial bill market,
e. Certificates of deposit market, and
f. Commercial paper market.

a. Call money markets:

- The call money market is operated by commercial banks to maintain their liquidity position. For meeting the liquidity demands of the operations, the commercial banks transact between them and other institutions.
- These are the transactions of very short period, of one day. They are renewable on the next day. This takes place as an inter bank transactions.
- The rate of interest depends on the market. In India the rate ranges between a maximum of 20per cent and a minimum of even 0.5 per cent.

- Call money markets in mostly confined to Bombay, Calcutta and Madras. Other places only have a limited and notional transactions.
- State Bank of India is significant in advancing the call money. Other important institutions are IDBI, UTI, LIC, NABARD, Discount and Finance House of India, co-operatives and commercial banks.
- The markets only cater to the needs of liquidity adjustments of the commercial banks.
- The rate of interest operational indicates the overall liquidity in the financial sector.

b. *Treasury Bill market :*

- Treasury bills were first issued by the Indian government in 1917. Treasury bills are short-term financial instruments that are issued by the Central Bank of the country.
- It is one of the safest money market instruments as it is free of market risks, though the return on investments is not that huge.
- Treasury bills are circulated by the primary as well as the secondary markets. The maturity periods for treasury bills are respectively 3-month, 6-month and 1-year. The price with which treasury bills are issued comes separate from that of the face value, and the face value is achieved upon maturity. On maturity, one gets the interest on the buy value as well. To be specific, the buy value is determined by a bidding process, that too in auctions.
- The Government of India in its day to day transactions issues treasury bills. The objective is to meet the deficits in its budgetary matters. They are called as the short term liabilities of the Government .
- The treasury bills are for a duration of 91,182 or 364 days. Reserve Bank of India discounts all the treasury bills presented to it by commercial Banks, RBI in the passive holder of these treasury bills, it holds upto 90 per cent of the total bills.
- These instruments are freely tradable among banks.

c. Repurchase Agreements

- Repurchase agreements are also called repos. Repos are short-term loans that buyers and sellers agree upon for selling and repurchasing.
- Repo transactions are allowed only among RBI-approved securities like state and central government securities, T-bills, PSU bonds, FI bonds and corporate bonds. Repurchase agreements, on the other hand, are sold off by sellers, held back with a promise to purchase them back at a certain price and that too would happen on a specific date.
- The same is the procedure with that of the buyer, who purchases the securities and other instruments and promises to sell them back to the seller at the same time.

d. Commercial bill market :

Commercial bills market is an important part of the money market in India. In trade, to facilities prompt payment, bills are drawn by the seller on the buyer. Such bills help the seller recover payment in advance and the commercial banks participate by way of discounting them.

The bill market has a prominent role in facilitating trade by offering credit on such transactions. The duration can range from 30days to 90days. The bills discounted by the commercial banks can b rediscounted with RBI. The rate application on rediscount is called bank rate.

The bill market was reinforced by the Bill market scheme of 1952 and later in 1970. The objective is to develop bill market as a potential money market in trade.

The new scheme encourages the commercial banks to rediscount bills in bunches of Rs. 50,000. Only bills on which genuine transactions have taken place are encouraged.

Bill market helps in maintaining the liquidity position of the traders.

The bill market in India is poorly developed because of the cash credit scheme to traders. The unorganized market is also responsible in the under development of bill market.

The call money market, treasury bill market and the commercial bill market are the traditional components of Indian money market. The Government has introduced new schemes of trading in many markets with instruments like the certificate of deposit in 1989 and the commercial paper in 1990.

Banker's Acceptance

A banker's acceptance is also a short-term investment plan that comes from a company or a firm backed by a guarantee from the bank. This guarantee states that the buyer will pay the seller at a future date.

One who draws the bill should have a sound credit rating. 90 days is the usual term for these instruments. The term for these instruments can also vary between 30 and 180 days. It is used as time draft to finance imports, exports.

e. Deposit Certificate market

- The deposit certificate market was introduced in 1989 to provide incentives to successful commercial banks.
- Under this scheme, the banks with surplus funds can deposit and obtain the certificate of deposit.
- These are short term deposits and the certificates are freely tradable at the rate of interest determined by the market.
- A certificate of deposit is a borrowing note for the short-term just similar to that of a promissory note. The bearer of a certificate of deposit receives interest. The maturity date, fixed rate of interest and a fixed value - are the three components of a certificate of deposit.
- The term is generally between 3 months to 5 years.
- The funds cannot be withdrawn instantaneously on demand, but has the facility of being liquidated, if a certain amount of

penalty is paid. The risk associated with certificate of deposit is higher and so is the return (compared to Treasury bills).

- The deposit certificates are issued in multiples of Rs. 25 lacs and a minimum of Rs. 1 crore. The duration of deposit ranges from 1 to 3 years.
- The Reserve Bank of India has allowed IDBI and IFCI to issue deposit certificates.

f. Commercial paper market :

- The commercial paper as an instrument was introduced in 1990. Under this scheme, listed public limited companies with a working capital of over Rs. 15 crores can issue commercial papers with a maturity of 3 to 5 months.
- These papers are freely tradable in the money market at the interest rate fixed by the market. The rate of interest varies between 10 to 21 per cent.
- Commercial papers are usually known as promissory notes which are unsecured and are generally issued by companies and financial institutions, at a discounted rate from their face value. The fixed maturity for commercial papers is 1 to 270 days.
- The purposes with which they are issued are - for financing of inventories, accounts receivables, and settling short-term liabilities or loans. The return on commercial papers is always higher than that of T-bills. Companies which have a strong credit rating, usually issue Commercial papers as they are not backed by collateral securities.
- Corporations issue Commercial papers for raising working capital and they participate in active trade in the secondary market. It was in 1990 that Commercial papers were first issued in the Indian money market.
- The commercial papers are issued by public limited companies and serve the purpose of short term funds.
- The Government is coming with innovative scheme to revise the money markets so that the organized sector will expand and enable the monetary policy to exercise its influence.

Unorganized money markets in India:

The unorganized money market in India is large enough to upset any policy moves to control market liquidity. The unorganized money market is unregulated by the Government. It being informal can not be governed by the policy.

The unorganized market is made up of financial intermediaries, *nidhis*, chit funds, money lenders and indigenous bankers. The unorganized money market can be described as follows.

1. Unorganized sector is sought when finances are not available through the formal sector.
2. It being informal, there are lesser procedural formalities and are easily accessible.
3. The finances are self generated. So, the policy of RBI has little effect on its functioning.
4. There are no standard practices. There are disparities between different regions.
5. The unorganized sector thrives mostly on the black money. Thus it is a parallel money market.
6. Unorganized sector is operated among small traders and wholesalers.
7. Being in informal sector, the operational and administrative costs are lowest.
8. The unorganized sector offers less scope for the user to bargain.
9. The interest rates are not regulated. So, it may often result is usury.
10. There is no co-ordination between various financial intermediaries of the informal sector.

Conclusion

- The most important feature of Indian money market is the large unorganized sector. The policy and plan objectives are diluted because of the unregulated sector.

- The unorganized sector which is mostly financed by black money develops a parallel economy. It accounts for half the total economic activity.
- The interest rate is not regulated. With free market, the interest should reflect liquidity and funds. The regulated interest does not reflect liquidity. The regulated interest does not reflect monetary strength.
- There is a total lack of integration between various segments of money market. Absence of co-ordination fails to project a uniform policy.
- The availability of funds remains scare in both organized and unorganized markets. The funds are scarce in relation to the total trading activity in the economy.
- There are unaccounted seasonal variations in the interest and availability of funds. It leads to certain speculative activities in the market.

Money market reforms

Money market underwent several reforms in the post reforms period to meet the growing needs of industry trade and commerce.

These reforms were primarily based on suggestions of Chakraborty Committee and Vagul working Group on money markets.

1. *Infrastructure:* Discount and Finance House of India

2. *Treasury bills:* The T Bills with 14, 28 and 91 days auctioning is introduced to meet the needs of varied groups

3. *Bill culture*: In encourage bill culture in trade and commerce, Government offered stamp duty exemption

4. *Innovative submarkets*: New sub markets were created to improve liquidity. These include collateral loan market, deposit certificate market and commercial paper market.

5. *Repos:* From November 1996 Repos were introduced to mop up excess liquidity. In 1997 it was extended to corporate debt, PSU bonds, Reverse Repos to primary dealers in Government securities market at bank rate.

Capital markets

Composition of Capital markets

Gilt-Edged Securities Market:

This market deals with the securities issued by Central Government, State Government, All-India Financial Institutions like IDBI, ICICI, IFCI, State Financial Institutions Like SFCs, SIDCs, and other governmental bodies.

The securities are issued in form of bonds and credit notes. The buyers of such securities are banks, insurance companies, employee's provident fund, RBI and even individuals.

These types of securities have the full backing of the Government and as such they are more secured as compared to other securities in the industrial securities market. The securities normally issued with different maturity dates.

New Issue Market (Primary Market)

It is also called as primary market. There are three ways in which a company may raise capital in the primary market:

Public Issue: This involves sale of securities, i.e. shares and debentures to the members of the public.

Rights Issue: This is a method of raising further funds from existing shareholders.

Private Placement: It involves selling securities to a small group of private investors.

Secondary Market:

The market for outstanding securities is referred to as secondary market or stock market. The stock markets are organized markets to trade securities i.e. shares and debentures of well-established companies. Every day crores of rupees are changing hands on the stock exchange.

Functions of capital markets

1. *Mobilize savings:*

   The capital markets make it possible to lend funds to various industrial concerns. Such savings are mobilized and then utilized for the economic development of the country.

2. *Lending of funds:*
   The capital markets make it possible to lend funds to various industrial concerns can borrow long - term funds from various financial institutions in the country.

3. *Direct collection of funds:*
   The primary markets make it possible to collect direct funds from the market. Interested individuals or corporate bodies do subscribe for the issue of shares and debentures.

4. *Easy liquidity:*
   The secondary market makes it possible for the investors to sell off their holdings in form of shares and debentures and convert them in liquid cash.

5. *Link between investors and users of funds:*
   The capital market acts a link between the owners of funds and the users of funds, i.e. A link between investors and industrial users.

6. *Profitable use of funds:*
   Capital market makes it possible to make productive and profitable use of funds. This is because the funds that are lying idle with the owners are utilized by industrial enterprises in a profitable manner, thus bringing rewards to the investors, users and the society.

Role and Importance of Capital Markets

6. *Accelerates Capital formation though mobilization of resources*
   Capital market plays a crucial role in mobilizing savings from people especially the small investors. By providing liquidity and security, the capital the security, the capital market attracts masses that bring investment in the capital market.

7. *Accelerates Industrial Growth*
   The resources mobilized by the capital market are utilized by the industrial sector for productive purposes. Thus it satisfies the investment requirements demanded by the private and the

public sector. Such activities help in promoting industrial growth.

Long term capital to the industrial sector

Capital market provides a permanent long-term capital for the companies.

Better allocation of resources through efficient market system

the capital market ensures the effective allocation of resources and high productivity.

Ready made market and healthy competition

The primary market provides facilities for new issues of listed companies while the follow up activities continue in the secondary market. The secondary market provides a readymade market for the securities already purchased.

Foreign capital

The capital market also acts as a source of foreign capital. Especially, since 1993 onwards, the foreign investors have turned towards the Indian market.

Encouraging role of financial institutions

The various agencies of capital market such as Industrial Financial Corporation of India (IFCI), State Finance Corporation, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India. Unit Trust of India, Life Insurance Corporation etc. have been rendering useful services to the growth of industries. They have been financing promoting and underwriting the functions of the capital market. They extend assistance to sick units and small units.

Primary Capital markets

The part of the capital market dealing with new securities is known as Primary Market. It is also known as New Issue Market. Both private and or public sector organizations can get funds by selling new shares or bonds. Usually, small or medium scale companies enter into the market of new

securities in order to widen the scope of their business. The selling process of new securities to investors is called underwriting.

The security dealers earn a commission that is added in the cost of the securities. A lot of formalities are required to be fulfilled before a security can be sold. Some of the important features of Primary Markets are as follows:

- It is the market that deals with new long-term securities, not the existing ones. That is, the securities are sold for the first time in the Primary Market.
- In the primary market, the securities are sold by the company directly to the investors. However, it is not so in the Secondary Market.
- New security certificates are issued to the investors once the company receives money from them.
- The funds from selling the securities are used by companies for starting new business or expanding the existing ones.
- It facilitates capital building in the economy. Thus, affecting the economic sector to a great extent.
- Primary Market doesn't include other new long-term external finance sources, like loans from financial institutions.

In Primary Market, the securities can be issued through any of the following methods:

- Initial public offering: It refers to the initial sale of securities by a private company to the public sector. Generally small and young companies are a part of Primary Market. However, large-scale private companies that desire to be publicly traded also become a part of this market.
- Rights issue (for existing companies): It refers to a special form of shelf offering or shelf registration. Under these rights, the existing shareholders enjoy the freedom to buy a specified number of new shares from the firm at a particular price and time. It is the opposite of Initial public offering where shares are issued to the general public through stock exchange.

- Preferential issue: Issue of shares kept aside for the designated buyers. For example, the employees of the issuing company.
- The investment banks play key role in Primary Market. They decide the starting price range for a particular security and then direct its sale to investors.
- Private capital is converted into public capital. That is, the securities are released for public. It is known as public issue or going public. After the initial sale of a security, Secondary Market deals with the further trading.

Growth of capital markets in India

During post reforms period the capital markets in India experienced rapid growth. It can be seen that after 20 years of reforms the capital markets tend to grow. It means that the growth is sustainable.
Following are the important factors responsible for the growth of capital markets:

1. Awareness and upraise of investment culture in middle class in India
2. Increase in household incomes and domestic savings
3. Growth of Mutual funds, specially after 1990 when private mutual funds started expanding the capital markets.
4. The levels of inflation were staying at a comfortable level
5. National stock exchange being established on the recommendations of high powered Pherwani Committee,
6. Number of Foreign Institutional Investors registered with SEBI has increased from none in 1992-93 to 528 in 2000-01 to 803 in 2005-06.
7. Extensive Capital Market Reforms were undertaken during the 1990s encompassing legislative regulatory and institutional reforms.
8. India's risk management systems have always been very modern and effective.
9. Sophisticated market having account period settlement alongside the derivatives products. From middle of 2001 uniform rolling settlement and same settlement cycles were prescribed creating a true spot market.

10. India is one of the few countries to have started the screen based trading of government securities in January 2003.
11. In June 2003 the interest rate futures contracts on the screen based trading platform were introduced.

Suggestions

- A separate task force has to be setup to monitor and govern the happenings in the capital markets.
- A proper mechanism has to be derived to regulate the operations of FIIs and contain them with required regulations.
- Government, RBI and SEBI should together take required steps to avoid the occurrence of scams, which will lead towards decreasing-morale of the investors.
- Municipal Bonds Market, Depository Receipts Market, Derivatives Market have to be developed to a greater extent so that the trading volumes in these markets will be increased substantially.
- Awareness among small investors has to be generated, and government has to take certain measures to create awareness and at the same time they must be protected from any kind of defaults.
- As the chances of risk can never be brought to zero level in any capital market, it should be seen that the risk is reduced to the minimum extent possible.

Securities Exchange Board of India

In 1988 the Securities and Exchange Board of India (SEBI) was established by the Government of India as a fully autonomous and statutory Board, in the year in 1992. It replaced the earlier Controller of Capital Issues.

The basic objectives of the Securities and Exchange Board were:

- to protect the interests of investors in securities;
- to promote the development of Securities Market;
- to regulate the securities market.

SEBI has legislative, judicial and executive functions combined into one. It drafts regulations, conducts investigation and enforcement action, and passes rulings and orders in its judicial capacity.

SEBI has promoted trading in stock indices (like S&P CNX Nifty and Sensex) in 2000. Such an index is useful because:

- It acts as a barometer for market behavior;
- It is used to benchmark portfolio performance;
- It is used in derivative instruments like index futures and index options;

- It can be used for passive fund management as in case of Index Funds.

SEBI has to be responsive to the needs of three groups, which constitute the market:

1. The issuers of securities: In the primary capital markets, SEBI ensures fair play for the promoting companies as well as investors.
2. The investors: The retail investor needs to be protected. As well as the FII need to be regulated and encouraged to pump in large funds
3. The market intermediaries: The market intermediaries like banks, and other financial institutions should have a ideal atmosphere to trade.

Functions

- The Board is responsible for the securing the interests of investors in securities and to facilitate the growth of and to monitor the securities market in an appropriate manner.
- To monitor and control the performance of stock exchange and derivative markets.
- Listing and monitoring the functioning of stock brokers, sub brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and others associated with securities markets by any means.

- Monitoring and Controlling the functioning of venture capital funds and mutual funds.
- Forbid unjust and dishonest trade practices in the security markets and forbid insider trading in the security market.
- Undertake periodic audits of stock exchanges, mutual funds, individuals and self regulatory organizations associated with the security market.

SEBI has jurisdiction in the following matters

1. Regulating the business in stock exchanges and any other securities markets
2. Registering and regulating the working of stock brokers, sub brokers, share transfer agents, registrars to an issue, merchant bankers and other intermediaries who may be associated with securities market in any manner.
3. Registering and regulating the working of collective investment schemes, including Mutual funds.
4. Promoting and regulating self regulatory organizations
5. Prohibiting Fraudulent and unfair trade practices
6. Promoting investors education and teaching of intermediaries
7. Regulating substantial acquisition of shares and take over of companies.
8. Levying fees or other charges for carrying out the purposes
9. Conducting research

Limitations of SEBI

- The regulations of SEBI monitoring capital markets need to be approved by the Government. This causes delays in implementations
- SEBI will have to seek prior approval for filling criminal complaints for violations for the regulations. This will again cause delay at government level.
- SEBI has not been given autonomy. Its Board of Directors is dominated by government nominees. Out of 5 directors only 2 can be from outside and these are to represent the Ministries of Finance, Law and Reserve Bank of India..

Mutual Fund

Securities Exchange Board of India formulated the Mutual Fund (Regulation) 1993, which for the first time established a comprehensive regulatory framework for the mutual fund industry. Since then several mutual funds have been set up by the private and joint sectors.

In India, the Mutual Fund industry started with the setting up of Unit Trust of India in 1964, as a single State Monopoly. Twenty-three years later Public Sector banks and financial institutions were permitted to establish Mutual Funds in 1987. The Industry was brought under the control of SEBI and opened for private sector participation in 1993.

The private sector and foreign Institutions began setting up Mutual Funds thereafter. The fast growing industry is regulated by the Securities and Exchange Board of India (SEBI). A Mutual fund in India is registered / incorporated as a public trust. As per Clause 14 of SEBI guidelines:

> *A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) executed by the sponsor in favor of the trustees named in such an instrument.*

If the Trust Deed so provides the trustees can appoint an Asset Management Company for the day to day administration of the MF and investment of its funds.

There are four constituents of a mutual fund in India:

- the sponsor,
- the board of Trustees or Trustee company,
- the asset management company and
- the custodian.

A Mutual Fund is a system where a number of investors come together to pool their money with common investment goal. Each Mutual Fund is managed by respective Asset Management Company.

The invested money in a particular scheme of a Mutual Fund is then invested by fund manager in different types of suitable stock and securities, bonds and money market instruments. Each Mutual Fund creates a portfolio which includes stock and shares, bonds, gilt, money-market instruments or combination of all.
Thus, Mutual Funds are managed by Asset Management Companies formed by financial institutions, banks, private companies or international firms.

The biggest Indian Asset Management Company is UTI while Alliance, Franklin Templeton etc are international Asset Management Companies.

All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

Mutual Funds offer several benefits to an investor such as potential return, liquidity, transparency, income growth, good post tax return and reasonable safety. There are number of options available for an investor offered by a mutual fund.

The advantages of investing in a Mutual Fund are:

1. Professional Management: The investor avails of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

2. Diversification: Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.

3. Convenient Administration: Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and unnecessary follow

up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

4. Return Potential: Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

5. Low Costs: Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

6. Liquidity: In open-ended schemes, you can get your money back promptly at net asset value related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some close-ended and interval schemes offer you periodically.

7. Transparency: You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

8. Flexibility: Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

9. Choice of Schemes: Mutual Funds offer a family of schemes to suit your varying needs over a lifetime.

10. Well Regulated: All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

Stock Exchange

Stock exchange market is a market where stock, shares, gilt-edge, bond and other securities are bought and sold.

According to Husband Dockeray

Securities or stock exchanges are privately organized markets which are used to facilitate trading in securities

Some Features of Stock Exchange Market

1. *Specialized market:* Stock exchange is a specialized market for the purchase and sale of industrial and financial securities.
2. *Standard guidelines:* There are large number of buyers and sellers who conduct their activities according to rigid rules.
3. *Corporate formation*. Its activities are controlled by the company ordinance in our country.
4. *Liquidity:* Stock exchange offers liquidity, a means of selling and buying.
5. *Price Transparency:* Because all trades for a stock flow through one exchange, this means that everyone sees and has the opportunity to execute on the same exact price as everyone else.
6. *Corporate Performance*: Stock exchange serve as a yard stick for measuring the performance of company etc.
7. *Economic barometer*. Stock exchange acts as a barometer; it forecasts the future economic trends
8. *Evaluation of policy*: the trends in the stock exchange evaluates the strength of economic policy

Bombay Stock Exchange

At the Bombay Stock Exchange the securities are listed in three groups

1. A Group large turnover and high floating stock. There are 150 scrips
2. B1 groups with equity of more than Rs. 3 crore high potential and trading frequency. There re around 1100 scrips in this group
3. B2 group are like B1 with fortnightly settlement. Low trading volumes. There are 3200 scrips.

- New F group was started in 1996 pertaining to debt segment

- Launched enterprise market for small and medium enterprises in 2005 to provide small and medium enterprises an easy access to capital market
- BSE introduced trading in derivatives
- BSE sensitive index was launched in 1986 with base year 1978-79. It has 30 scrips. There are several other indices like FMCG index, Health care index, Tech Index.

National Stock Exchange

NSE was incorporated in 1992

- To Establish a nation wide debt market
- To Ensure investors all over the country equal access and communication
- To provide fair and transparent securities market
- Enable shorter settlement cycles through electronic trading system
- To establish international standards.

Role and importance of Derivative markets

(Forward and future market)

History

Before the North American futures market originated some 150 years ago, farmers would grow their crops and then bring them to market in the hope of selling their inventory. But without any indication of demand, supply often exceeded what was needed and unpurchased crops were left to rot. Conversely, when a given commodity - wheat, for instance - was out of season, the goods made from it became very expensive because the crop was no longer available.

In the mid-nineteenth century, central grain markets were established and a central marketplace was created for farmers to bring their commodities and sell them either for immediate delivery (spot trading) or for forward delivery. The latter contracts - forward contracts - were the forerunners to today's futures contracts. In fact, this concept saved many a farmer the loss of crops and profits and helped stabilize supply and prices in the off-season.

Today's futures market is a global marketplace for not only agricultural goods, but also for currencies and financial instruments such as Treasury bonds and securities (securities futures). It's a diverse meeting place of farmers, exporters, importers, manufacturers and speculators

Forward contracts

Contract that obligates one counter party to buy and the other to sell a specific underlying asst at specific price, amount and date in future is known as forward contract.

- *Decided by buyer and seller: The terms and delivery schedule are decided by the mutual parties to the forward contract*
- *Constant price till maturity:* The price and quantity remain unchanged till the maturity of the deal.
- *Can not be marketed to market:* Can not be transferred to individuals in between. There can not be a separate market for trading of instrument.
- *Counter party risk exist:* the risk of non fulfillment of contract exists. There can be default in delivery as well as payment.
- *No limit on the number of contracts:* There is no limit on the number of contracts in this mode
- *Provides hedging specific to need:* Forward contracts are indeed are meant for hedging specific uncertainties in commodity trade.
- *Doses not need trading exchange:* There is no need for any organized system for forward trading, but a system improves dependability and volume of transactions
- *Delivery is specifically decided:* The contracts have specific custom based delivery norms.
- *No liquidity:* The contracts are so specific they fail to offer extensive liquidity. The transactions are specific to parties.

Futures market

A futures contract is a type of derivative instrument, or financial contract, in which two parties agree to transact a set of financial instruments or physical commodities for future delivery at a particular price.

- Terms of contract are standardized
- Price changes every day
- Marked to market each day
- Counter party risk does not exist
- Allowed only 4 to 12 contracts per year
- No perfect hedging - limited to month
- Traded on exchange on every day
- Cash delivery is standardized
- High liquidity

Futures and options are the derivative instruments in which the buyer and seller enter into an agreement or transaction which will get settled on a future date. In simple terms it is a promise between buyer and seller to transfer the actual underlying assets (commodities, gold, stock, currency etc) on a specific future date at a specific stipulated price as per the agreement.

Futures

In futures contract the buyer and seller enter into an obligatory agreement to exercise the contract at maturity.

Both the buyer and seller have the obligation to exercise the contract which means on maturity, seller will transfer the underlying securities and buyer will make the cash payment as per agreed price.

The buyer does not have to pay any amount for buying a futures contract because it is an enforceable agreement which will get settled on maturity date.

Options

In options contract the buyer is given an option to decide whether or not he wants to exercise the contract at maturity.

Buyer of the contract has the option to exercise it anytime on or before expiry but seller has the obligation to exercise it. If buyer demands to buy the asset, seller will have to sell it. Options are of two types:

Call option: It gives the buyer, the right to buy the asset at a strike price.

Put Option: It gives the buyer a right to sell the asset at the 'strike price' to the buyer

The buyer has to pay an amount called as "Premium" for acquiring an additional right of having an option to exercise the contract or not.

The emergence of the market for derivatives products, most notable forwards, futures, options and swaps can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets can be subject to a very high degree of volatility.

Through the use of derivative products, it is possible to partially or fully transfer price risks by locking-in asset prices. As instruments of risk management, derivatives products generally do not influence the fluctuations in the underlying asset prices. However, by locking-in asset prices, derivatives products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

Factors generally attributed as the major driving force behind growth of financial derivatives are:

- Increased Volatility in asset prices in financial markets,
- Increased integration of national financial markets with the international markets,
- Marked improvement in communication facilities and sharp decline in their costs,
- Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
- Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets, leading to higher returns, reduced risk as well as transaction costs as compared to individual financial assets.

The need for a derivatives market

The derivatives market performs a number of economic functions:

- They help in transferring risks from risk adverse people to risk oriented people
- They help in the discovery of future as well as current prices
- They catalyze entrepreneurial activity
- They increase the volume traded in markets because of participation of risk adverse people in greater numbers
- They increase savings and investment in the long run

Commodity Market

The commodities and future market in the country is regulated by Forward Markets commission.

Nature of Commodity Market:

- Commodity market provides hedging, price insurance and liquidity
- The objective of commodity market is to provide goods flow through reducing risk
- Producers, dealers, traders, speculators participate in commodity market
- The period of dealing is in cash for a period of two to three months
- Commodity market deals with commodities that are durable with price uncertainties and uncontrolled supply

The Government has made almost all commodities entitled for futures trading. The commodity trading is organized by three multi commodity exchanges for the retail investors. The three national exchanges in India are:

1. Multi Commodity Exchange
2. National Commodity and Derivatives Exchange
3. National Multi-Commodity Exchange

Currently, the various commodities across the country account for an annual turnover of Rs 1,40,000 crore (Rs 1,400 billion). With the introduction of futures trading, the size of the commodities market grows many folds here on.

The size of the commodities markets in India is significant. Commodities related industries constitute about 58 per cent of GDP of Rs 13,20,730 crores.

The commodities market will have three broad categories of market participants apart from brokers and the exchange administration - hedgers, speculators and arbitrageurs. Brokers will intermediate, facilitating hedgers and speculators.

Hedging: The primary purpose of futures markets, is to provide an efficient and effective mechanism to manage price risk. By buying or selling futures contracts, these contracts establish a price level now for items to be delivered later. Individuals and businesses seek to achieve insurance against adverse price changes. This is done by buying or selling futures contracts, with a price level established now, for items to be delivered later.

Speculators: The speculative investor is looking for the risks that hedgers wish to avoid. Speculators have no intention of making or taking delivery of the commodity Instead, they seek to profit from a change in the price. They buy when they believe prices will rise; and they sell when they believe prices will decline.

Buying a futures contract in anticipation of price increases is known as 'going long'. Selling a futures contract in anticipation of a price decrease is known as 'going short'. Interaction between hedgers and speculators helps to provide active, liquid and competitive markets. Speculative participation in futures trading has increased with the availability of alternative methods of participation.

There are two different types of markets for commodity trading.

- Spot markets are markets where immediate trading takes place. This could be personal purchases (buying jewelry with cash) or spot trading on a much larger scale (trading in oil or large quantities of gold).

- Commodities trading are also known as futures trading. When one trades futures, he/she does not actually buy or own anything. The

contract is bought in order to speculate on the future direction or movement of the price of the commodity.

Commodities are traded at organized commodity exchanges. Most of the trading involves commodity futures. Here, the underlying asset of the futures is a particular commodity, such as gold, silver, corn or wheat.

When such contracts are bought, the buyer of such future contract gets the right to buy or sell the underlying commodity at a specified price and at a specified future date. The buyer of the contract pays a price to the seller for this right and this is known as the premium.

Section II
Module IV - Public Finance

Changing trends in Tax and non-tax revenues

Trends in tax revenue

Some of the other features of trends in tax revenue are as follows:

- Tax revenue, on an average, could finance about 60 per cent of the center's revenue expenditure during the eighties. The proportion during nineties, however, was about 55 per cent only.
- Continuing reforms and rationalization of the tax structure, have resulted in a structural shift in composition of tax revenue
- A fall in the share of indirect tax collections from about 80 per cent of total tax revenue in eighties to about 70 per cent in the nineties could not be fully compensated by the increase in direct tax revenue.
- On the states' side, the dip in tax buoyancy occurred as revenue from sales tax, the principal component of their own tax revenue, showed a declining growth trend owing to tax competition among the States to attract trade and industry.

Trends in Non Tax Revenue

On the whole, non-tax revenue growth has practically stagnated at both levels of government, during the nineties. But there is a change in trends in the pattern of non tax revenues.

Apart from the interest receipts the other two main items of non-tax receipts. They are:

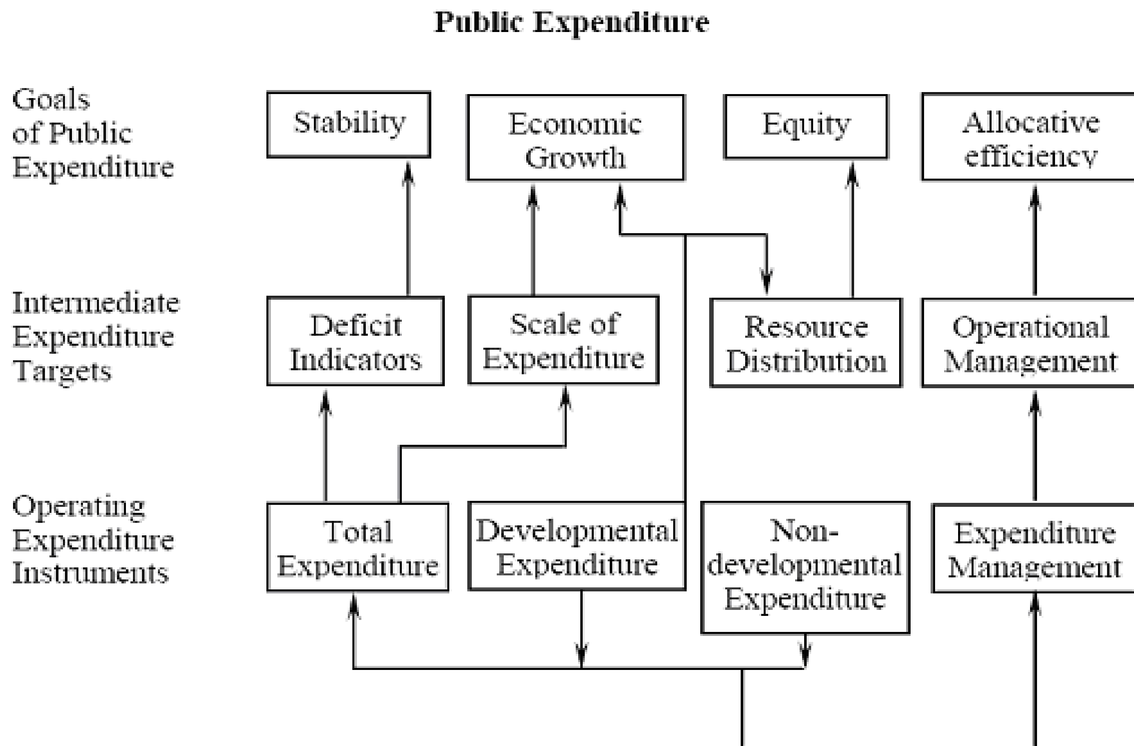
- return on investments of the Government and
- recovery of cost of public services.

By way of dividend and interest, return on Central government investment in public enterprises even though has shown some improvement was about 5.21 per cent. Trends in profitability and finances of Central Public Enterprises have shown a distinct improvement. Rates of return of most of the State government enterprises show that it does not cover even a fraction of their cost of funds.

The Union government is entitled to royalty on oil and gas produced from offshore fields whereas the state governments get royalty from onshore fields. Royalty payable by the national oil companies from the nominated fields vary from that for production from the fields that are governed by production-sharing contracts. This is significant additional revenue.

The revenue from petroleum and exploration sector was Rs 9,423 crore in 2008-09. In 2009-10, the revenue from petroleum sector was Rs 13,333 crore.

Public expenditure



Types of public expenditure:
Public expenditure can be classified in terms of its revenue yielding capacity, self financing nature or direct welfare.

1. *Productive and unproductive expenditure*
   The expenditure is called productive when the expenditure yields revenue and is self financing. Capital expenditure on economic overheads falls under this group.

   Unproductive expenditure is the one which does not yield any revenue. It does not directly generate welfare. Defense expenditure, interest payment on public debt and the expenditure on calamity and disaster management and relief fall under this group.

2. *Plan and non plan expenditure*

Plan expenditure

This is essentially the Budget support to the central plan and the central

assistance to state and Union Territory plans. Like all Budget heads, this is also split into revenue and capital components.

Non-plan Expenditure

This is largely the revenue expenditure of the government. The biggest item of expenditure is interest payments, subsidies, salaries, defense and pension. The capital component of the non-plan expenditure is relatively small with the largest allocation going to defense.

3. Revenue and capital expenditure

Revenue Receipt/Expenditure:

All receipts and expenditure that in general do not entail sale or creation of assets are included under the revenue account. On the receipts side, taxes would be the most important revenue receipt. On the expenditure side, anything that does not result in creation of assets is treated as revenue expenditure. Salaries, subsidies and interest payments are good examples of revenue expenditure.

Capital Receipt/Expenditure:

All receipts and expenditure that liquidate or create an asset would in general be under capital account.

If the government sells shares (disinvests) in public sector companies, like the receipts from the sale would go under capital account. On the other hand, if the government gives someone a loan from which it expects to receive interest, that expenditure would go under the capital account. In respect of all the funds the government has to prepare a Revenue Budget (detailing revenue receipts and revenue expenditure) and a capital budget (capital receipts and capital expenditure).

Objectives of public expenditure

There are several objectives of public expenditure, these objectives change with changing Sate functions.

Following are the important objectives of public expenditure:

- Provision of civic administration enforcing law and order
- Maintenance of police for internal security
- Defense to guard against external aggression
- Public debt management for raising resources for development and disaster management.

- Providing industrial infrastructure for increasing production and productivity
- Creation of social infrastructure and assets for increasing social benefit
- Provision of public health as apart of human resource management
- Provision of social goods
- Grant economy providing social justice and social security

Trends in the public expenditure in India

	Public expenditure (Cr)	Public expenditure as percent of GDP
1950-51	900	9.1
1960-61	2,631	15.3
1970-71	7,843	17.2
1980-81	37,218	25.6
1990-91	1,62,084	28.5
2007-08	13,39,009	28.4

- The volume of public expenditure has increased over a period from Rs 900 crores in 19950-51 to Rs 13,40,000 crores in 2008.
- Public expenditure s a percent of GDP has increased from 9.1 percent in 1950 to 28.4 percent in 2007-08.
- During recent years the share of public expenditure as a share of GDP has stabilized at around 28 percent. This is large compared to ant developing or developed economy

Causes of rapid increase in public expenditure

Wagner's Law

The value of public expenditure has been increasing rapidly all over the world after 1930s Great Depression. With development it is natural for the public expenditure to increase due to extensive and intensive expansion of Government functions. This was identified by several economists, important among them is Wagner. This is called as the Wagner's Law.

- Population: The population has increased from 68 crores in 1950 to 102 crores in 2001. Hence the pressures on civic amenities and social goods increase. The public expenditure increases.
- Development: The National income has increased at a rate of 5.7 percent between 1980 and 2008. Rapid growth in national income increases public expenditure.
- Per capita income has been increasing at the rate of 3.6 percent between 1980 and 2008 in spite of increase in population
- Urbanization: Urbanization has increased from 17 percent in 19980 to 27.8 percent in 2008. Rapid urbanization increased pressures on city infrastructure. The public expenditure increases.
- Defense: The defense expenditure has increased from 3600 crores in 19980 to Rs 92,000 crores in 2008. This is due to international relations and tensions.
- Public debt: The debt which was 42.6 percent o GDP in 1980 increased to 61 percent in 2008. Larger debt means larger interest payments. The public expenditure increases.
- Welfare state: Subsidies as part of grant economy constitute 6.6 percent of public expenditure. It is stable in spite of WTO agreements on reducing subsidies.
- Grant economy
- Distribution functions
- Provision of industrial an agricultural infrastructure
- Demand for more civic amenities
- Management of human resources : health and education
- International relation, diplomatic relations

Effects of public expenditure

1. Effects on consumption : increase in consumption , better standards of living, personal development, better human resources, increasing human capital
2. Effects on production: increasing production and productivity through -
    - *Efficiency effect*: development of entrepreneurial skills, soft loans for innovative enterprises
    - *Incentive effect*: creation of infrastructure, increased productivity of labor though better education training, research and development

- *Allocative effect :* diversion of economic resources, increased utilization of resources,

3. Effects on distribution : equitable distribution of income, redistribution effect, poverty alleviation, employment generation

Public Debt

A Government resorts to public debt when its expenditure exceeds revenue. The expenditure may exceed revenue due to several reasons.

Public debt can be classified according to the nature, purpose and burden. Public debt can be raised for repaying past debt or consolidation of smaller debts. If an economy falls into debt trap it may have to borrow even for paying interest.

Classification of Public debt
Accordingly, public debt is classified as
1. *Public debt as a fiscal instrument for regulation and stabilization.*
Public debt raised as an instrument in fiscal management is useful in generating resources. Public debt raised for reducing monetary pressures helps in controlling inflation.

2. *Productive and unproductive debt*
Productive debt raised for self-liquidating public projects which produce monetary revenues. Debt raised as capital revenue is used for financing economic or social infrastructure. Such debt helps in increasing production, productivity and growth.

Debt raised for projects where the proceeds become collective investment in long-term capital projects, which are calculated to yield social income.

Unproductive debt is a dead weight debt with permanent burden. In case of emergencies like calamities and war public debt is an important source of raising resources. Public debt remains a burden for ever.
Public debt issued during war periods and purchased largely by the banking system

3. *Internal and External debt*
Internal debt deals with resources raised form within the country. It is in local currency and payable internally. The resources remain within the economy.

External debt is raised in foreign currency from another country. It can be institutional borrowing from international agencies, or intergovernmental loan. External debt brings in foreign currency but at the same time, the resources leave the country and may cause a drain on foreign earnings in future.
It is believed that internal debt is lesser consequence whereas external debt impoverishes the economy.

In India debt is classified in seven heads: multilateral, bilateral, IMF loans, Trade Credit, Commercial Borrowings, NRI Deposits, and Rupee Debt.

Burden of Public debt
Burden of debt depends on the nature, purpose and source of debt. The burden of internal debt is different from external debt. The present burden is different form future burden and the redistribution caused by debt and repayment may cause burden

The burden of public debt depends on the liability it creates, the wealth it generates, and the mechanism of repayment.

- Repayment of the debt affects income distribution. If working taxpayers will be paying interest to the mainly wealthier groups who hold the bonds, this probably increases income inequality.
- Since interest must be paid out of government revenues, a large debt and high interest can increase tax burden and may decrease incentives to work, save, and invest for taxpayers.
- A higher proportion of the debt is owed to foreigners than in the past, and this can increase the burden since payments leave the country.

Internal and external debt

- Debt causes transfer of purchasing power across time. The loan raised today is replayed by future tax payers

- Debt causes transfer of purchasing power across sections of society. The interest payment goes from the tax payers to the persons who lent money to the Government.
- Debt causes transfer of purchasing power across countries. External debt repayment shifts the resources form the borrowing country to the lending country.
- Internal debt is of lesser consequence whereas external debt impoverishes the economy
- Public debt by virtue, lays the burden of repayment also on the lender. The lender of public debt is also a tax payer. At the time of repayment, the lender repays a part of his own loan.
- Internal debt has no direct money burden. Whereas, external debt has direct money burden on future generations
- The burden of external debt is shifted to future generations. The external debt is replayed in foreign currency and leaves the economy. This involves a direct money burden
- External debt reduces the future potential of imports. At the time of repayment, external debt drains the foreign exchange earnings. To this extent the country looses, its import potential.
- In the future when a debt is repaid, the tax payers will be made to pay more tax. This is the burden which is shifted to the future generations.
- The burden of debt servicing is in foreign currency. This again implies that, the forex resources are drained without corresponding return.
- Due to these reasons it is said that '*internal debt is of lesser consequence where as external debt impoverishes the economy*.'
- However, the burden of debt, external or internal, can be reduced if it is utilized for productive use. When the debt is self liquidating out of its own revenue, the burden is reduced.

The Union Budget

According to Dimock

> "A budget is a financial plan summarizing the financial experience of the past, stating the current plan and projecting it over a specified period of time in future."

The Indian Budget is a schematic plan of India's financial and operational goals. It is an action plan that facilitates allocation of resources in India. The Government of India Budget, also known as the Union Budget, is primarily made up of the Revenue Budget and Capital Budget.

Revenue Budget: The revenue budget primarily comprises Government revenue receipts like tax and expenditure met from the revenue. The tax revenues principally constitute yields of taxes and other duties imposed by the Government of India.

Capital Budget: The capital budget primarily comprises capital receipts and payments.

The primary components of capital receipts include loans brought up by Government of India from public, termed as market loans. Some of the other components of capital receipts include borrowings by Government from Reserve Bank and loans obtained from foreign governments and bodies.

The primary components of capital payments include capital expenditure on acquisition of assets like equipment, machinery, land and buildings. Capital payments also include transactions in the Public Account and investments in shares.

Types of Deficits

Fiscal Deficits

Fiscal deficit is one of the more comprehensive measures of government's deficit. It can be looked upon as the sum of budgetary deficit and borrowings and other liabilities of the government.

When the government's non-borrowed receipts (*revenue receipts plus loan repayments received by the government plus miscellaneous capital receipts,*

primarily disinvestment proceeds) fall short of its entire expenditure, it has to borrow money from the public to meet the shortfall. The excess of total expenditure over total non-borrowed receipts is called the fiscal deficit.

International Monitory Fund (IMF) usually looks at the country's fiscal deficit to determine how healthy the economy is.

In other words, fiscal deficit reflects the indebtedness of the government i.e. the country's ability or the inability to repay loans.

Budgetary Deficits
Budgetary deficit is nothing but the difference in total government earnings (receipts) and the total government expenditure. In India, budgetary deficit is covered mainly by creation of new money (called deficit financing).

Creation of new money leads to an increase in the money supply and consequently to inflationary rise in prices. Some economist believe that Budgetary deficit does not reflect the true picture of a government's deficit because it is an accounting entity which can be easily manipulated.

Primary Deficits
The revenue expenditure includes interest payments on government's earlier borrowings. The primary deficit is the fiscal deficit less interest payments. A shrinking primary deficit would indicate progress towards fiscal health.

The concept of primary deficit was introduced for the first time in the budget of 1993-94. This indicates the real posit ion of the government finances after having paid off the interest burden.

The fiscal deficit may be large, but if it is small compared to the size of the economy then it is not such a bad thing. Prudent fiscal management requires that government does not borrow to consume, in the normal course.

Revenue deficits
The excess of disbursements over receipts on revenue account is called revenue deficit. This is an important control indicator. All expenditure on revenue account should ideally be met from receipts on revenue account; the revenue deficit should be zero. When revenue disbursement exceeds

receipts, the government would have to borrow. Such borrowing is considered regressive as it is for consumption and not for creating assets. It results in a greater proportion of revenue receipts going towards interest payment and eventually, a debt trap.

Monetized Deficit

Monetized deficit is indicated by the increase in holdings of treasury bills by the Reserve Bank of India and its contribution to the market borrowings of the government. This it shows the extent of deficit financing (creation of new money) on the part of government.

Public debt

In normal accounting, debt is a stock, to be measured at a point of time, while borrowing and repayment during a year are flows, to be measured over a period of time. These are respectively borrowings and repayments during the year. The difference between the two is the net addition to the public debt.

Public debt can be split into two heads, internal debt (money borrowed within the country) and external debt (funds borrowed from non-Indian sources).

The internal debt comprises of treasury Bills, market stabilization scheme, ways and means advance, and securities against small savings.

Budgetary trends in India

	1990-91 cr	*2007-08 cr*
Revenue receipts	54000	486000
Tax	43000	400000
Non tax	12000	825000
Revenue Expenditure	73500	558000
Interest payments	21500	1,59,000
Subsidies	9500	51000
Defense	10800	54000
Revenue deficit	18500	71500
Total Expenditure	98000	680000
Capital Expenditure	24750	122600
Fiscal deficit	37600	151000
Primary deficit	16108	-8047

Fiscal deficit = Total expenditure-Revenue receipts-recovery of loans-other receipts

Primary deficit = Fiscal deficit-interest payments

The FRBM Act

The FRBM Act was enacted by Parliament in 2003 to bring in fiscal discipline. The government had notified the FRBM Rules in July 2004.

The FRBM Rules impose limits on fiscal and revenue deficit. So, it is the duty of the Union government to follow the deficit targets.

As per the target, revenue deficit, (revenue expenditure - revenue receipts) should be reduced to zero in five years beginning 2004-05. Each year, the government is required to reduce the revenue deficit by 0.5 percent of the GDP.

The fiscal deficit is required to be reduced to 3 percent of the GDP by 2008-09.It would mean reduction of fiscal deficit by 0.3 percent of GDP every year.

The FRBM Act has four main prescriptions

1. First, it requires the Government to prepare three statements, covering Medium Term Fiscal Policy, Fiscal Policy Strategy and Macroeconomic Framework.

2. The Act prescribes fiscal management principles, asking the Centre to "reduce the fiscal deficit" and to "eliminate revenue deficit" by March 31, 2008.

   It requires the Government to set a ceiling on guarantees (the Rules prescribe 0.5 per cent of GDP). The Act provides that the ceilings may be exceeded on grounds of "national security or national calamity or such other exceptional grounds as the Central Government may specify".

3. The Act prohibits the Centre from borrowing from the Reserve Bank of India that is, it bans `deficit financing' through Money creation.

   The RBI is also barred from using primary issues of Central Government securities. Temporary Ways and Means advances to tide over cash flow problems are permitted.

4. The Finance Minister is required to keep Parliament informed through quarterly reviews on the implementation, and to take corrective measures if the reviews show deviations. The Act provides that no deviation shall be permissible "without the approval of Parliament".

The rules impose limits on fiscal and revenue deficit which the central government is required to stick to. In case of a breach, the government is held accountable under the law and is required to explain to Parliament the reasons for the breach, corrective steps, as well as the proposals for funding the additional deficit.

According to the target, revenue deficit has to be reduced to nil in five years beginning 2004-05. Each year, the government is required to reduce the revenue deficit by 0.5 per cent of the gross domestic product (GDP). Similarly, the fiscal deficit is required to be reduced to 3 per cent of the GDP by 2008-09 or a reduction of 0.3 per cent of GDP every year.

Revenue deficit occurs when a government spends more than the revenue it receives in the current financial year. When a government's total expenditure exceed the revenue that it generates (excluding money from borrowings), it results in fiscal deficit.

Revenue deficit for the period April-November 2008-09 registered a growth of 102 per cent (surplus of 17.2 per cent for the same period in 2007-08) thanks to a string of financial stimulus provided by the government to the counteract the impact of the global slowdown on the Indian economy, outgo towards the Sixth Pay Commission and waiver of dues towards farm loans.

The fiscal deficit too increased by 85.7 per cent (surplus of 12.2 per cent for the same period in 2007-08).

In order to address the economy's liquidity concerns, RBI had injected funds worth Rs 4,28,000 crore into the system. Of this, about Rs 1,65,000 crore was injected through refinance facilities, for which additional borrowings have to be made.

As against the budgeted net market borrowings of Rs 99,000 crore, the government till date has mobilized Rs 1,51,697 crore from the market.
In addition to this, special bonds worth 1.1 per cent of GDP, or Rs 58,000 crore, have been issued to oil marketing and fertilizer companies.

In its statement, RBI has explained that the additional borrowing is on account of the shortfall in revenue generation by the government due to lower direct and indirect tax collections, following the cuts in excise and customs duties. In its latest review of the economy (January 2006-09), the economic advisory council to the prime minister has placed the consolidated fiscal deficit of the central government at 8 per cent of the GDP for 2008-09.

Fiscal Responsibility and Budget Management Rules 2004

Parameter	Provisions in the FRBM
1	2
Fiscal Deficit (GFD)	GFD to be reduced by 0.3 per cent or more of GDP every year, beginning with the year 2004-05, so that the GFD does not exceed 3 per cent of GDP by end-March 2008
Revenue Deficit (RD)	RD to be reduced by 0.5 per cent or more of GDP at the end of each year, beginning from 2004-05, in order to achieve elimination of the RD by March 31, 2008, as prescribed in the FRBM Act. Subsequently, it was proposed in the Union Budget 2004-05 to move an amendment to eliminate the RD by 2008-09
Contingent Liabilities	The central government shall not give guarantees aggregating an amount exceeding 0.5 per cent of GDP in any financial year beginning 2004-05
Additional Liabilities	Additional liabilities (including external debt at current exchange rate) shall not exceed 9 per cent of GDP for the year 2004-05. In each subsequent year, the limit of 9 per cent of GDP shall be progressively reduced by at least one percentage point of GDP
Borrowings from RBI	Direct Borrowings from the RBI prohibited from the year 2006-07 except by way of WMA to meet temporary mismatches or under exceptional circumstances

Module V – International trade and WTO

Gains from Trade

International trade benefits both the trading countries. The free trade policy which was the trading legacy till the beginning of 19th century yielded benefits to all the countries that traded internationally.

In the process of trade, a country exchanges a good which can be produced with cost advantage against a good where the country does not have cost advantage,

Such free trade grants a host of gains to both the trading countries. The aggregate benefit from trade is called the gains from trade. The terms of trade will define the share of each country in the total gain from trade.
The gains from international trade are multifold:

1. Trade maximizes the volume of merchandise. When countries trade freely, the national product increases.
2. Countries would specialize on the basis of resources and the cost advantage will be maximum.
3. When countries operate according to cost advantage, the resource used will be most efficient.
4. The cost of production will be low enabling lower prices and advantage to the consumers.
5. Free trade develops mutual dependence and friendly economic relation.
6. It allows free flow of technology.
7. Offers larger choice to the consumer
8. It provides wider markets to the industry
9. Finally, the global welfare maximizes

Balance Of Payments

Balance of payments is a systematic record of transactions between one country and rest of the world during a period of time.

Balance of payments emerge as an important feature of modern international trade, whereby the country can evaluate its position in terms of international trade, currency movements, terms of trade and strength of the currency.

Balance of payments can also project the development status of the economy in terms of industrial growth, economic stability and national income.

Balance of payments is a record of transactions under two different heads:

1. Current account:

   It deals with the movements of merchandise (goods) by way of exports and imports. The merchandise may be private or Governmental. Merchandise is a major item on the current account. Other items appearing under current account include :
   Transportation, insurance, tourism, and foreign remittances are called as the invisibles because it involves foreign exchange flows but has no physical movement of goods. The remittances can be in or out of the country. Other items are non-monetary gold and miscellaneous head for non-classified current transactions.

   Each one of these items have a credit or debit depending on the principles of double entry book keeping.
   On current account there can be deficit or surplus, depending on the nature of transactions.

   The position on the merchandise account is called the balance of trade. The difference between exports and imports determine the position of balance of trade. It is an important indicator because it will highlight the foreign exchange commitments of the country with respect to each country and currency.

2. Capital account :

   It deals with capital movements between one country and rest of the world. Capital movements can be private, governmental or institutional (IMF, World Bank and others).It can be again classified as short term and long term capital movements.

   Other items include amortization, debt servicing, monetary gold and miscellaneous. Amortization is the loan liquidated, debt servicing is the repayment of principle and interest and non-monetary gold is the payments made in terms of gold.

   These capital transactions will also have a debit or credit depending on the directions of flows. Capital account can show a deficit or a surplus revealing the strength of the economy. The deficits of the

current account will be financed by the capital account. So there is a spill over of deficits of current acceptant into capital account.

Finally, the balance of payments will have the deficit or surplus, reflecting the overall position of all the international transactions.

Important ratios:

1. Balance of trade:

   Balance of trade is an important indicator of the efficiency of export sector and import substitution sector. It is the position of an economy in terms of merchandise on current account. It is an important indicator because it will highlight the foreign exchange commitments of the country with respect to each country and currency.

2. Basic balance:

   This is the difference between exports + inflow of long term capital AND imports + out flow of private capital. It is measure of gross movements in currencies in and out of the economy.

3. Liquidity balance:

   In international trade, liquidity is a major consideration in international payments. Liquidity balance deals with the difference in the official exchange holdings over a given period of time. High liquidity balance improves the credit worthiness of a country.

4. Official settlement balance:

   It is a gross indicator of financial position arising out of the balance of payments. It is the difference between exports + all private capital inflows AND imports + all private out flows. It gives a clear picture of the balance of payments position pertaining to a given time period.

Does balance of payments always balance?

Balance of trade and balance of payments:

In the classical school of thought it was popularly believed *that balance of payments should always balance*. It was backed by the idea that under barter

system of exchange, every import shall have a corresponding export. So exports will always be equal to imports.

Further, with no capital flows the payments can not be differed. With this there will not be any difference between balance of trade and balance of payments. Hence it was felt that balance of payments shall always balance.

With monetized transactions, barter is ruled out. There are capital movements which can always upset export-import equality. Moreover, what the classical economics considered balance of payments was indeed balance of trade.

There is no need for the balance of payments to balance, not even the balance of trade. There can be deficit or surplus in any of the measures. On the other and the balance of payments position reveals the strength of the country and currency.

It is desirable to have a surplus in the balance of payments . A deficit in balance of payments is called disequilibrium. Continuous deficits lead to problems of mounting external debt burden and unstable currency.

Types and causes of disequilibrium in the balance of payments

In general terms, a deficit in the balance of payments is called disequilibrium. Such a deficit may be at the capital account, current account ; occasional, chronic ; cyclical, enlarging deficits. Each type is caused by different set of factors. But in general, disequilibrium is an unfavorable position in BoP caused by continuous deficits which are large.

Types of disequilibrium in BoP :
Following are the different types of disequilibrium in BoP :

1. Cyclical disequilibrium: This is caused by the trade cycles. The economic activity changes in cyclical fashion with boom depression. In each state, the disequilibrium is caused depending on the spurt of incomes, intensity of demand for imports, domestic prices and nature of exports and imports.
   The impact of cyclical disequilibrium is found in developed economies as compared with less developed economies.

2. Secular equilibrium: Secular disequilibrium depends on the level of growth in an economy.
   An economy can be a primitive economy, or an economy under preparatory stage for development or an economy in the take-off stage or an economy with high mass consumption. These are the stages of growth as given by W.W.Rostow.

   Secular disequilibrium is characterized by the level of population, capital accumulation, technology and resources.

3. Structural disequilibrium:
   This is caused mainly due to the nature and composition of exports and imports. The elasticities of exports and imports determine the efficiency of any methods of correcting the trade. For example , stagnant exports and elastic imports cause BoP problems. Correction of such disequilibrium will need structural changes in the composition of trade and foreign exchange position.

Causes of disequilibrium in developing countries:
BoP disequilibrium is common with most developing economies. Study of the factors and nature of disequilibrium will help in correction and design of methods of protection.
Following are the important causes of disequilibrium:

1. Large population, increasing growth rates of population.
2. Stagnant exports due to out dated products
3. Increasing demand for imports
4. Low productivity and poor growth rates
5. Lack of bargaining power
6. Large external debt due to which the burden of debt servicing increases.
7. Adverse terms of trade.
8. Cyclical fluctuations in economic activity
9. Problems of international liquidity
10. Absence of ant trading association or regional block
11. Weak currency
12. Absence of trade ties with developed economies.
    In addition all the problems of under development contribute to disequilibrium in BoP. Since there is no effective mechanism to correct, the disequilibrium becomes chronic.

Methods of correcting balance of payments disequilibrium

There are several methods to correct balance of payment disequilibrium. The methods depend on the nature and causes of disequilibrium.

The methods can be classified into two groups : viz. monetary and non monetary methods.

Monetary methods:

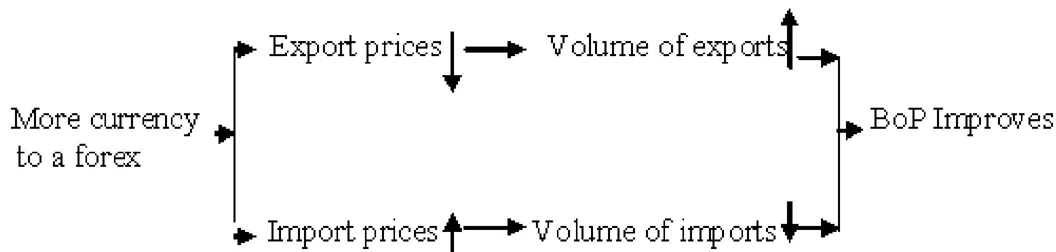
Monetary methods of correction affect the balance payments by changing the value or flow of currencies; both domestic and foreign. Indirectly, it affects the volume and value of exports and imports.

With flexible exchange rate it is possible to affect the value and volume of exports and imports.

Following are the various monetary methods of BoP correction :

1. Devaluation:

Devaluation means decreasing the value of domestic currency with respect to a foreign exchange. Devaluation is done by the Government of the country of origin. Devaluation is done deliberately to get its advantages.



The Government officially declares the devaluation, indicating the extent of decrease in the value of its currency. The Government can decide the time and the amount of decrease.

Devaluation can determine a specific currency with which it is devalued. In such case the trade with the target country improves. The devaluation is irreversible. The country can not change the value of currency frequently.

With a decrease in the value of its currency, the country has to pay more in exchange to a foreign currency
In case of exports the price shows a decline to the extent of decrease. The exports become cheaper.

At the same time the imports become expensive because more domestic currency is payable.

With this the exports increase and the imports decrease.

This way the balance of payments position improves. The country gets better terms of trade.

Devaluation is opted during such times when:

a. The imports are increasing rapidly,
b. The exports are stagnant,
c. The domestic currency has low demand
d. The foreign currency is in high demand

The efficiency of devaluation , however depends on

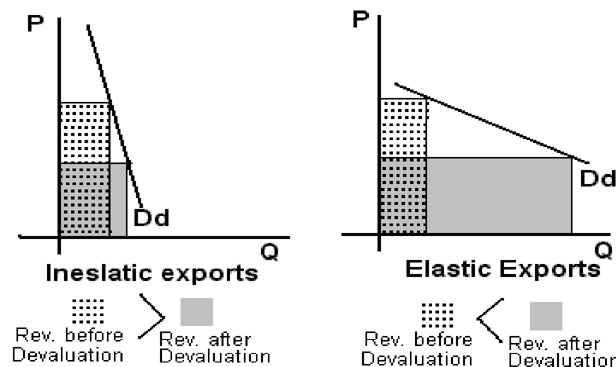
Marshall-Lerner Condition

According to the Marshall-Lerner condition. Devaluation helps only incase the elasticities of demand of exports and imports is equal to 1

$$e_x + e_m = 1$$

It is advisable to devalue currency only when the sum of the elasticities of exports and imports in equal to one.

Incase the exports and imports are inelastic, the devaluation will help the country. Generally, the developing countries have inelastic exports and imports. Devaluation in such countries is not always useful.



In case of inelastic exports, the decrease in price can not get proportionate increase in the volume. So, there is a decrease in the revenue due to devaluation

When the exports are elastic; The increase in the volume of exports will be grater than the decrease in the price. The revenue from trade will increase after devaluation.

Similar case can be proved with imports where, outgoing are larger with inelastic imports.

The Marshall-Lerner condition stipulates the limitations of applicability of devaluation. Further, devaluation can also bring in large scale retaliation from other countries. This again will affect the BoP position the devaluating country.

There are some other methods which are similar to devaluation but the nature is different.

2. *Depreciation*:

   Depreciation is similar to devaluation but it is done by the exchange market. The exchange market is made up of demand and supply of currency. Depending on the demand and supply, the value of currency can be appreciated or depreciated, Depreciation is similar to devaluation. It involves a decrease in value.

   Depreciation is done by the market; the Government has no control over the value. Further, the value changes are small and reversible depending on the demand and supply conditions.

3. *Pegging operations.*

   Pegging down the value of currency is done by the Government. The Central bank depending on the need may artificially, increase or decrease the value of currency, temporarily.

   Pegging operations can be done any number of times. Since it is done by the Government, it may be beneficial. It is reversible; it offers the Government the flexibility to manage the value of the currency for its advantage.

4. Deflation:

With flexible exchange rate mechanism, the domestic value of currency affects the international value of currency. The domestic value of currency can be improves by any of the anti-inflationary methods. By reducing the domestic money stock, the value of money can be improved. It improves the foreign exchange rate as well.

4. *Exchange controls:*

Deliberate management of exchange markets, value, and volumes of currencies form the exchange controls. There are several methods of exchange controls which can affect the value and flows of currencies for improving the BoP position.

Exchange controls include methods like, pegging operations, multiple exchange rates, mutual clearing agreements etc.

It can be seen that, monetary methods of correcting BoP disequilibrium aim at solving the crisis on capital account and directly managing flow of foreign exchange. Indirectly, the value of currency can bring equilibrium on current account as well by changing volume of exports and imports.

II) Non-monetary methods: Non-monetary methods deal with real sector for correcting BoP disequilibrium. All the non-monetary methods directly affect exports and imports. Following are the important non-monetary methods :

1. Export Promotion: The country with deficits can take up export promotion measures like providing fiscal incentives, financial aid, Infrastructural facilities, marketing support and support of imported inputs.

   The Government offers a package of tax incentives which will reduce the costs and make exports competitive in the world market.
2. Import Substitution: The economy can progressively develop technology of import substitution. A country produces those goods which were earlier imported. It may require import of capital goods, technology or collaborations.

3. Import Licensing: The Government can have stringent controls over the usage of imports. This can be done by licensing the users based on centralized imports.
4. Quota: Import quotas are important non-tariff barriers. They are positive restrictions on incoming goods.
5. Tariffs: Tariff is a tax duty levied on imports. The objective is to make imports expensive, which will in turn produce domestic demand and make home industry competitive.
6. Regional economic organizations: Regional economic organizations like custom unions improve bargaining power and grant better terms of trade.

Every country has to use a combination of monetary and non-monetary methods to effectively correct balance of payment disequilibrium and also prevent retaliation from any developed country.

India's balance of payment since 1991

The trends in the Balance of payment can be divided into three stages:
1. Balance of payments trends up to 19190
2. 1990 Balance of payments crisis and economic reforms
3. Balance of payments trends in the post reforms period (1991 onwards)

1. Balance of payment trends up to 1990:

- The Balance of payments between 1970 and 1990 had been showing diverse trends. During 1972 and later in 1975 the Balance of trade showed a surplus. Invisibles retained their surplus throughout. The capital account had a huge deficit which grew over the years. The Balance of payments position can not be considered independent. There are several events which determined the trends in the Balance of payments. Following are the major International events which greatly influenced the course of Balance of payments.
- In the beginning of 1970s, the Government of India gave up the concessional import of wheat from USA under the agreement PL (Public Law) 480.This was due to good harvests and increase in food grain production.

- The Regime of controls had begun by greatly enhancing the tariff rates. The prohibitive rates of tariffs helped in reducing imports. The imports. The OGL (open general license) for imports was shortened.
- The increase in petroleum prices in 1974 greatly increased the import bill.
- The Crude prices increased from $2.5 to $11.65 per barrel. Large dependence on petroleum imports disturbed the Balance of payments position.
- The Gulf economy opened new labour markets for India large influx of labour from India resulted in inflow of foreign remittances. These remittances helped in balancing deficits to a large extent.
- In 1979 the petroleum prices increased once again from 13 to 35. This time the foreign remittances were inadequate to meet the growing deficits.
- The first half of 1980s is marked with global recessionary trends.
- Reducing volumes of global trade also affected Indian trade. India borrowed $ 3.9 bil from IMF to came over crisis.
- Export promotion and liberalization were initiated for the first time. Package of export promotion incentives were launched by way of export councils, export processing zones, tax concessions, duty drawback system etc.

2. Balance of Payments crisis 1990 and onset of liberalization

- By 1990 the Balance of payments deficit turned into crisis with only $ 1.1 bil FOREX reserves and mounting NRI withdrawals and depleting credit worthiness.
- The Balance of payments crisis of 1990 forced the Government of India to take certain major steps like devaluation, decontrols and globalization of the economy.
- To tide over the crisis, India had to borrow $ 6.7 bil from IMF. This was highly essential during such period when the world over India was loosing credibility. To make sure India's intentions towards debt liability 40 tone of Gold was moved from RBI to Central Bank of England (Gold Swap).
- Rupee was devalued twice in quick succession to a total of 18 percent. This was a major devaluation after 1966 devaluation. Chelliah committee strongly recommended lowering of tariff

rates substantially. In certain cases the decline was from 200 percent to 65 percent.

- The excise duty was to be reduced so as to make Indian industry competitive in the international markets.
- Imports were liberalized and export promotion sector got concessions.
- The limit for foreign capital participation increased to the level of holding company (51 percent).
- Automatic technology collaborations were solicited with foreign companies in priority sectors.
- The environment was prepared for 100 percent foreign capital ventures. The equity was allowed to come by way of imported capital goods.
- The terms of repatriation of foreign capital was eased.
- The Narasimham committee on financial sector reforms allowed foreign capital participation in the capital markets.
- The Rupee was to be made convertible freely. It was to reduce the government interference in the exchange markets. Convertibility of rupee means the currency is convertible into a foreign exchange at the market rates. The convertibility is still in the process. Convertibility is presently valid on the current account and it need to be made even on the capital account.

5. Trends in the Balance of Payments since 1991

The trends in the balance of payments show mixed trends. There is an increase in the forex reserve, NRI deposits and capital flows. At the same time the imports have risen faster than the exports showing a large trade deficit.

$ bil

	Trade balance	Current a/c balance	Capital a/c bal
1990-91	-9438	9680	7118
2000-01	-12460	-2666	8535
2004-05	-33700	-2470	28629
2005-06	-51904	-9902	25954
2007-08	-90060	17403	108031

1. It can be seen that there is continuous increase in the capital account balance. This is due to increase in FDI and portfolio investment. Due to this the forex reserves have increased to around $ 340 bil. This is equal to 15 months import bill.

2. Non resident Indian deposits have increased to $ 179 mil in 2008 which constituted 9.3 percent of capital inflows
3. Foreign direct investment increased to $ 15545 mil in 2008 which was 41 percent of capital flows
4. Similarly the portfolio investment increased from $1952 to $29261 between 2001 and 2008
5. Foreign assistance from USA, UK, Germany, IMF, World Bank was at 2114 mil. These were the instruments with 2.2 percent interest and 35 years maturity.
6. Earnings from invisibles were always encouraging. Invisibles include that part of current account earnings where there is no clear transfer of goods. E.g. tourism, shipping etc. Between 2001 and 2008, the invisibles increased from $ 9794 to $72657
7. On merchandise trade there has been an increase from 11574 to $90060 between 2001 and 2008. It can be noted that during this period India entered complete WTO free trade regime from 2005.
8. The import cover, which was 4.9 months in 1991 increased to 15 weeks by 2008. Import covers refers to forex reserves which can finance import bill in terms of weeks.
9. The current account deficit remained same over the years at around 1.5 percent of GDP.
10. The External debt to GDP ratio stood at 41 percent in 1991. Presently, it has declined to 17.5 percent.

With faster growth of IT based exports and strong capital flows in times to come the balance of payments will continue to remain favorable.

WTO and India

From 1947 to 1994, General Agreement on Trade and Tariff (GATT) was the forum for managing trade barriers. The World Trade Organization (WTO) was established on 1st January 1995. . The WTO has 148 members,

accounting for over 97 percent of world trade. Around 30 others are negotiating membership.

Main functions of the WTO:

1. To oversee implementing and administering WTO agreements;
2. To provide a forum for negotiations; and
3. To provide a dispute settlement mechanism.

These objectives are laid down so as to achieve certain global objectives like:

- Raising standards of living;
- Ensuring full employment;
- Ensuring large and steadily growing real incomes and demand; and
- Expanding the production of and trade in goods and services.

Agreements under WTO

WTO prescribes several conditions governing trade agreements in agriculture, service sector, intellectual property rights, and international disputes. These are given as agreements.

1. General Agreement on Tariffs and Trade 1994
2. Agreement on Agriculture
3. Agreement on Trade-Related Investment Measures
4. General Agreement on Trade in Services
5. Agreement on Trade-Related Intellectual Property Rights

General Agreement on Tariffs and trade (GATT) (for goods),

1. Protection to Domestic Industry through Tariffs:

a. The General Agreement on Tariffs and Trade (GATT) covers international trade in goods. The workings of the GATT agreement are the responsibility of the Council for Trade in Goods (Goods Council) which is made up of representatives from all WTO member countries. GATT requires the member countries to protect their domestic industry/production through tariffs only.

b. It prohibits the use of quantitative restrictions, except in a limited number of situations.

2. *Binding of Tariffs:* The member countries are urged to
a. Eliminate protection to domestic industry/ production by reducing tariffs and removing other barriers to trade in multilateral trade negotiations.
b. The reduced tariffs are bound against further increases by listing them in each country's national schedule.
c. The schedules are an integrated part of the GATT legal system.

3. Most Favored-Nation (MFN) Treatment:
a. The rule lays down the principles of non-discrimination amongst member countries.
b. Tariff and other regulations should be applied to imported or exported goods without discrimination among countries.
c. Exceptions to the rules i.e., regional arrangements subjected to preferential or duty free trade agreements, Generalized System of Preferences (GSP) where developed countries apply preferential or duty free rates to imports from developing countries.

4. National Treatment Rule:
The rule prohibits member countries from discriminating between imported products and domestically produced like goods in the matter of internal taxes and in the application of internal regulations.

General Agreement on Trade in Services (GATT)

Services sector represent the fastest growing sector of the global economy and account for two thirds of global output, one third of global employment and nearly 20 per cent of global trade. General Agreement on Trade in Services provides for the following:

- *Commitments on market access and national treatment-* Individual countries' commitments to open markets in specific sectors. GATS does not require any service to be deregulated.

- *International payments and transfers* - Once a government has made a commitment to open a service sector to foreign competition, it must not normally restrict money being transferred out of the country as payment for services supplied.
- *Progressive liberalization* - The goal is to take the liberalization process further by increasing the level of commitments in schedules.
- *Movement of natural persons* - individuals' rights to stay temporarily in a country for the purpose of providing a service.
- *Financial services* - protection of investors, depositors and insurance policy holders, and to ensure the integrity and stability of the financial system.
- *Telecommunications* - Governments must ensure that foreign service suppliers are given access to the public telecommunications networks without discrimination

Trade-Related Aspects of Intellectual Property Rights (TRIPS),

The areas covered by the TRIPS Agreement

- Copyright and related rights
- Trademarks, including service marks
- Geographical indications
- Industrial designs
- Patents
- Layout-designs (topographies) of integrated circuits
- Undisclosed information, including trade secrets

(a) *Copyrights and related rights;*

- Protection of computer programs as literary works and of compilations of data.
- Recognition of computer programs, and cinematographic works
- Recognition of a 50 years' minimum.

(b) *Trade marks;*

- Protectable subject matter includes any sign, combination of signs capable of distinguishing the goods or services from others. Registration depends on distinctiveness end use.

- • Rights on the owners of registered trademark conferred to prevent third party not having his consent, from using in course of trade relating to identical goods/ services.
- The minimum term of protection is seven years, indefinitely renewable.

(c*) Geographical Indications*;

- Legal means shall be provided to prevent use of an indication in a manner that misleads the public or when it constitutes unfair competition, and to invalidate a trademark if the public is misled as to the true place of origin.
- Additional protection is conferred on geographical indications for wines and spirits
- Obligations only relate to geographical indications that are protected in their country of origin.

(d*) Industrial Designs;*

- Protection to new or original designs.
- Protection for textile designs through industrial design or copyright law.
- Exclusive rights can be exercised against acts for commercial purposes, including importation.
- Minimum Term of Protection is ten years.

(e) *Patents;*

- Patents shall be granted for any inventions, whether products or processes, in all field of technology, provided they are new.
- The term of protection shall be at least 20 years from the date of application.

(f*) Layout designs of integrated circuits;*

- Protection shall extend to layout designs as such and to the industrial articles that incorporate them.
- Term of protection is a minimum of 10 years notification.

(g) *Protection of undisclosed information (trade secrets).*

- Undisclosed information is to be protected against unfair commercial practices, if the information is secret, has commercial value and is subject to steps to keep it secret.

Agreement on Agriculture (AoA)

WTO Agreement on agriculture covers

1. Market access: This involves tariffication, and reduction in tariff and access opportunities. Tariffication means all non-tariff barriers like quotas, variable levies, minimum support prices, discretionary licensing and state trading measures need to be placed with tariffs. This is 24 percent for developing countries.
2. Domestic support: Policies are subject to reduction, from the total support given 1986-88. Total Aggregate Measure of Support (Total AMS) shall be 13 percent.
3. Export subsidies: Export subsidy expenditure to be reduced to 36 per cent and for developing countries is 24 percent.

As special differential treatment, developing countries are permitted untargeted subsidized food distribution to meet requirements of urban and rural poor.

In operation WTO prescribes a four fold approach:

- Green Box: It contains fixed payments to producers for environmental programs, so long as the payments are not a part of current production
- Blue Box: Minimum support price and direct payments to agriculture
- Special and differential box: Investment subsidies
- Amber Box: Contains domestic subsidies that governments have agreed to reduce but not eliminate. The Blue Box contains subsidies which can be increased without limit, so long as payments are linked to production-limiting programs.

India and WTO:

India has undertaken is to bind its tariffs on primary agricultural products at 100 per cent; processed foods at 150 per cent; and edible oils at 300

per cent. Further, India's share in total agricultural exports from developing Asia is 8 per cent

- Maintains quantitative restrictions due to Balance of Payments reasons
- No commitment regarding market access.
- Green box is considered with development box
- Agricultural exports do not get direct subsidy.
- Indirect subsidy by way of exemption of export profit from Income tax
- Subsidies on cost of freight on export shipment of fruits, vegetables, floral products
- Share of Indian agriculture in world market is negligible except rice
- Subsidies of rich nations does not effect Indian exports
- Indian products are cost effective
- No fear of Indian markets being flooded by imports
- It is important to protect food and livelihood security to alleviate poverty, rural development and employment
- There is a need to create opportunities for expansion of agricultural exports with meaningful market access in developing counties.

Development in various Ministerial meetings

WTO has been blames to be pro developed nations. It is felt universally, that free trade regime benefits only the developed countries. So all the agreements have been undergoing reviews in different conferences.

All annual conference of WTO experienced protests and demonstrations from the third world countries. In each of these conferences major agreements have been made to improve acceptability of WTO regime.

- The Doha Declaration 2001, brought new round of negotiations on agricultural subsidies, public health, environment and labour issues.
- Cancun conference 2003 brought out the issues of liberalization of agriculture and new multilateral issues.
- Hong Kong conference 2005, discussed cuts in tariff.

Module VI – Exchange rate determination

Purchasing Power Parity Theory

The gold standard method determines the exchange rate up to the end of II world war. During the reign of gold standards the currencies were fully convertible into gold. This facilitates international transactions and liquidity. With increasing demand for currency and inelastic supply of gold the currency standard change.

During gold standards the exchange rate remained fixed because gold was a neutral commodity which had no seasonality in supply or demand. The fixed exchange rate provides stability of value in international transaction.

The gold standard was replaced with paper Standards. The currency is how valued on the basis of its purchasing power. The price determines domestic value of currency as well as exchange rate.

With the exchange rate becomes highly flexible and floating. Such flexible exchange rate mechanism makes an economy open to the external sector can be brought about with domestic policy.

The purchasing power is worked out on the basis of prices existing in the economy for the basket of consumption. With the changing price the exchange rate also freely changes. The domestic rates of inflation and monetary policy determines international exchange rate.

In 1971 ` Gustav Cassel ‘proposed to replace the existing Mint Parity. The purchasing power of currency emerged as an important determinant of exchange ratio.

To a given base rate of exchange variation are calculated with price indices suggests two methods

1. Absolute version
2. Relative version

In case of absolute version the variation in a given exchange rate is calculated with respect to domestic price indices. In case of relative version the foreign price index is also considered.

The variation which is domestic and foreign price indices provide the real exchange rate. These indices are based on the consumption basket.
Under absolute version, the exchange rate is measured as,

$$\text{Exchange rate} = Ex_o \times DPI$$

In relative version, the exchange rate is determined as,

$$\text{Exchange rate} = Ex_o \times \frac{DPI}{FPI}$$

$$= Ex_o \times \frac{Dp_o}{DP_1} \Big/ \frac{FP_o}{FP_1}$$

Where, Ex_o is base exchange rate
DPI Domestic price index
FPI Foreign price index
Dp_o Domestic price in base year
DP_1 Domestic price in current year
Fp_o Foreign price in base year
FP_1 Foreign price in current year

- Paper standards is useful in monitoring the currency values by using domestic monetary policy.
- It makes the entire economy very sensitive to exchange rate.
- It enables the Central bank to interfere and make suitable changes in the exchange rate.
- Any over valued or under valued currency is automatically gets adjusted to real value of the currency. Depending on the value changes the flow of currency changes the direction.

Evaluation

- The concept of basket of goods is imaginary.
- The basket of goods may not be comparable within countries
- The basket of goods may be different from the goods actually traded between the countries
- The economy becomes over sensitive to external changes.

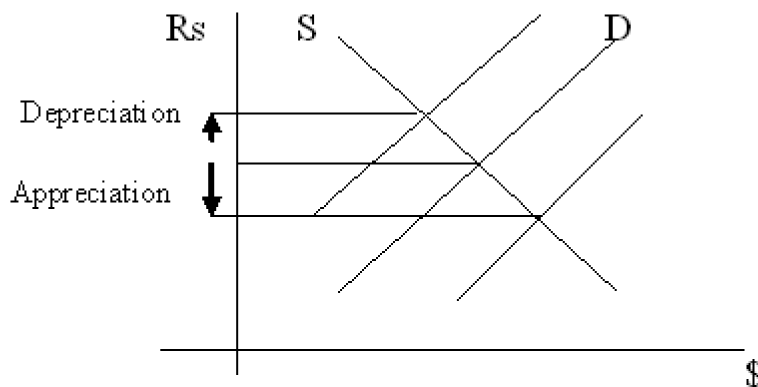
- The flexible exchange rate causes insecurity and instability in foreign trade and currency movements.

Exchange Markets

In international trade exchange markets plan an important role in facilitating payments. The exchange marked is made up of demand and supply forces. The demand and supply together determine equilibrium value. This is exchange rate.

The demand for currency is made up of imports, interest payment outward remittance and debt servicing.

The supply of currency is made up of exports inflow of capital investment, debt servicing received and inward remittance.
The demand and supply determine the value of a given foreign currency.



When the demand for a foreign currency increases, more of domestic currency, becomes payable. The domestic currency gets depreciated. Similarly, when the demand for foreign currency decreases, the domestic currency appreciates.

Features and functions of FOREX Market

The features of the FOREX market which contributes to its growth are:

- *Transfer Function*: International trade involves the transition between the exporter and importer whose are not established. Thus the foreign exchange dealers and commercial banks perform the transfer function through respective central banks.
- *Credit Function:* International transaction involves large time periods. There is a gap between shipment & realization of income. Credit function provides a bridge between the transaction gap.
- *Hedging:* In the region of free and floating exchange rate the value of currency may change frequently. It involves a rise to the exporter or importer. In such a case the trader can see insurance cover against value changes. This is called Hedging function.
- *Liquidity:* Higher the liquidity, the more powerful will be from the investor side as it gives them the choice to open or close a position of any size.
- *Promptness and Availability:* The FOREX market need not have to wait to give any certain respond to any given occasion due to its 24 hour work schedule and likelihood to trade round the clock.
- *Value:* Except for the natural bid market spread between the supply and demand price the FOREX market has usually incurred no service charge.
- *Market trend:* Each currency reveals its own typical temporary modifications which represents investments managers with the chances to manipulate in the FOREX market.
- *Margin*: Widespread credit leverages or margins in conjunction with highly variable currency quotations makes this market a highly gainful but also very chancy.

Foreign Exchange Market in India

Foreign exchange consists of trading one type of currency for another. Unlike other financial markets, the FOREX market has no physical location and no central exchange. It operates "over the counter" through a global

network of banks, corporations and individuals trading one currency for another. The FOREX market is the world's largest financial market, operating 24 hours a day with enormous amounts of money traded on a daily basis.

The spot and forward exchange markets

In a spot transaction the seller of exchange has to deliver the foreign exchange he has sold 'on the spot' (usually within 2 days). Similarly the buyer of exchange will receive the foreign exchange he has bought immediately.

There is another important market, the Forward Market. In a forward market when the bargain is settled, the seller agrees to sell at a certain amount of foreign exchange to be delivered at a future date at a price agreed upon in advance.

Similarly, a buyer agrees to buy certain amount of foreign exchange at a future date at a predetermined price. Commonly used forward contracts are for duration of one month(30 days) 3 months (ninety days),six months (180 days), nine months (270 days) and one year (360 days). The linkage between the spot and forward exchange rates come from the actions of three groups of economic agents who use the market, viz. arbitrageurs, hedgers, and speculators.

Foreign Exchange Rate

Exchange rate is the price of one currency expressed in terms of another. It is the relationship between two monetary units. Exchange rate is the medium though which one currency is exchanged for another.

Direct and Indirect quotations

There are two FOREX quotations. One is to quote so many Rupees for each Dollar and the second option is to quote so many Dollars per rupee or per hundred rupees. The first is called the Direct Method and the second is called the Indirect method.

Direct Method (Home Currency Quotation):
US$ = Rs.43.20 (Spot)
Indirect Method (Foreign Currency Quotation):
Rs.100 = US$ 2.35 (Spot)

Earlier foreign exchange rates for various types of merchant transactions (both spot and forward) were fixed by the Foreign Exchange Dealers Association of India (FEDAI) in consultation with RBI. Recently however this arrangement was abolished and the Individual Banks are permitted to quote competitive rates, based on the on-going inter-bank or overseas market rates.

Buy and sell rates

Authorized Dealers quote exchange rates on daily basis. The Bank which offers the exchange rate is known as the Quoting Bank ands the Bank/person/Organization asking for the rate/price is known as the asking bank/firm/person. The quoting Bank always quotes two way prices,

1. A price at which it buys
2. A price at which it sells.

Both rates are quoted against a common currency.
While quoting rates the Quoting Bank keeps a spread between the buying and selling rate. The spread is kept to cover operational costs and margin of profit.

Example

Rs.100 = US$ 2.3500/50.
This means it is prepared to sell US$2.3500 for Rs.100/- and is Prepared to buy US$2.3550 for Rs.100
The spread is 50 cents.

The maxim applied is *"Buy High and Sell Low"* for Indirect quotes. For Direct Quotes the maxim is reversed "Buy Low and Sell High". The objective of buying and selling operations is to cover the operational costs and also to earn an exchange profit. Bankers consider exchange profit as an important source of income. It is earned without the buyer/seller being aware of this income.

Trading in FOREX market

Foreign Exchange:

"Foreign Exchange" refers to money denominated in the currency of another nation or group of nations. A foreign exchange transaction is a shift of funds from one country and currency to another.

Offer Rate:

The price at which a market maker is prepared to sell (a currency) or lend (money)

Swap:

Simultaneous sale and purchase of identical amounts of one currency against another, for different maturities. A swap could be spot (purchase or sale) against forward (sale or purchase) or forward against forward.

Arbitrage:

The simultaneous sale (or purchase) of a financial instrument and the taking of an equal and opposite position in a similar instrument to provide a profit. That is, exploiting pricing differences (anomalies) across markets. True arbitrage is risk free.

Exchange Rate

Exchange Rate is the rate at which one currency is traded against another.

Foreign Exchange market in India

Foreign exchanged market in India is regulated by RBI and also by a voluntary association (Foreign Exchange Dealers Association).

Only Dealers authorized by RBI can undertake such transactions. Specified hotels and Government owned Shops are also given restricted licenses to accept payment from non-residents in foreign currencies. IDBI, and Exim Bank are permitted handle and hold foreign currencies in a restricted way.

The FOREX market is the 24 hour cash market where currencies are traded, typically via brokers. Foreign currencies are constantly and simultaneously bought and sold across local and global markets and traders' investments increase or decrease in value based on currency movements.

Foreign Exchange Dealer's Association of India

In a regime where exchange rates were fixed and there were restrictions on outflow of foreign exchange, the RBI encouraged the banks to constitute a self regulatory body and lay down rules for the conduct of FOREX business.

Accordingly, Foreign Exchange Dealer's Association of India (FEDAI) was set up in 1958 as an Association of banks dealing in foreign exchange in India (typically called Authorized Dealers - ADs) as a self regulatory body and is incorporated under Section 25 of The Companies Act, 1956.
Functions of FEDAI:

1. Providing guidelines and Rules for FOREX Business.
2. Training of Bank Personnel in the areas of Foreign Exchange Business.
3. Accreditation of FOREX Brokers
4. Advising/Assisting member banks in settling issues/matters in their dealings.
5. Represent member banks on Government/Reserve Bank of India/Other Bodies.
6. Announcement of daily and periodical rates to member banks.

Exchange rate management

In march 1992 the liberalized exchange rate management system (LERMS) was introduction and as a result the foreign exchange market in India effectively became a 2 ties one, with a direct exchange rate system in force, one rate was the administration (or official) one at which specified type or proportion of currency exchange had to be transacted by demand and supply in the transaction in March 1993 this system was abolished and now single market determined rate in applicable for all transaction.

Following are the main features of Liberalized Exchange Control Management System:-

- The exchange rates of the rupee are determined by the free market forces of demand and supply. Free market rates are quoted by authorized dealers (ADs).

- Like any other market prices, the exchange rates both spot and forward can vary within a day, between days and even around medium term rend.
- All commercial transactions in the current account and capital account are undertaken at the free-market driven rates, whether on government or private account.
- Foreign exchange remittances abroad are subject to exchange control regulations although the AD can remit in many areas up to certain amounts without Reserve Bank's permission. This implies full convertibility is not applicable to the invisible trade.
- All export proceeds and inward remittances need to be surrendered with a 156 per cent retention option in a foreign currency account with the AD.
- The intervention currency continues to be U.S. dollar, which the Reserve Bank can buy and sell from and to the Ads at its discretion. This route can provide temporary stability in the exchange markets.
- The Reserve Bank provides two way quotes of the U.S. Dollar, which can change several times in a day, depending on market pressures.
- The Reserve Bank will not ordinarily buy or sell any other currency, either spot ort forward; rather will undertake swap transactions with the Ads. A swap involves the Reserve Bank buying the U.S. Dollar spot and selling forward simultaneously for delivery in two to six months.
- The RBI will sell U.S. Dollars to the AD at the market rate, for debt service payments on Government Account and other payments, only a transitory arrangement, such as for meeting 40 per cent value of imports under advance licenses, special import licenses, REP licenses for import of raw materials, gems and jewellery exports, and for meeting the full value of imports under the outstanding EXIM scrips and such other licenses treated on part with these scrips.
- For trade with Russian Republics where the invoicing is in freely convertible currency the market related exchange rate are applicable.
- Transactions routed through the ACU arrangement (except those settled in the Indian rupees) will be based on Reserve

Bank’s rate for ACU currencies and for the Asian Monetary Unit.

RBI Intervention

The balance of payments crisis in 1990-91 prompted policy changes and the liberalization of the exchange rate regime. Initially, in 1992, a ‘dual exchange rate regime’ was instituted; market rate and the rate announced by RBI. Subsequently unified exchange rate in 1993 when RBI withdrew from fixing daily

India is on a floating exchange rate system, where banks and other foreign exchange dealers are free to announce the exchange rate (or, equivalently, the rupee price of the dollar), the RBI can influence the rate by buying and selling the foreign exchange market.

RBI's response to volatile exchange rate movements has been a combination of monetary policy and administrative measures together with intervention.

RBI a ‘quantity intervention’ whereby the RBI simply states the quantity of dollars that it wants the public sector bank to buy on its behalf.

The focus of operation shifted directly from intervening in the market to identifying those demands that could rectify the imbalance. The RBI does not target any exchange rate or resist fundamentals.

RBI is prepared to intervene in the market to dampen excessive volatility as and when necessary; RBI’s purchases or sales of foreign currency are undertaken through a number of banks and are generally discrete and smooth; and market operations and exchange rate movement should, in principle, be transaction-oriented rather than purely speculative in nature.

For every dollar the RBI buys from the market, an equivalent amount of rupees is pumped into the system, thereby adding to the liquidity surge.

The RBI will resort to open market operations to flush out liquidity and stem the volatility in the bond market. However, it may not be required to do so for the fortnight as advance tax outflows will automatically check volatility and prevent bond yields from falling.

Pattern of Question Paper

I. There will be 4 questions. All the questions are compulsory, having internal choice.
II. Question No. 1 is long answer 15 marks question based on Modules I and IV.
III. Question No. 2 is short answer 15 (8+7) marks questions based on Modules II OR III.
IV. Question No. 3 is short answer 15 (8+7) marks questions based on Modules V and VI.
V. Question No 4 is objective type questions including True/False, with reasons and multip
questions based on all modules.

Q1. A. (15 marks) From Module I
OR
B. (15 marks) From Module IV.

Q2. A. (8 marks) From Module II
B (7 marks) From Module II
OR
C. (8 marks) From Module III
D (7 marks) From Module III

Q3. A. (8 marks) From Module V
B (7 marks) From Module VI
OR
C. (7 marks) From Module V
D (8marks) From Module VI

Q4. A. True/False, with reasons. Attempt any four (4x2=8)
i. From Module I
ii. From Module II
iii. From Module III
iv. From Module IV
v. From Module V
vi. From Module VI
B. Multiple Choice Questions. Attempt any seven (7x1=7)
i. From Module I
ii. From Module I
iii. From Module II
iv. From Module II
v. From Module III
vi. From Module III
vii. From Module IV
viii. From Module IV
ix. From Module V
x. From Module V
xi. From Module VI
xii. From Module VI