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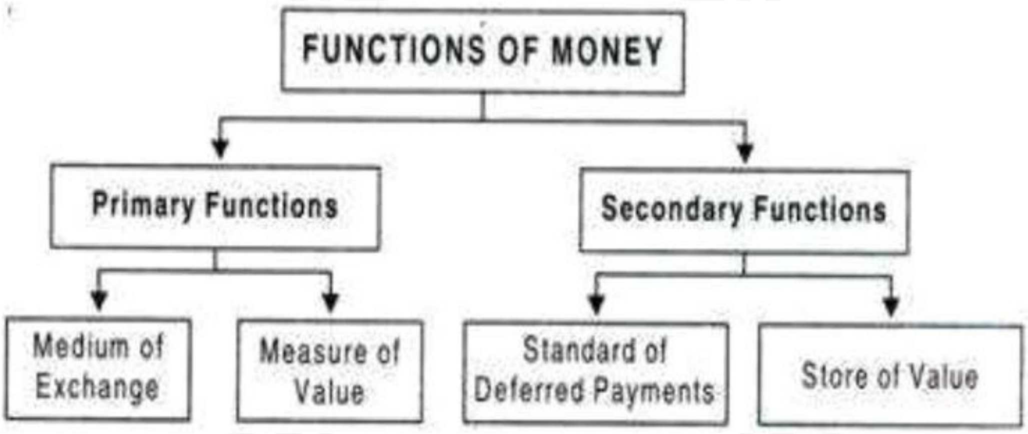
ECONOMY

Money

Meaning of Money

- Money is a commonly accepted medium of exchange.
- Money is anything that can be generally accepted as payment for goods and services or settlement of debts.



Primary Functions of Money

- **Measure of value:** Money serves as a common measure of value or unit of account.
- **Medium of exchange (transaction):** people can easily exchange goods and services with money.

Money

Derivative Functions of Money:

- **Deferred Payment:** Money also serves as a standard mode of deferred payments.
- **Transfer of Value:** Money has the same value throughout the country and has its value is transferrable.
- **Store of Value:** It can be kept as savings (in bank account) and could be used for investment purpose e.g. Buying property.

Paper Money (Fiat Money)

- Paper money acted as money (Legal tender) because they are guaranteed by the national governments.
- Fiat money is legally recognized to settle all debts & payments within territorial jurisdiction.
- Fiat money gives central banks greater control over the economy because they can control how much money is printed.
- **Examples:** US dollar, Indian Rupee, Euro, etc.

Money

Liquidity of Money

- Money is the most liquid of all assets.
- Liquidity Order is as following:
  - Currency
  - Demand deposits in Banks
  - Savings deposits in Banks
  - Term (Time) deposits in Banks

Q. Consider the following liquid assets: (UPSC 2013)

1. Demand deposits with the banks
2. Time deposits with the banks
3. Savings deposits with the banks
4. Currency

The correct sequence of these assets in decreasing order of liquidity is

a) 1-4-3-2

b) 4-3-2-1

c) 2-3-1-4

d) 4-1-3-2

Money

Creation of Money

- **Money supply:** It is all the currency and other liquid instruments in a country's economy on the date measured.
- The money supply is roughly composed of both cash and deposits that can be used almost as easily as cash.

Currency Deposit Ratio (CDR)

- The currency deposit ratio (cdr) is the ratio of money held by the public in currency to that they hold in bank deposits
- It reflects people's preference for liquidity. It is a purely behavioural parameter which depends, among other things, on the seasonal pattern of expenditure.
- For example, cdr increases during the festive season as people convert deposits to cash balance for meeting extra expenditure during such periods.

Money

Reserve Deposit Ratio

- Reserve deposit ratio (rdr) is the proportion of the total deposits commercial banks keeps as reserves.
- Reserve money consists of two things:
  - Vault cash in banks and
  - Deposits of commercial banks with RBI.
- Banks hold a part of the money, that people keep in their bank deposits as reserve money and loan out the rest to various investment projects.
- RBI requires commercial banks to keep reserves in order to ensure that banks have a safe cushion of assets to draw on when account holders want to be paid.
- RBI uses various policy instruments to bring forth a healthy rdr in commercial banks. Example- Cash Reserve Ratio, Statutory Liquidity Ratio, Bank Rate, etc.

Q. When the Reserve Bank of India announces an increase of the Cash Reserve Rate, what does it mean? [CSE -2010]

a) The commercial banks will have less money to lend
b) The Reserve Bank of India will have less money to lend
c) The Union Government will have less money to lend
d) The commercial banks will have more money to lend

Money

Commercial Banks

- Commercial Banks accept deposits from the public and lend out this money to interest earning investment projects.
- The rate of interest offered by the bank to deposit holders is called the 'borrowing rate' and the rate at which banks lend out their reserves to investors is called the 'lending rate'
- The difference between the two rates, called 'spread', is the profit that is appropriated by the banks.
- Deposits are broadly of two types – demand deposits, payable by the banks on demand from the account holder, e.g. current and savings account deposits, and time deposits, which have a fixed period to maturity, e.g. fixed deposits.

Q. Which of the following is not included in the assets of a commercial bank in India?

(a) Advances

(b) Deposits

(c) Investments

(d) Money at call and short notice

Money

Function of Commercial Banks

- Primary Functions
  - Accepting deposit and Providing loans
- Secondary Functions
  - Collection and payment of various items e.g. Cheques, Bills
  - Purchase and sell of securities & remittance of money
  - Purchase and sell of foreign exchange
  - Acting as executors and trustees of wills & underwriting of shares
  - Lockers facility & Travellers' cheque and letter of credit

Q. The main functioning of the banking system is to__________(CDS-2013)

a) Accept deposits and provide credit

b) Accept deposits and subsidies

c) provide credit and subsidies

d) accept deposits, provide credit and subsidies

Money

Value of Money

- By value of money, we mean the purchasing power of money.
- Purchasing Power is the amount of goods or services that can be purchased with a unit of currency.
- When the value of money rises i.e. its purchasing power increases, the general price level falls and vice versa. This means the value of money is inverse of the general price level.
- For instance, at a point of time, Rs. 10 were able to purchase 2 packets of biscuits, but on another times it can buy only one packet because of erosion of purchase power of that currency. This also results in increased purchase power of biscuit packet, it became Rs.7.

Demand For Money

- Money is the most liquid of all assets in the sense that it is universally acceptable and hence can be exchanged for other commodities very easily.
- On the other hand, it has an opportunity cost. If, instead of holding on to a certain cash balance, you put the money in a fixed deposits in some bank you can earn interest on that money.

Money

- Total demand for money in an economy is composed of transaction demand and speculative demand. Demand for money balance is thus often referred to as liquidity preference.
- People desire to hold money balance broadly for following motives:
    - Transaction Motive
        - The principal motive for holding money is to purchase goods and services in day to day life and carry out transactions

    - Speculative Motive
        - When people wish to hold money rather than buying assets/bonds/risky investment. An individual may hold her wealth in the form of landed property, bullion, bonds, money etc.
        - E.g. If interest rates are high, and people expect interest rates to fall, then there is likely to be greater demand for buying bonds and less demand for holding money. If interest rates fall, then the price of bonds will rise.

Money

- Precautionary Motive
  - The precautionary demand for money is the act of holding real balances of money for use in an emergency situation.
  - As receipts and payments cannot be perfectly foreseen, people hold precautionary balances to minimize the potential loss arising from a Contingency

Opportunity Cost of Money

- Opportunity cost refers to a benefit that a person could have received, but gave up, to take another course of action.

Determinants of Money Demand

- The prevalent price level
  - High interest rate or price level will reduce demand for money and vice versa.
- Inflation level in an economy
  - Inflation level reduces demand for money because people prefer to save instead of expenditure because of price rise.
- Real income (Real GDP)
  - Real income is how much money an individual or entity makes after accounting for inflation.

Money

- Disposable income
  - Higher the disposable income, there will be higher tendency to spend more.
- Innovation level in an economy.

Money Supply (Monetary Aggregates)

- The supply of money is a total stock of money in circulation among the public at a particular point of time.
- The measures of money supply in India are classified into four categories M1, M2, M3 and M4 along with M0.

Q. Which of the following measures would result in an increase in the money supply in the economy? [CSE -2012]

1. Purchase of government securities from the public by the Central Bank
2. Deposit of currency in commercial banks by the public
3. Borrowing by the government from the Central Bank
4. Sale of government securities to the public by the Central Bank

Select the correct answer using the codes given below:

a) 1 only b) 2 and 4 only

c) 1 and 3 d) 2, 3 and 4

Money

Reserve Money (M0)

a. It is also known as High Powered Money, monetary base, base money etc.
b. Reserve Money is the monetary base of the economy.
c. M0 = Currency in circulation + Bankers' Deposits with the RBI + 'Other' deposits with the RBI.

Narrow Money (M1 and M2)

a. In banking terminology, M1 and M2 is called narrow money as it is highly liquid and banks cannot run their lending programmes with this money.
b. M1 = Currency with the Public + Demand Deposits with the Banking System + 'Other' deposits with the RBI.
c. M2 = M1 + Savings Deposits of Post-office Savings Banks

Money

Broad Money (M3 and M4)

d. The money component M3 and M4 is called broad money. With this money (which lies with banks for a known period) banks run their lending programmes.

e. M3 = M1 + Time Deposits with the Banking System.

f. M4 = M3 + All deposits with Post Office Savings Banks (excluding National Savings Certificates).

Ques. Consider the following:

1. Currency with the public
2. Demand deposits with banks
3. Time deposits with banks

Which of these are included in Broad Money (M3)

a) 1 and 2

b) 1 and 3

c) 2 and 3

d) 1, 2 and 3

Money

Ques. Following are some components of money supply in India:

1. Currency with the public
2. Aggregate demand deposits with banks
3. Aggregate time deposits with banks
4. 'Other' deposits with the Reserve Bank of India

Which of the aforesaid items are components of narrow money (M1) in India?

a) 1, 2 and3

b) 2 and 4 only

c) 1, 2 and 4

d) 1and 4 only

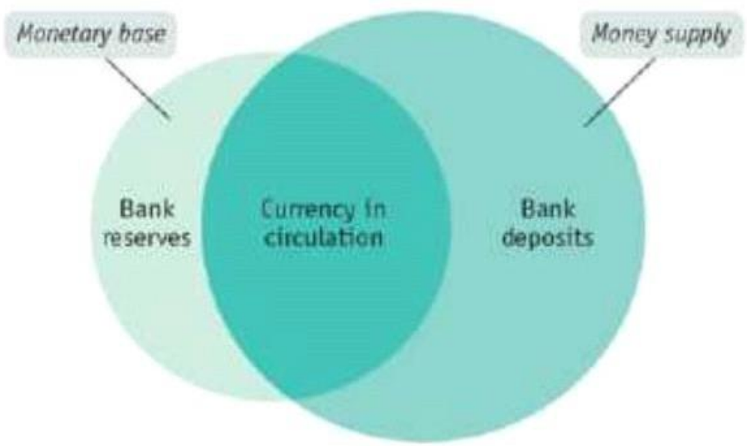
Money

Money Multiplier

- The money multiplier is maximum amount of broad money that could be created by commercial banks for a given fixed amount of base money and reserve ratio.
- Its value is determined in ratio of total money supply to the stock of the high-powered money in an economy.

$$\text{Money multiplier} = \frac{M}{H} = \frac{1 + cdr}{cdr + rdr} > 1$$

$$rdr < 1$$



Money Multiplier
=
Money Supply
÷
Monetary Base

Money

Q. The money multiplier in an economy increases with which one of the following?

a) Increase in the cash reserve ratio

b) Increase in the banking habit of the population

c) Increase in the statutory liquidity ratio

d) Increase in the population of the country

Monetary Policy Of RBI

- Monetary policy refers to all those operations, which are used to control the money supply in the economy.
- The RBI implements the monetary policy through instruments like open market operations, bank rate policy, CRR, SLR, reserve system, credit control policy, moral suasion etc.

Objective of Monetary Policy

- To maintain economic and financial stability - by targeting healthy inflation range.
- To ensure adequate financial resources for the purpose of development
- Ensuring price stability in market by maintaining optimum inflation level.
- Adequate flow of credit to productive sectors.

Money

- Promotion of productive investments & trade by ensuring conducive monetary policy, E.g. by credit rationing tool.
- Promotion of exports and economic growth – by providing timely credit and favourable monetary stimulus through various monetary policy tools.

TOOLS OF MONETARY POLICY

- Quantitative Instruments
- Qualitative Instruments

Quantitative Instruments	Basis	Qualitative Instruments
These are the instruments of monetary policy that affect overall supply of money/credit in the economy.	**Meaning**	These instruments are used to regulate the direction of credit.
Traditional methods of control	**Alternative Name**	Selective methods of control
(*i*) Bank rate (*ii*) Repo Rate (*iii*) Reverse Repo Rate (*iv*) Open market operation (*v*) Cash reserve ratio (*vi*) Statutory liquidity ratio	**Instruments**	(*i*) Marginal requirement (*ii*) Moral suasion (*iii*) Selective credit control

Money

Monetary Policy Committee (MPC)

- Monetary policy refers to the credit control measures adopted by the central bank of a country. RBI is the sole monetary authority which decides the supply of money in the economy.
- MPC is a statutory body created under Monetary Policy Framework Agreement 2015 between the RBI and Government in 2016.
- MPC is entrusted with the responsibility of fixing the benchmark repo rate (policy rate) required to contain inflation as defined in the Monetary Policy Framework Agreement.
- The meetings of the MPC are held at least 4 times a year and it publishes its decisions after each such meeting.
- MPC is 6-member body including 3 members from RBI and 3 members to be nominated by the Central Government.
- Chairperson of MPC – RBI Governor
- Quorum for meeting - 4 members
- Decisions are taken by majority with the Governor having the casting vote in case of a tie.
- To ensure transparency - Govt can send message only in writing.

Money

Inflation Targeting

- It is a monetary policy where a central bank follows an explicit target for the inflation rate for the medium-term and announces this inflation target to the public.
- The Government of India has notified a medium term inflation target of 4 %, with a band of +/-2%.
- If Target fail: If inflation not kept in 4% +/-2% zone for 3 consecutive quarters then the Committee must send report to Govt. with reasons and remedies.

Objective of MPC

- Price Stability for promoting economic development through ensuring optimum inflation level which will drive economic growth in long run.
- Controlled Expansion of Bank Credit with special attention to seasonal requirement (E.g. for agricultural purposes) for credit without affecting the output.
- Promotion of Fixed Investment to increase the productivity of investment by restraining nonessential fixed investment.

Money

- Promotion of Exports and Food Procurement Operations by paying special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.
- Desired Distribution of Credit: Monetary policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.
- Equitable Distribution of Credit to all sectors of the economy and all social and economic class of people.
- To promote economic efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.
- Reducing the Rigidity and encouraging more competitive environment and diversification.

Banking in India

RBI : Origin And Evolution

- Prior to establishment of RBI, the functions of a central bank were virtually done by the Imperial Bank of India. RBI started its operations from April 1, 1935.
- It was established via the RBI act 1934, so it is a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1955.
- RBI did not start as a Government owned bank but as a privately held bank.
- Post-independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation.
- Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned bank.

Timeline

- 1926: The Royal Commission (Hilton Young commission) on Indian Currency and Finance recommended creation of a central bank for India. On the basis of mainly this commission, the RBI Act was passed.

Banking in India

- 1934: The RBI Bill was passed and received the Governor General's assent.
- 1 April 1935: Reserve Bank commenced operations as India's central bank as private shareholders' bank with a paid up capital of rupees 5 crore.
- 1949: The Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.

Governor of RBI

- Appointment
  - Appointed after the proposal made by the Financial Sector Regulatory Appointments Search Committee (FSRASC), headed by the Cabinet Secretary.
- Term
  - According to Section 8 (4) of the RBI Act, the Governor and Deputy Governors shall hold office for such term not exceeding 3 years as the Central Government may fix when appointing them.
- Re-Appointment
  - They are eligible for reappointment.

Banking in India

- **Qualification**
  - The RBI Act does not provide for any specific qualification for the governor.
- **Removal**
  - The governor can be removed by the central government.

Functions of RBI

1. Bank of Issue

- Issuing money is exclusive right of RBI.
- All notes except Rs.1 note and coins are issued by RBI.
- It also exchanges or destroys old damaged currencies.
- Rs.1 notes and coins are issued by Ministry of Finance and circulated by RBI.

2. Custodian and Manager of Foreign exchange

- RBI keeps the foreign exchange (i.e. foreign currency) which flows into the country.
- It also keeps the foreign exchange rate stable to certain extent.

Banking in India

3. Banker and Debt Manager to Government

- It acts as a banker to both central and state governments (except Jammu and Kashmir and Sikkim).
- It keeps deposits of governments and lends to governments.
- RBI carries out lending and borrowing operations by issuing government securities on behalf of the government.
- Though RBI is not a banker to Sikkim and Jammu and Kashmir it manages their public debt to some extent.

4. Banker to bank

- It is the banker of all the banks.
- It keeps the reserve of the banks like cash reserve ratio (CRR) with it.
- It provides financial assistance to banks against mortgaged securities.
- It rediscounts bills of exchange.
- Usually banks borrow and lend money among themselves via call money market, regulated by RBI.
- RBI provides enough money to banks and so called as lender of last resort.

Banking in India

5. Monetary Management
   - Controller of Money Supply, Makes Monetary Policy, Credit Control etc
6. Financial Regulator
   - To Commercial banks, Credit information Companies, RRBs, Local Area Banks, NBFC etc.
7. Representative role
   - RBI represents govt. as a member of the IMF and World Bank.
8. Central Clearance and Accounts Settlement
   - As RBI keeps cash reserves from commercial banks therefore it rediscounts their bills of exchange easily.
9. Developmental role
   - Performing a variety of developmental and promotional functions under which it did set up institutions like IDBI, SIDBI, NABARD, NHB, etc.
10. Promotional Roles
    - Consumer protection, Ombudsman, Financial Inclusion through PSL norms, 25% rural branch requirements etc.

Banking in India

Priority Sector Lending (PSL)

All Indian banks have to follow the compulsory target of priority sector lending (PSL).

Categories	Domestic scheduled commercial banks (excluding RRB and SFB) and Foreign banks with 20 and above branches	Foreign banks (less than 20 branches)
Total Priority Sector	40 per cent of Adjusted Net Bank Credit or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.	40 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, to be achieved in a phased manner by 2020.

Banking in India

Agriculture	18% of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher. Within this 18% Target, 8% is prescribed for Small and Marginal Farmers.	Not Applicable
Micro Enterprises	7.5% of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.	Not Applicable
Advances to Weaker Sections	10% of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is Higher	Not applicable

Monetary Policy Of RBI

- Monetary Policy is an instruments under RBI aimed at regulating interest rates, money supply and availability of credit in an economy.

Banking in India

- RBI decides monetary policy cycle on bi-monthly basis.

Objectives of Monetary Policy

- Economic and financial stability
  - To regulate monetary expansion so as to maintain a reasonable degree of price stability. Maintaining price stability.
- Development
  - To ensure adequate financial resources for the purpose of development.
- Flow of credit
  - Adequate flow of credit to productive sectors.
- Employment and growth
  - Promotion of productive investments & trade. Equitable distribution of income. Employment generation
- International trade and exports - Promotion of exports and economic growth. Maintaining exchange rate stability.

Banking in India

Tools of Monetary Policy

Quantitative Instruments of Monetary Policy

Cash Reserve Ratio (CRR)

- CRR is the certain % (fixed by the RBI) of Net Time and Demand Deposits of a Scheduled bank in India need to kept with the RBI in the form of cash only.
- CRR aimed to have control over banks credit.
- An increase in CRR --> higher proportion of deposits to be kept with RBI by banks --> less funds are available to be provided as credit to the economy --> money supply will decrease

Banking in India

Statutory Liquidity Ratio (SLR)

- The schedule banks needs to also keep certain % (fixed by the RBI) of their Net Time and Demand Deposits kept with itself (i.e. not with RBI) in the form of liquid assets such as cash, gold and select government securities.
- An increase in SLR --> higher proportion of funds to be kept aside by banks in liquid form --> less funds available to be provided as credit to the economy --> money supply will decrease.

Q. When the Reserve Bank of India reduces the Statutory Liquidity Ratio by 50 basis points, which of the following is likely to happen? (CSE-2015)
a) India's GDP growth rate increases drastically
b) Foreign Institutional Investors may bring more capital into our country
c) Scheduled Commercial Banks may cut their lending rates
d) It may drastically reduce the liquidity to the banking system

Banking in India

Q. In the context of Indian economy, which of the following is/are the purpose / purposes of 'Statutory Reserve Requirements? (2014)

1. To enable the Central Bank to control the amount of advances the banks can create.
2. To make the people's deposits with banks safe and liquid.
3. To prevent the commercial banks from making excessive profits.
4. To force the banks to have sufficient vault cash to meet their day-to-day requirements.

Select the correct answer using the code given below.

a) 1 only
b) 1 and 2 only
c) 2 and 3 only
d) 1, 2, 3 and 4

Bank Rate

- Rate at which RBI provides long-term borrowings to its clients.
- Its clients include GoI, state governments, banks, financial institutions, cooperative banks etc.

Banking in India

- An increase in bank rate will make:
  - Borrowing from RBI expensive
  - discourage banks to borrow from RBI
  - money supply will tend to decrease.

Q. An increase in the Bank Rate generally indicates that the (CSE-2013)
a) market rate of interest is likely to fall
b) Central Bank is no longer making loans to commercial banks
c) Central Bank is following an easy money policy
d) Central Bank is following a tight money policy

Q. The lowering of Bank Rate by the Reserve Bank of India leads to (CSE-2012)
a) More liquidity in the market
b) Less liquidity in the market
c) No change in the liquidity in the market
d) Mobilization of more deposits by commercial banks

Banking in India

Repo Rate (Policy Rate)

- It is the rate (Rate of Repurchase) at which commercial banks borrow from RBI (which provides short-term liquidity to banks) by mortgaging their dated Government securities and Treasury bills
- Increase in repo rate --> borrowing from RBI expensive --> banks will borrow less from RBI --> less credit will be provided by banks to households --> money supply will decrease.
- Decrease in Repo Rate --> Borrowing from RBI is cheaper --> Banks will borrow more --> More credit is available --> money supply will increase.

Reverse Repo Rate

- It is the rate at which RBI borrows from commercial Banks by mortgaging its dated Government securities and Treasury bills.
- An increase in reverse repo rate means that commercial banks will get more incentives to park their funds with the RBI, thereby decreasing the supply of money in the market.

Banking in India

Marginal Standing Facility (MSF)

- Liquidity management window given by RBI under which banks can borrow additional overnight (one day) liquidity over and above LAF window.
- Introduced to deal with unforeseen liquidity crunch because under LAF banks can borrow overnight liquidity only by pledging securities over and above the securities held under SLR requirement.

Q. The terms 'Marginal Standing Facility Rate' and 'Net Demand and Time Liabilities', sometimes appearing in news, are used in relation to (2014)

a) Banking operations
b) Communication networking
c) Military strategies
d) Supply and demand of agricultural products

Open Market Operation (OMO)

- OMO refers to sale and purchase of government securities by RBI in the open market with the aim of influencing liquidity in the economy in the medium term.

Banking in India

If RBI sells	If the RBI buys
If the RBI sells these instruments, banks and public will buy it and pay money to the RBI.	If the RBI buys these instruments from instrument holders, it will pay money to the latter.
During inflation the RBI sells government securities. As a result money supply in the economy falls causing Prices to fall	During deflation, the RBI will buy back the securities thus causing money supply to rise which increases demand

Q. With reference to Indian economy, consider the following: (2015)

1. Bank rate
2. Open market operations
3. Public debt
4. Public revenue

Which of the above is/are component/components of monetary policy?

a) 1 only

b) 2, 3 and 4 only

c) 1 and 2 only

d) 1, 3 and 4

Banking in India

Q. In the context of Indian economy, 'Open Market Operations' refers to (2013)

a) borrowing by scheduled banks from the RBI

b) lending by commercial banks to industry and trade

c) purchase and sale of government securities by the RBI

d) None of the above

Liquidity Adjustment Facilities (LAF)

- Monetary policy instrument that the RBI uses in order to influence the liquidity conditions in the market in the short term.
- Under the LAF window, the RBI uses various instruments to inject or absorb liquidity to or from the market respectively.

Long Term Repo Operations (LTRO)

- New policy tool used by the RBI to inject more liquidity into the Economy.
- Similar to the term repos, but with a longer maturity period of 1 year and 3 years.
- Through the LTRO, the RBI seeks to inject long term liquidity into the economy at a lower interest rate.

Banking in India

Qualitative Instruments of Monetary Policy

Credit Rationing

- Rationing of credit is a method by which the RBI seeks to limit the maximum amount of loans and advances and, also in certain cases, fix ceiling for specific categories of loans and advances.

Margin Requirements

- Qualitative tool used by the RBI in order to regulate the credit flow to a particular sector.
- When a bank advances credit to its customers it does so against collateral. However there is a difference between the value of the security and the loan offered. This difference is called 'Margin'.

Moral Suasion

- It refers to a method adopted by the Central Bank to persuade or convince the commercial banks to advance credit in the economic interest of the country.
- Since it involves no administrative compulsion or threats of punitive action, it is a psychological and informal means of selective credit control.

Banking in India

Differential Rate of Interest

- The differential rate of interest (DRI) is a lending programme launched by the government in April 1972 which makes it obligatory upon all the public sector banks in India to lend 1% of the total lending of the preceding year to 'the poorest among the poor' at an interest rate of 4% p.a.

Direct Action

- This step is taken by the RBI against banks that don't fulfill conditions and requirements.
- RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.

Prompt Corrective Action (PCA)

- The PCA is triggered when banks breach certain regulatory requirements like minimum capital, and quantum of non-performing assets.
- To ensure that banks don't go bust, RBI has put in place some trigger points to assess, monitor, control and take corrective actions on banks which are weak and troubled.

Banking in India

Consumer Credit Regulation

- RBI can issue rules to set the minimum/maximum level of down-payments and periods of payments for purchase of certain goods.

Other Monetary Tools Use By RBI

Call Money Market

- It is a Inter Bank money market for short-term financial assets that are close substitutes of money.
- The call money market is an important segment of the money market where borrowing and lending of funds take place on overnight basis (for one day)
- Money market also known as 'overnight borrowing money at call'.
- Funds raising/borrowing maximum period --> 14 days (Short notice)
- Borrowing can take place against securities or without securities.

Market Stabilisation Scheme (MSS)

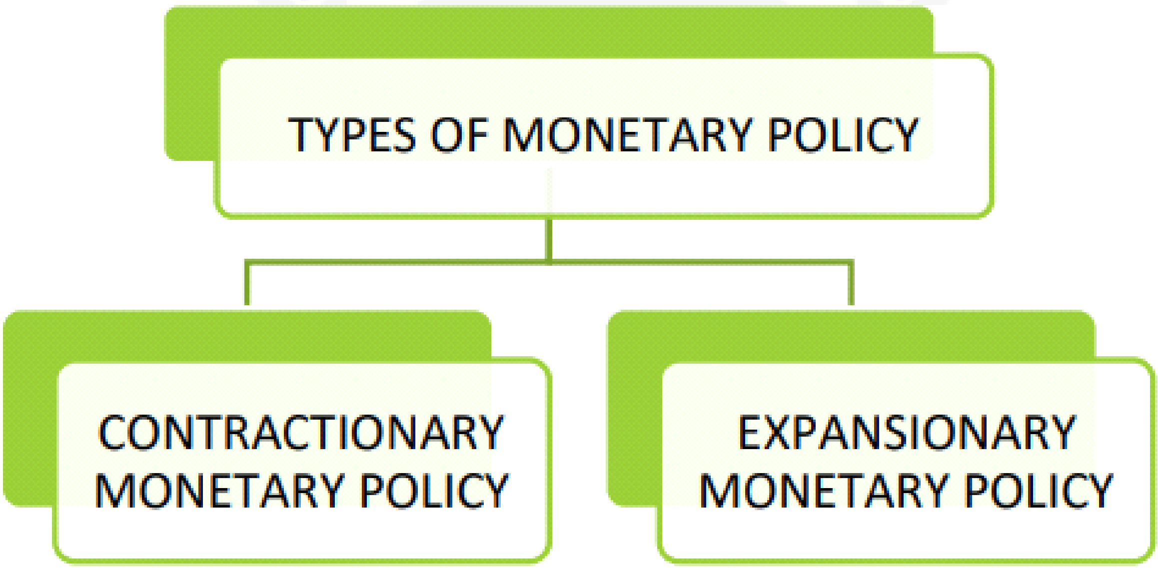
- MSS is a policy tool used by the RBI to suck out excess liquidity from the market through issue of securities like T-Bills, Dated Securities etc. on behalf of the government.

Banking in India

Standing Deposit Facility Scheme

- Standing deposit facility is a collateral free liquidity absorption mechanism which aims to absorb liquidity from commercial banking system into RBI.
- The scheme is aimed at helping RBI to manage liquidity in a better way, especially when the economy is flush with excess fund (as was seen after the demonetisation 2016)

Types of Monetary Policy



Banking in India

Expansionary Monetary Policy

- This policy is adopted to increase money supply in the economy in order to stimulate economic growth.
- It is also pursued to overcome recession.
- CRR, SLR, Repo Rate, Reverse Repo Rate, Bank Rate should be reduced.
- It is called Cheap Money policy as interest rates are low thus borrowing money becomes cheap.

Contractionary Monetary Policy

- This policy is adopted to decrease money supply in the economy in order to counter inflation
- CRR, SLR, Repo Rate, Reverse Repo Rate, Bank Rate should be increased.

Monetary Policy Transmission

- Monetary policy transmission is said to have occurred when the changes in the policy rates (repo, reverse repo) will lead to corresponding change in the interest rates in retail sector (Housing, auto loans etc.)

Banking in India

Benchmark Prime Lending Rate (BPLR)

- Under BPLR, bank loans were priced on the actual cost of funds.
- However, the BPLR was subverted, resulting in an opaque system. The bulk of wholesale credit (loans to corporate customers) was contracted at sub-BPL rates and it comprised nearly 70% of all bank credit.
- Under BPLR system, banks were subsidising corporate loans by charging high interest rates from retail and small and medium enterprise customers.

Base Rate

- Base Rate is the interest rate below which Scheduled Commercial Banks will lend no loans to its customers
- It replaced the idea of BPLR on 1 July, 2010. The BPLR system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates.

Banking in India

- This was mainly because under this system, banks could lend below BPLR. This made a bargaining by the borrower with bank- ultimately one borrower getting cheaper loan than the other, and blurred the attempts of bringing in transparency in the lending business.
- Loans taken between June 2010 and April 2016 from banks were on base rate.
- Base rate is calculated on following three Parameters:
    - Blended Cost of Funds
    - Marginal Cost of Funds
    - Average Cost of Funds
- Hence, the rate depended on individual banks and they changed it whenever their cost of funds and other parameters changed.
- For the same reason, it was also difficult to assess the transmission of policy rates of the Reserve Bank to lending rates of banks.

Banking in India

Marginal Cost of Funds Based Lending Rate

- The MCLR refers to the minimum interest rate of a bank below which it cannot lend, except in some cases allowed by the RBI.
- It is an internal benchmark or reference rate for the bank.
- In 2016, RBI introduced the concept of MCLR in order to ensure monetary policy transmission.
- Under MCLR, the banks use the marginal cost for obtaining funds to set their lending rates.
- Marginal cost includes cost that the banks incur to obtain fund like in case of deposit from customers or at repo rate from RBI.
- MCLR has replaced base rate system of fixing interest rates in 2016.

Reasons for Implementing the MCLR System

- To improve the transmission of monetary policy
- To bring transparency in the methodology of banks to fix interest rates.
- To ensure that bank credit is available at interest rates which are fair to both borrowers and lenders.

Banking in India

Problem With MCLR-Based System

- Due to internal benchmarking of loan, policy rate cuts often don't reach the borrowers.
- It is opaque since it's an internal benchmark that depends on the way a bank does its business.

External Benchmarking of Interest Rates

- Under the new system which will come into effect from April 1, 2019, banks will have to link their lending rates with an external benchmark instead of MCLR.
- Better transmission of policy rate cuts.
- It will make interest rate fixing more transparent.
- Better benchmark for borrowers to compare loans offered by different banks.

Banking in India

Ways And Means of Advances (WMA)

- The RBI gives temporary loan facilities to the centre and state governments as a banker to the government. This temporary loan facility is called WMA.
- It is a mechanism to provide to States to help them tide over temporary mismatches in the cash flow of their receipts and payments.
- It was introduced on April 1, 1997, after putting an end to the four-decade-old system of ad-hoc (temporary) Treasury Bills to finance the Central Government deficit.
- Under Section 17(5) of RBI Act, 1934, the RBI provides Ways and Means Advances (WMA) to the central and State/UT governments.

Ways to Avail WMA

- This facility can be availed by the government if it needs immediate cash from the RBI.
- The WMA is to be vacated after 90 days.
- The interest rate for WMA is currently charged at the repo rate.
- The limits for WMA are mutually decided by the RBI and Government of India

Banking in India

- Special WMA or Special Drawing Facility is provided against the collateral of the government securities held by the state.
- After the state has exhausted the limit of SDF, it gets normal WMA. The interest rate for SDF is 1% point less than the repo rate.
- The number of loans under normal WMA is based on a three-year average of actual revenue and capital expenditure of the state.
- The RBI has raised the Ways and Means Advances, or WMA, limit by 30% for all States and UTs to enable them to tide over the crisis caused by COVID-19 outbreak.

Commercial Bank

- Commercial banks may be defined as any banking organization that deals with the deposits and loans of business organizations.
- Commercial banks issue bank cheques and drafts, as well as accept money on term deposits.

Banking in India

Nationalization of the Bank

- In India, the banks which were previously functioning under the private sector were transferred to the public sector by the act of nationalization and thus the nationalized banks came into existence.
- Post-independence, the GOI adopted a planned economic development model for the country. Nationalisation was in accordance with the national policy of adopting the socialist society.
- The first major step was Nationalization of the Imperial Bank of India in 1955 via the State Bank of India Act.
- In 1969, a major phase of nationalization was carried out and 14 major commercial banks in India were nationalized.
- The second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with six more banks.

Banking in India

Recent Reforms in Banking Sector

- Deregulation of interest rates
- Differentiated banking – Small and Payment banks
- Increased autonomy to banks
- Basel III compatibility of banks
- Regulation of NBFCs etc.

Reasons For Natonalization of Banks

- Wars with China (1962) and Pakistan (1965) that put immense pressure on public exchequer.
- Two successive years of drought had led to severe food shortages and also compromised national security (PL 480 program).
- Resultant three-year plan holiday affected aggregate demand as public investment was reduced.
- India's economic growth barely outpaced population growth in 1960-70s and average incomes stagnated.
- Share of the industrial sector in credit disbursement bey commercial banks almost doubled between 1951 and 1968, from 34% to 68 whereas agriculture received less than 2% of total credit, though more than 70 percent of the population was dependent upon it.

Banking in India

- **Priority Sector Lending:** the agriculture sector and its allied activities were the largest contributors to the national income.
- Nationalisation aimed at mobilizing the savings of the people to the largest possible extent and to utilize them for productive purposes.
- Reducing inter and intra-regional imbalance to curb the urban-rural divide
- Controlling private monopolies over financial sectors.
- Ensuring Socio-economic welfare as enshrined in preamble of the Indian constitution.
- Expansion of banking to rural pockets to ensure financial inclusion.
- To shift from 'class banking' to 'mass banking' (social banking)

Impact of Nationalization of Banks

- Nationalization of the Banks brought the public confidence in the banking system of India.
- After the two major phases of nationalization in India, 80% of the banking sector came under government ownership.

Banking in India

- After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800% in deposits, and advances took a huge jump by 11,000%
- Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.
- Indian banking system has reached even to the remote corners of the country.
- More equitable and prioritized disbursement of credit to different sectors of economy.
- Nationalization of banks led to a smooth and streamlined Indian growth process, particularly in the Green revolution.
- Aim of nationalization is to promote rapid growth in agriculture, small industries and export, to encourage new entrepreneurs and to develop all backward areas.

Down Side of Nationalisation of Banking

- Efficiency and profitability of Banks declined drastically
- Issue of NPA becoming major roadblock in profitability of banking sector.

Banking in India

- Nationalization of banks led to an interest rate structure that was incredibly complex - different rates of interest for different types of loans.
- Nationalization drive has led to lesser competition between the public sector and private sectors Banks.
- Bureaucratic attitude and procrastination in the functioning of the banking system.
- Lack of responsibility and initiative, red-tapism, inordinate delays are common features of nationalized banks.
- Ruthless expansion of these banks are now facing the problems of heavy overdue loans and economically unviable branches.
- Political interference led to disbarment of loans which were against the sound banking rules and weakened the economic viability of these institutions.

Banking in India

Regional Rurak Banks (RRB)

- RRBs are financial institutions which ensure adequate credit for agriculture and other rural sectors.
- They were conceived as low cost institutions having a rural ethos and pro poor focus, but with expertise of commercial banks.
- It was set up on the basis of the recommendations of the Narasimham Working Group (1975), and after the legislations of the Regional Rural Banks Act, 1976
- The sources of funds of RRBs comprise of owned fund, deposits, borrowings from NABARD, Sponsor Banks and other sources including SIDBI and National Housing Bank.
- RRBs are at par with commercial banks as far as compliance requirements to CRR and SLR is concerned.
- The RRBs combine the characteristics of a cooperative in terms of the familiarity of the rural problems and a commercial bank in terms of its professionalism and ability to mobilise financial resources.

Banking in India

- Each RRB is owned by three entities with their respective shares as follows:
  - Central Government → 50%
  - State government → 15%
  - Sponsor bank→ 35%
- However, PSL target of RRBs is 75% of total outstanding advances (PSL norm is 40% for a commercial bank).

Small Finance Banks (SFB)

- According to RBI guidelines, small and payment banks are 'niche' or 'differentiated' banks with a common objective of increasing financial inclusion.
- These are private financial institutions for the objective of financial inclusion without any restriction in the area of operations, unlike the RRBs or Local Area Banks.
- They can provide basic banking services like accepting deposits and lending to the unbanked sections such as small farmers, micro business enterprises, micro and small industries and unorganised sector entities.

Banking in India

- They were proposed by the Nachiket Mor Committee of RBI as one of the differentiated banking systems for credit outreach and announced in the annual Budget of 2014.
- Currently, SFBs constitutes 0.2% of the total deposits of all scheduled commercial banks and makes up 0.6% of the total lending undertaken by the scheduled commercial banks in India.
- Some of the operational Small Finance Banks in India are:
  - Ujjivan SFB
  - Janalakshmi SFB
  - Equitas SFB
  - AU SFB
  - Capital SFB.
- They focus and serve the needs of a certain demographic segment of the population.

Banking in India

Payments Banks

- According to RBI guidelines, payment banks are 'niche' or 'differentiated' banks with a common objective of increasing financial inclusion.
- Payments Banks can accept demand deposits (only current account and savings accounts).
- They would initially be restricted to holding a maximum balance of Rs 1 lakh per customer. Based on performance, the RBI could enhance this limit.
- The banks can offer payments and remittance services, issuance of prepaid payment instruments, internet banking, functioning as business correspondent for other banks.
- Payments Banks cannot set up subsidiaries to undertake NBFC business.
- Payments banks will be entitled to issue ATM or debit cards to their customers but cannot issue a credit card.
- Similar to commercial banks, reserve ratios will be applicable to the Payments banks.
- Payments banks cannot provide loans or lending services to customers.

Banking in India

SMALL BANKS CAN GO PAN-INDIA

	PAYMENTS BANKS	SMALL BANKS
WHO CAN PROMOTE	➤ Prepaid card issuers, telecom companies, NBFCs, business correspondents, supermarket chains, corporates, realty sector co-ops & PSUs	➤ Individuals/professionals with 10 years experience in finance, NBFCs, microfinance cos, local area banks
WHAT THEY MUST DO	➤ Have a minimum capital of Rs 100cr ➤ Maintain 75% of deposits in govt bonds ➤ Maintain 25% of deposits in other banks ➤ Have at least 26% investment by Indians ➤ Get listed if net worth crosses Rs 500cr ➤ Have 25% of branches in unbanked areas ➤ Be fully networked and technology driven ➤ Have Rs 1 lakh cap for deposits in one a/c	➤ Have a minimum capital of Rs 100cr ➤ Extend 75% of loans to priority sector ➤ Have 25% of branches in unbanked areas ➤ Maintain reserve requirements ➤ Cap loans to individuals and groups at 10% and 15% of net worth ➤ Have a business correspondent network
WHAT THEY CAN DO	➤ Offer internet banking ➤ Sell mutual funds, insurance, pensions ➤ Offer bill payment service for customers ➤ Have ATMs and business correspondents (BC) ➤ Can function as BC of another bank	➤ Sell forex to customers ➤ Sell mutual funds, insurance, pensions ➤ Can convert into a full-fledged bank ➤ Expand across the country
WHAT THEY CAN'T DO	➤ Offer credit cards ➤ Extend loans ➤ Handle cross-border remittances ➤ Accept NRI Deposits	➤ Extend large loans ➤ Float subsidiaries ➤ Cannot deal in sophisticated financial products

Banking in India

Non-Banking Financial Institutions (NBFIs)

- NBFC is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares or stocks or bonds or debentures or securities issued by Government or local authority or other marketable securities of a like nature.

NABARD

- National Bank for Agriculture and Rural Development (NABARD) is an apex development financial institution in India to provide finance for agriculture and rural development.
- Functions of NABARD
    - The major functions of NABARD include promotion and development, refinancing, financing, planning, monitoring and supervision.
    - Promotional and developmental initiatives in the areas of farm, off-farm, micro finance, financial inclusion, Convergence with Govt sponsored Programmes.

Banking in India

- Supporting the financial inclusion efforts of RRBs and Cooperative Banks
- Loans to State Governments for developing rural infrastructure and strengthening of the Cooperative Credit Structure
- Refinance to Rural Financial Institutions for investment credit (long term loan) and production and marketing credit (short term loan) purposes for farm and off-farm activities in rural areas.
- Assist in policy formulation of GoI, RBI and State Governments on matters related to agricultural credit and rural development
- Credit Planning and Monitoring, Coordination with various agencies and institutions.

Banking in India

Commercial Bank Vs NBFCs

Parameters	Commercial bank	NBFCs
Registration	Banking Regulation Act 1949	Companies act 1956
Supervision	RBI	Varies- Mutual funds: SEBI Insurance Co: IRDAI
Investment	They can keep depositor's money in RBI approved securities but not in shares directly.	Can invest client's money in the share market. Ex- Mutual Funds, Insurance Companies.
Loan Rate	Decided as per RBI's methodology from time to time	Varies & depends on nature of business
Foreign Investment	Allowed up to 74% for private sector Banks	Allowed up to 100%
Deposit Insurance Facility	Available	Not available

Banking in India

Capital Adequacy Ratio (CRAR)

- Banking is a segment of the service sector in any economy.
- It is called the back home of the economy because today economies are more dependent on banks than in the past.
- Banks credit creation (loan disbursals) are highly risky business. The depositors' money depends on the banks, quality of lending.
- In banking system risks are always there and they cannot be made nil because loan forwarded to any entity or individual can become a bad debt probability of this being 50%.
- CRAR also known as Capital Adequacy Ratio (CAR) is the ratio of a bank's capital to its risk.

Capital Adequacy Ratio

$$\frac{\text{Tier one capital + Tier two capital}}{\text{Risk Weighted Assets}}$$

This ratio is used to protect depositors and promote the stability and efficiency of financial system around the world.

Banking in India

- CRAR is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process.
- In India, scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12% as per RBI norms.
- CRAR is arrived at by dividing the capital of the bank with aggregated risk-weighted assets for credit risk, market risk and operational risk.

Q. Consider the following statements: (CSE-2019)

1. Capital Adequacy Ratio (CAR) is the amount that banks have to maintain in the form of their own funds to offset any loss that banks incur if the account holders fail to repay dues.
2. CAR is decided by each individual bank.

Which of the statements given above is/are correct?

a) 1 only

b) 2 only

c) Both 1 and 2

d) Neither 1 nor 2

Banking in India

Basel Accord

- The Basel Accords (i.e., Basel I, II and now III are a broader and inclusive set of agreements set by the Basel Committee on Bank Supervision
- The purpose of the accords is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.
- They are of paramount importance to the banking world and are presently implemented by over 100 countries across the world.
- The BIS Accords were the outcome of a long drawn initiative to strive for greater international uniformity in prudential capital standards for banks' credit risk.

BASEL I (1998)

- Focus on capital adequacy of financial institution
- CRAR: 8% by BIS but 9% by RBI
- It was not a legal document
- First international solution for banking risk.
- It is said that Basel-I looked G-10 centric because details of its implementation were left to national discretion.
- India adopted Basel 1 guidelines in 1999

Banking in India

BASEL II (2004)

- It was to be fully implemented by 2015, however India. Adopted in 2009
- Three pillars: minimum capital requirements, supervisory review and market discipline.
- Banks need to mandatory disclose their risk exposure to the central bank.
- 8% by BIS and 9% by RBI as minimum CRAR
- The second Basel Accord is to be fully implemented by 2015.
- The focus of this accord is to strengthen international banking requirements as well as to supervise and enforce these requirements.

BASEL III

- It is a Global Regulatory Framework for more Resilient Banks and Banking systems.
- The third Basel Accord is a comprehensive set of reform measures aimed to strengthen the regulation, supervision and risk management of the banking sector.
- Launched in 2010

Banking in India

- Basel III norms stipulated a Capital to Risk weighted assets (CRAR) of 8%.
- The buffer will range from 0% to 2.5%.
- Focus on: Minimum capital, supervisory review, market discipline and liquidity coverage ratio.

Capital Conservation Buffer

- Another key feature of Basel III is that now banks will be required to hold a capital conservation buffer of 2.5%.
- It is the mandatory capital that financial institutions are required to hold above minimum regulatory requirement
- It will increase the resilience of banks to losses, reduce excessive or underestimated exposures and restrict the distribution of capital.
- Recently, The RBI board, while deciding to retain the capital adequacy requirement for banks at 9 per cent, agreed to extend the transition period for implementing the last tranche of 0.625 per cent under the capital conservation buffer (CCB), by one year up to March 31, 2020

Banking in India

Counter-Cyclical Buffer

- The counter cyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times.
- The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times.
- The buffer will range from 0% to 2.5%

NPA and Stressed Assets

- A Non-Performing Assets is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days. NPAs are the bad loans of the banks.

Substandard Assets	Doubtful Assets	Loss Asset
• Assets which have remained NPA for a period less than or equal to 12 months.	• An asset which had remained in the substandard category for a period of 12 months.	• Loss asset is considered uncollectable and of such little value that its continuance as bankable asset is not warranted.

Banking in India

Status of the NPA

- NPA problem is one of the most severe plaguing the Indian Banking sector posing questions over the stability of Indian Banking System.
- An RBI "Report on the trend and progress of the banking sector" shows that gross nonperforming loans of banks improved to 9.1% by the close of September 2019, compared to 11.2% in year 2018.
- According to Economic survey 2018-19, the performance of the banking sector and Public Sector Banks in particular, improved in 2018-19.
- However, the GNPA ratio of NBFC sector deteriorated to 6.5% as in December 2018 from 6.1 per cent in March 2018.

Ways to Recover NPAs

- Possession/ sale of collateral
- Restructure loans to maintain cash flow
- Convert bad loans into equity
- Selling of loan on discount to collection agency

Banking in India

Rise of NPA In India

- India's bad loans fifth highest in the world.
- NPA rose drastically in India from 2015.
- RBI tightened norms for NPA recognition in 2015.
- Forced banks to identify standard assets as NPA.
- NPA originated in mid- 2000s due to economic boom.
- Corporations granted loans based on performance.
- Recession led to stagnated economic growth.

Legislations Relating To NPA and Bankcruptcy

- Insolvency and Bankruptcy Code, 2016
- SARFAESI Act, 2002
- Recovery of Debts Due to Banks and Financial Institutions (DRT) Act
- Lok Adalats
- Under Banking Regulation Act 1949
- Fugitive Economic Offenders Act, 2018

RBI's Guidelines to Resolve NPA

- Strategic Debt Restructuring.
- Allows banks to change management of defaulter.
- Joint Lenders Forum.
- Lenders evolve resolution plan.

Banking in India

- Lenders can vote on its implementation
- Project Sashakt

Positive Externalities of Declining NPA

On Banks:

- It increases the profitability & liquidity of the banks as annual return on assets come increases and also the amount given as loan also gets opened which can now be used for some return earning asset otherwise. Banks can grow faster when the
- The Monetary Policy Transmission becomes faster for banks to pass on the RBI-induced rate reductions.
- Banks eases credit to small and medium enterprises (SMEs) that are India's potential for prosperity of an entrepreneurial middle class.

On Borrowers:

- Banks may begin lowering interest rates on some products once Non-performing assets decrease.
- As a result, the cost of capital will decrease, making the different businesses financially viable.

Banking in India

On Overall Economy:

- Economy will grow as there will be more Availability of credit from the security market, which increases employment generation, and development of the country.

Ways for Further Improvement

- **Managing Risks:** Risk management processes still need substantial improvement in PSBs. Compliance is still not adequate, and cyber risk needs greater attention
- **Improve the process of project evaluation:** Monitoring to lower the risk of project NPAs. Significantly more in-house expertise can be brought for project evaluation.
- **Strengthen the recovery process further:** Both the out of court restructuring process and the bankruptcy process need to be made faster and strengthened.
- **Infusion of Capital:** The government must infuse at one go whatever additional capital is needed to recapitalise banks providing such capital in multiple instalments is not helpful.

Banking in India

Special Mention Accounts (SMA)

- It is a tool for early stress discovery of bank loans.
- Introduced as a corrective action plan.
- Accordingly banks should identify potential stress in the account by creating a new sub-asset category viz. 'Special Mention Accounts'
- In March 2016, RBI had notified a mechanism for resolving stressed MSME loans of up to Rs 25 crore.
- According to the stress level such loans are categorised into three categories:
  - SMA 0 (Delay up to 30 Days)
  - SMA 1 (Delay up to 31-60 Days)
  - SMA 2 (Delay up to 61-90 Days)

Note: The loans still remain standard even in these categories and turn bad only after a delay in payment of more than 90 days.

Banking in India

Sarfaesi Act 2002

- GoI finally cracked down on the wilful defaulters by passing the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002
- The Act gives far reaching powers to the banks/FIs concerning NPAs
- Banks/FIs having 75% of the dues owed by the borrower can collectively proceed on the following in the event of the account becoming NPA
    - Issue notice of default to borrowers asking to clear dues within 60 days
    - On the borrower's failure to repay:
        a. Take possession of security and/ or
        b. take over the management of the borrowing concern and/or
        c. appoint a person to manage the concern.
    - If the case is already before the BIFR, the proceedings can be stalled if banks/FIs having 75 per cent share in the dues have taken any steps to recover the dues under the provisions of the ordinance.

Banking in India

- The banks or FIs can also sell the security to a securitisation or Asset Reconstruction Company (ARC), established under the provisions of the Ordinance. (The ARC is sought to be set up on the lines similar to the USA, few years ago.)

Limitations of SARFAESI Act 2002

- Understaffed DRTs and DRATs results into pendency of cases. More than 1 lakh cases pending (2016), so, case will go on for years and the debtor will remain in possession of asset. This leads to erosion of asset-value (machinery, vehicles) even when DRT allows auction at a later time.
- In some businesses, auction or liquidation may not yield the best returns for the banks.
- **Example:** hotel resort in remote area, where no other hoteliers are keen to invest.
- In such cases, if the loans were restructured, then banks could salvage more value. But, SARFAESI act doesn't facilitate such arbitration.

Banking in India

Fugutive Economic Offenders Act 2018

- The Fugitive Economic Offenders Act, 2018 seeks to confiscate properties of economic offenders who have left the country to avoid facing criminal prosecution.
- Offences involving amounts of Rs. 100 crore or more fall under the purview of this law.
- Some of the offences listed in the schedule of the bill are- counterfeiting government stamps or currency, cheque dishonour for insufficiency of funds, money laundering, transactions defrauding creditors etc.
- The Bill allows the central government to amend the schedule through a notification.

Who is Fugitive Economic Offender?

- A fugitive economic offender has been defined as a person against whom an arrest warrant has been issued for committing any offence listed in the schedule of the proposed bill.
- Further the person has:
    - Left the country to avoid facing prosecution.
    - Refuses to return to face prosecution.

Banking in India

Swift System

- Society for Worldwide inter-bank Telecommunication (SWIFT) is a messaging network which connects banks and financial institutions across the world.
- International transactions of the banks and institutions are ultimately based on this network.
- The network was in news in India after the LoU (Letter of Undertaking) related banking fraud occurred with the Punjab National Bank by February 2018.
- Meanwhile, the RBI has enforced (February 2018) a new guideline under which all banks and financial institutions of India need to link their core banking system to the SWIFT to protect themselves from occurrence of any future financial fraud.

Financial Markets

Financial Market

Financial market refers to a place where buyers and sellers participates in the trade. It is platform that facilitates traders to buy and sell financial instruments/securities.

Importance of Financial Market

- Helps in acceleration of economic growth of country
- Helps savers to become investors
- Helps businesses to raise money/capital to expand their businesses.

Functions of Financial Market

- Price determination and discovery
- Mobilization of funds
- Capital formation
- Ensures liquidity
- Saves time and money
- Determines capital formation rate

Financial Markets

Important Definitions

- Money Markets
  - Market for overnight to short-term funds and instruments having a maturity period of 1 or less than 1 year.
- Capital Market
  - Market for long-term funds–both equity and debt–that have maturity period greater than year
- Equity Market
  - Market where equities (stocks) are traded or issued Debt Market/Fixed
- Income Markets
  - Market where debt instruments (bonds, debentures, etc) are issued or traded
- Securities
  - A 'Security' means a certificate/document indicating that its holder is eligible to receive a certain amount of money at a particular time. This could be a debt (bond/debenture) or equity (Share certificates)

Financial Markets

Types of financial (or securities) market:

On the basis of Tenure:

- Money Market (for period of less than 1 year of maturity)
- Capital Market (one year or above maturity)

On the basis of freshness:

1. Primary Market (where new securities are issued for the first time). Helps a company /government to connect with the investor. It has no separate physical existence but classified as such for economic analysis.

2. Secondary Market (where the old securities are resold). It has physical existence such as Bombay Stock Exchange (BSE) at Dalal Street, Mumbai. Provides liquidity & confidence to investors to buy new securities in Primary Market.

On the basis of Settlement:

1. Future Market: Where parties write contract today to buy/sell something at specific price on a future date
2. Spot Market: If bought & sold for immediate delivery.

Financial Markets

Money Market Vs Capital Market

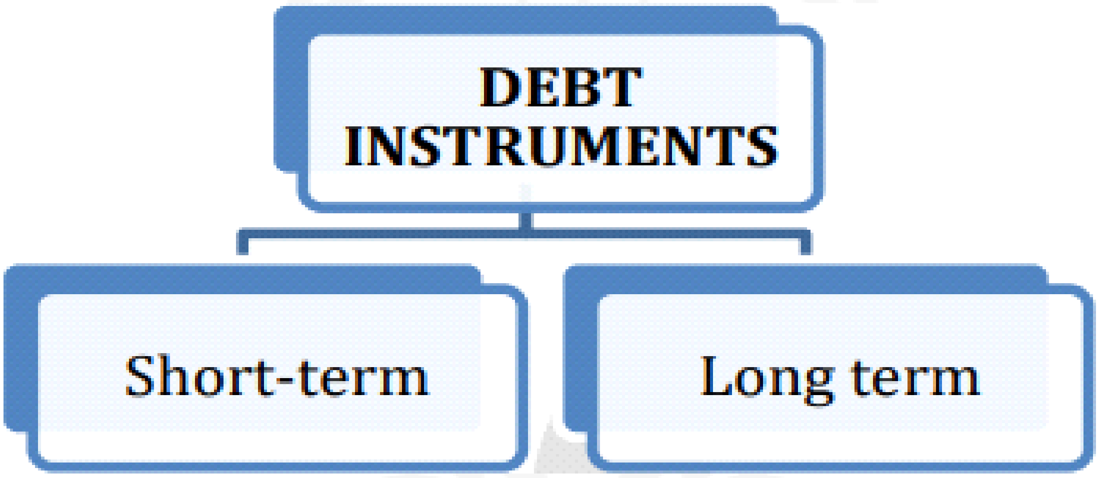
Difference between money and capital market

Basis	Money market	Capital market
Meaning	It is a market dealing in securities of short-term funds, whose maturity period is upto one year.	It is a market dealing in securities for long-term funds, whose maturity period is more than one year.
Participants	Major participants are RBI, commercial banks, financial institutions and finance companies.	Participants of capital market are financial institutions, banks, corporate entities, foreign investors and ordinary retail investors from the members of public.
Instruments	Instruments traded are T-bills, commercial bills, certificate of deposits, etc.	Main instruments traded are shares, debentures, bonds, preference shares, etc.
Investment outlay	In money market, instruments require huge sums of money, because these are quite expensive.	It does not require huge capital outlay, as the value of units of securities is generally low, i.e. ₹ 10 or ₹ 100. Even the trading lot is kept low at 5,50, 100 or so.

Financial Markets

Debt Instruments

- Debt Market deals with Bonds/Debentures
- Debt instruments are creditors to company. This instruments facilitates and ensures the first claim during liquidation of an asset.
- These instruments accrues assured interest irrespective of profit of company.



Financial Markets

Short term debt instruments

- Short-term debt, also called current liabilities, is a firm's financial obligations that are expected to be paid off within a year.
- Tenure for short term debt instruments are less than 1 year
- Short term debt instruments are usually 'unsecured' because not backed by any asset.
- These instruments usually sold at discount and repurchased at Par value/Face value.
- The difference between these two prices is then interest earned by investor. Another synonym for this process: "rediscount the bills."
- Short term debt instruments are traded at Money Market and are (usually) 'negotiable and transferable' in nature i.e. lender can sell to third party, and third party can demand money from borrower.
- Near Money is an asset that is highly liquid and can be readily converted into cash.

Financial Markets

Call Money

- Call Money is required mostly by Financial Intermediaries (Banks/Non-Banks) to borrow money without collateral from other banks to maintain a minimum cash balance known as CRR (Cash Reserve Ratio).
- Under call money market, funds are transacted on overnight basis. An over-the-counter (OTC) market without the intermediation of brokers.

Notice Money

- Under notice money market, funds are borrowed/lent for a period between 2-14 days.

LIBOR

- London Inter-Bank Offered Rate (LIBOR) is the average interest rate at which banks in London give short term loans to each other.
- It serves a benchmark, using which Global banks decide their call money /notice money rates.

Financial Markets

Repo

- It is an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed.

Reverse Repo

- It is an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent. Used for absorption of liquidity.

TREDS (Trade Receivables Electronic Discounting System)

- An online mechanism. MSME sellers pledge their (unpaid) invoices made to corporates → MSME receive (short-term) finance from Banks and NBFCs.
- Budget-2019 – we will make amendments in Factoring Regulation Act, 2011 to allow all NBFCs to directly participate on the TReDS platform.

Financial Markets

Q. Find Correct statements:(CSE-2018)

1. The Reserve Bank of India manages and services Government of India Securities, but not any State Government Securities.
2. Treasury bills are issued by the Government of India and there are no treasury bills issued by the State Governments.
3. Treasury bills offer are issued at a discount from the par value.

Options:

(a) 1 and 2 only

(b) 3 only

(c) 2 and 3 only

(d) 1, 2 and 3

Financial Markets

Long Term Debt Instruments

- Long Term Debt Instruments have tenure of 1 year or above.
- Coupon Bonds
  - Contain detachable coupons. Coupons are presented to the issuer to claim the interest. Therefore, bond interest rate is also called 'coupon rate'.
- Zero Coupon Bonds
  - These bonds are sold on discount and repurchased at face value, do not have any coupons.
- Bearer Bonds
  - Not linked to a PAN card, Aadhar card or passport, voter card or social security number.
  - Anyone who presents it to the issuer, will get interest and principal. Usually issued during the war time.
- Dated Securities
  - Dated G-Sec are long term securities or bonds of the government that carries a fixed or floating coupon (interest rate)

Financial Markets

- Government Securities
  - G-Sec are financial instruments and securities issued by a government towards raising a loan from the public.
  - It is also called Gilt Edged Securities because repayment is assured by Government.
  - But they give lower interest rate because of low risk to the investor
- Sovereign bonds
  - It is a specific debt instrument issued by the government. They can be denominated in both foreign and domestic currency.
- Sovereign Gold Bond (2015)
  - They are denominated in gold grams. Annual interest 2.5-2.75% (depending on which year you bought), and after 8 years you get the amount equivalent to prevailing gold prices at that time.

Financial Markets

- Junk Bonds
  - A junk bond is debt that has been given a low credit rating by a ratings agency, below investment grade.
  - As a result, these bonds are riskier since chances that the issuer will default or experience a credit event are higher.
  - The Credit Rating Company will mark it as Junk Bonds ("BB to D" Grade) e.g. IL&FS.
  - Such company will have to offer a very high interest rate when issuing bonds next time.
- Redeemable Bonds
  - Will repay regular interest and will return principal on maturity.
- Irredeemable Bonds
  - Will pay only interest but no principal returned. Sometimes issued by PSB to meet BASEL capital requirements. Although in reality they offer 'redemption' after 5-10 years when holder has 'option' to redeem principal & exit.
- Non-convertible Bond/Debenture
  - Cannot be converted into shares.

Financial Markets

- Hybrid instruments
  - Issued as "Bond" but can be converted into Share.
- Masala Bonds
  - Masala Bonds are rupee-denominated bonds, i.e, the funds would be raised from overseas market in Indian rupees.
  - World Bank's sister agency International Financial Corporation (IFC) launched 'Masala Bonds' to help Indian public sector and private sector companies

Q. With reference to `IFC Masala Bonds', sometimes seen in the news, which of the statements given below is/are correct? (CSE-2016)

1. The International Finance Corporation, which issues them, is an arm of the World Bank.
2. They are the rupee-denominated bonds and are a source of debt financing for the public and private sector.

Answer:

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither1 nor 2

Financial Markets

- Panda Bonds
    - Panda bonds are Chinese Renminbi (yuan) denominated bonds from a non-Chinese issuer, sold in the People's Republic of China.
    - The first two Panda bonds were issued in October 2005 by the International Finance Corporation and the Asian Development Bank on the same day. Kangaroo Bonds
    - A kangaroo bond is a type of foreign bond issued in the Australian market by non-Australian firms and is denominated in Australian currency.
- Maharaja Bond
    - Better rating than Govt of India bonds but lower interest rate.
    - It is Rupee denominated bond.
    - Tenure is 5 / 10 years.
    - Issued within India's domestic financial market.
- Green bonds
    - A green bond is a type of fixed-income instrument that is specifically earmarked to raise money for climate and environmental, renewable energy, pollution control projects.

Financial Markets

- There is no standard definition of green bonds as of now.
- Green bonds are issued by multilateral agencies
- such as World Bank, corporations, govt. agencies and municipalities.
- Green bonds are open for investment by insurance companies, mutual fund companies, pension funds among others.
- SEBI's indicative list for investment – clean transportation, sustainable water management, climate change adaptation, energy efficiency, sustainable waste management and land use, biodiversity conservation.
- 2007: World's first Green Bond launched by World Bank
- 2015: India's first Green Bond launched by Yes Bank
- 2016: BRICS Bank (New Development Bank) issued Yuan- denominated green Bonds
- 2018: Indian Renewable Energy Development Agency (IREDA) launched India's first Masala Green Bond at London Stock Exchange

Financial Markets

- Blue Bond
  - It is a debt instrument issued by governments, development banks, etc to raise capital from investors to finance marine and ocean-based projects.
  - It will help in expansion of marine protected areas, improved governance of priority fisheries and the development of the blue economy.
  - The blue bond is a sub-type of green bond.

- Catastrophe Bond
  - Catastrophe bonds, also known as Cat bonds, allows the transfer of risks to bond investors.
  - For the issuer - typically governments, insurers, and reinsurers - cat bonds signify financial protection in case of a major natural catastrophe, such as a hurricane or an earthquake
  - For the investor, buying the bonds means they may get high returns for their investment, which is not subject to financial market fluctuations.
  - If disaster doesn't happen then principal will be returned.

Financial Markets

- **Social Impact Bonds**
  - A Social Impact Bond, also known as Pay for Success Financing, a Pay for Success Bond or a Social Benefit Bond is a contract with the public sector in which a commitment is made to pay for improved social outcomes that result in public sector savings
  - Social Impact Bond bonds will be offered to High Net worth Individuals (HNI), Impact Investors (rich people interested in 'indirect' social service) etc. Investors will earn 3% annual interest rate for tenure of 5 years.
  - In 2019, SIDBI issued ₹ 300 cr. worth Women's Livelihood Bonds with the help of World Bank, UN Women org etc.

Financial Markets

Equity Instruments

Equity holders are called as owners of the company. If company makes profit, they will get dividend. However, during liquidation of an company, their claim will be at last.

Authorized Capital

- It is the maximum amount of the capital for which shares can be issued by the Company to shareholders.
- The Authorised capital is mentioned in the Memorandum of Association of company under heading of "Capital Clause" The Authorised capital can be increased at any time in future.

Paid Up Capital

- Paid- up capital is the amount paid by the shareholders for the shares held by them in the company.
- It is the actual fund that the company receives from the issue of shares

Financial Markets

Equity shares

- Have voting power in the meetings of shareholders. Equity shareholders are given dividend only after paying it to the preference shareholders. Last claim during liquidation.

Preferential Shares

- These are shares of an enterprise's stock with dividends that are paid out to the members before equity shares dividends are circulated. During liquidation, these investors will be given money before the ordinary (equity) shareholders.

Sweat Equity Share

- Sweat Equity Share given at discount to directors & employees for their value addition to company.

Penny stocks

- Penny stocks are those that trade at a very low price, have very low market capitalisation, are mostly illiquid, and are usually listed on a smaller exchange.

Financial Markets

Blue Chip stocks

- A blue-chip stock is a huge company with an excellent reputation. Shares of a nationally recognized, well-established and financially sound company with a history of generating good dividend.

Venture capital funds (VCF)

- Venture capital is a type of private equity, a form of financing that is provided by firms or funds to small, early-stage (seed), emerging firms that are deemed to have high growth potential, or which have demonstrated high growth.

Angel Investors

- Group of individuals or an individual itself who invest their own money in the early (concept) Stages of the company and in return take a share in the company. They invest typically less money than the Venture Capitalists

Market capitalization

- Sum of the market value of all the stocks derived by multiplying the price of the share by the number of equity shares out- standing

Financial Markets

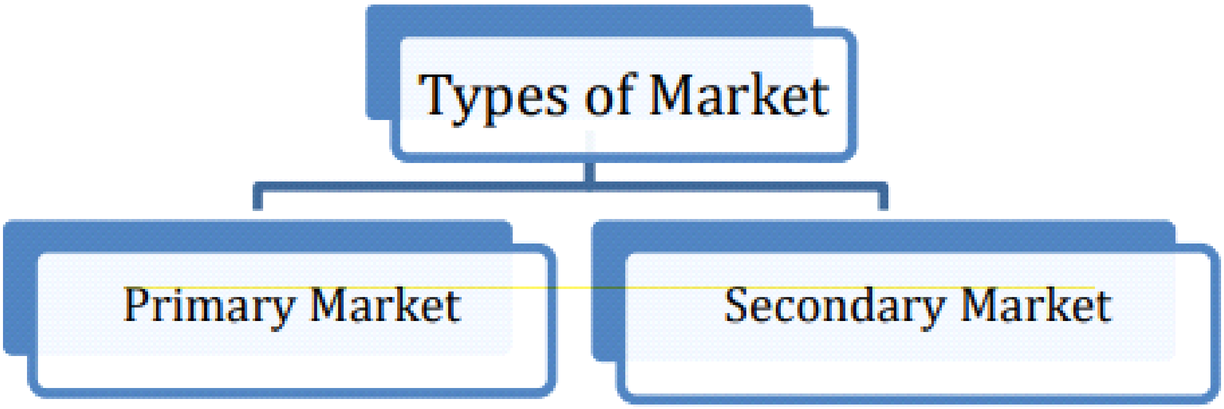
Angel investor Vs Venture capital

Angel Investor	Venture Capital
• They usually invest less than one million dollar . • They usually don't involve with company. • They invest in early stage of business or we can say start ups • They use their own money they don't demand board seat which leads to quick decision making.	• They usually invest more than one million dollar • They usually involve with company • They unlikely to invest in start ups • They use fund providers money • They demand board seat which leads to delay in decision making.

Methods of Issuing Shares

- Share have printed price on the certificate called Face Value or Par Value. If they are sold at higher price than face value, it's called "Premium Value"

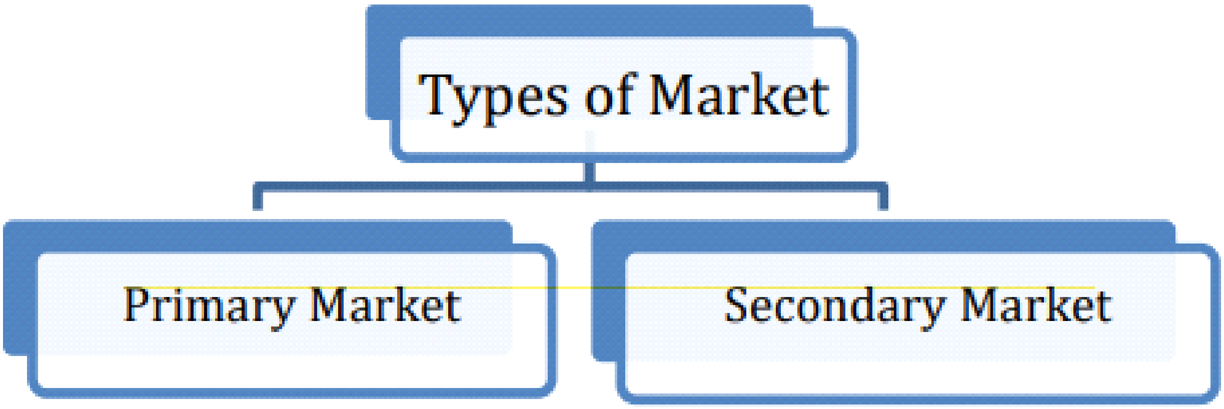
Financial Markets



Primary Market Vs Secondary Market

	Primary Market	Secondary Market
1. Role	A capital market where securities are issued for the first time	A capital market for trading previously issued securities
2. Alternate name	New issue market	After issue market
3. Products	Corporate or government bonds, fresh stocks of companies, notes, and bills.	Equity shares, preference shares, bonds, debentures, etc.
4. Intermediaries	Investment banks and other underwriter firms	Brokers
5. Type of purchasing	Direct	Indirect
6. Parties involved	Buying and selling takes place between the issuing company and investors	Buying and selling takes place among investors and traders without the involvement of the issuing company
7. Price of shares	Remains fixed	Fluctuates depending on changes in supply and demand
8. Beneficiary	Issuing company	Investors

Financial Markets



Public Issue

- This issue is for retail investors to buy the shares of the company
- Methods:
  1. Initial Public Offer (IPO)
     - When an unlisted company decides to go public.
     - Company hires an underwriter (usually, a merchant bank, investment bank) for a fee.
     - Underwriter invites application from public & sells them shares at face value or higher. If less subscription, then underwriter will buy the unsold securities by himself.

Financial Markets

2. Further Public Offer (FPO)
    - Already listed company generates further funds (to obtain more capital) by issuing shares.

Types of Investors

- Qualified Institutional Buyers (QIB)
    - QIBs are the institutional investors who are perceived to possess expertise and the financial muscle to evaluate and invest in the stock markets.
    - They must be registered with SEBI as QIBs
- Anchor investors
    - These are sub-type of qualified institutional buyers who buy a large chunk of shares a day before an IPO process opens.
    - They help arriving at an approximate benchmark price for share sales and generate confidence among retail investors.
    - The anchor investor would be a qualified institutional buyer (QIB) and an issuer can allot up to 60 per cent of Quota for QIBs.

Financial Markets

- **Retail Investors**
  - An individual investor who is not a QIB. Underwriter will keep quota for each category of investors, as per SEBI norms.

- **Non Institutional Investor**
  - Investor which is neither Retail not QIB would be called Non Institutional Investor

Mutual funds

- A mutual fund collects money from investors and invests the money, on their behalf, in securities (debt, equity or both).
- It charges a small fee for managing the money.
- Mutual fund sectors are one of the fastest growing sectors in Indian economy that have potential for sustained future growth.
- The advantages of the mutual funds include professional management, diversification, variety, liquidity, convenience as well as strict government regulations and full disclosure.
- Mutual funds are compulsorily registered with SEBI.

Financial Markets

- A mutual fund is run by a group of qualified people who form a company, called an asset management company (AMC) and the operations of the AMC are under the guidance of another group of people, called trustees.
- Whatever dividend/ interest is generated from the portfolio, it is distribute among investors in the proportion of their units.
- Investor has to pay Entry Load (fees for joining) and Exit Load (fees for quitting). SEBI regulates these fees.

Hedge Fund

- Hedge fund is a private investment partnership and funds pool that uses varied and complex proprietary strategies and invests or trades in complex products, including listed and unlisted derivatives.
- Hedge fund is special type of Mutual Fund which tries to hedge risks to investor's capital against market volatility by employing alternative investment approaches.

Financial Markets

InvITs

- It is like a mutual fund, which enables direct investment of small amounts of money from possible individual/institutional investors in infrastructure to earn a small portion of the income as return.
- InvITs can be treated as the modified version of REITs designed to suit the specific circumstances of the infrastructure sector.
- They are similar to REIT but invest in infrastructure projects such as roads or highways which take some time to generate steady cash flows.

REITs

- A REIT is roughly like a mutual fund that invests in real estate although the similarity doesn't go much further.
- The basic deal on REITs is that you own a share of property, and so an appropriate share of the income from it will come to you, after deducting an appropriate share of expenses.
- Essentially, it's like a group of people pooling their money together and buying real estate except that it's on a large scale and is regulated.

Financial Markets

Securities And Exchange Board of India (SEBI)

- SEBI was constituted by an executive order in 1988 as an interim administrative body under the Finance Ministry.
- 4 years later, on 4th April 1992 a notification awarding statutory powers to SEBI was issued (Securities and Exchange Board of India Act, 1992).
- SEBI is a quasi-legislative, quasi-judicial and quasi-executive body
- SEBI can draft regulations, conduct inquiries, pass rulings and impose penalties.
- SEBI Board Composition: Chairman + 1 officer from RBI + 2 officers from Union Government + 5 members appointed by Union Government.
- Chairman: upto 5 years / 65 age, whichever earlier. Reappointment is eligible.
- Securities Appellate Tribunal: SAT has been constituted to protect the interest of entities that feel aggrieved by any of SEBI's decision. Endowed with powers of civil court. Appeal against SAT lies in Supreme Court.

Financial Markets

Reforms Introduced By SEBI

- De-materialization of share certificates (1999).
- Banned entry loads for mutual fund schemes in 2009
- Circuit Braker System
- Discontinuing Carry forward system (Badla System) in 2001 and introduced (T+2) rolling settlement system
- SEBI made PAN Card compulsory for opening Demat Accounts.
- ASBA (Applicant Supported by Blocked Amount): It allows the underwriter to block the amount in IPO investor applicant's bank account, but only if shares allotted to the applicant, his bank money will be deducted.
- Investor Protection Fund was set up for investors
- Dabba Trading (Bucketing or Box Trading) was declared illegal
- Insider Trading was declared illegal
- Rules for ALGO Trading (Computer based trading). While SEBI has not banned it, but issued technical measures e.g. a single broker / investor can't place more than 100 online orders per second.

Financial Inclusion

Meaning of Financial Inclusion

- According to the World Bank, Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.
- Financial inclusion ensures financial literacy and Financial democracy for the people.
- This ensures social, economic and transaction security, improves social harmony, women empowerment, helps reaping the benefit of "Less Cash Economy"

Objective of Financial Inclusion

- **Bank accounts:** Ensuring universal access to bank accounts, which are a gateway to all financial Services
- **Digital payment services:** Providing access to digital payment services and increasing its penetration.
- **Insurance:** Ensuring universal coverage of insurance for life, accidents, etc.

Financial Inclusion

- **Asset diversification:** Allowing diversification of asset portfolio of households through increased participation in capital markets.
- **Social Security:** a system of payments / assistance by the government to citizens who are ill, handicapped, poor, aged or unemployed.
- **Better access to credit** at a reasonable cost for those presently excluded
- **Social Justice:** distribution of wealth, opportunities, and privileges within a society through reservation in jobs, admissions and election and through legal safeguards for protection of civil rights, prevention of atrocity and personnel laws.

Banking Sector And Financial Inclusion

- **1955,1969, 1980:** Nationalization of Banks to improve its customer base, reach in various parts and financial inclusion.

- **1961:** DICGCI Act – formation of corporation to insure customers deposits in bank.

Financial Inclusion

1966: Cooperative Banks under RBI's Ambit

1969: Lead Bank Scheme (State Cooperative Banks - Pvt or Public) given lead role in district. They prepared credit plan with 'Service Area Approach', and coordinate with the efforts of Government, banks and NBFCs.

1971: State level Bankers' Committee to monitor progress of financial inclusion

1972: Differential rate of interest was introduced to provide bank finance at a concessional rate of interest of 4% per annum to the weaker sections of the community for engaging in productive and gainful activities so that they could improve their economic conditions.
Regional Rural Bank (RRB) setup through Act - expanded banking in rural pockets. Further, RBI requires commercial banks to setup atleast 25% of their branches in unbanked rural areas. Similar norms for White label ATM Companies.

Financial Inclusion

1992: The Self-Help Group-Bank Linkage Programme (SBLP) started as a pilot programme on the basis of recommendation of S K Kalia Committee.

2005: RBI permitted no-frills account with zero balance

2006: RBI permitted Banking Business Correspondent Agents to ensure banking in rural and remote areas

2011: Government's Swabhiman to increase banking presence in rural area.

2013: e-KYC permitted.

2014: Jan-Dhan Yojana, new Private Commercial Banks (Bandhan, IDFC First), Bhartiya Mahila Bank.

2015: Small Finance Banks and Payment Banks.

2018: India Post Payment Banks

2020: The RBI released the National Strategy for Financial Inclusion 2019-2024.

Financial Inclusion

Q. Service Area Approach was implemented under the purview of ____________(CSE-2019)

a) Integrated Rural Development Programme

b) Lead Bank Scheme

c) Mahatma Gandhi National Rural Employment Guarantee Scheme

d) National Skill Development Mission

Pradhan Mantri Jan Dhan Yojana

- PMJDY was launched by Dept of Economic Affairs with two phases in 2014.
- PM-JDY bank account can be opened in any Commercial or Cooperative Bank provided RUPAY that bank has CBS and bank is tied with RuPay Payment Gateway.
- Basic Savings Bank Deposit Account-anyone of Age 10 or above can open Zero balance account. However, Chequebook will be issues only with Balance.

Financial Inclusion

Q. Pradhan Mantri Jan-Dhan Yojana' has been launched for____________(CSE-2015)

a) providing housing loan to poor people at cheaper interest rates

b) promoting women's Self-Help Groups in backward areas

c) promoting financial inclusion in the country

d) providing financial help to the marginalized Communities

PM KISAN Samman Nidhi (PM-KISAN)

- PM-KISAN Scheme inaugurated by the Prime Minister on 24th February, 2019 which provides for transfer of an amount of Rs. 6000/- per year in three equal instalments each of Rs. 2000/- directly into the bank account of beneficiary farmer families.

Recent Initiatives By GOI to improve Financial Inclusion

- JAM- Jandhan (banking), Aadhar (trinity), Mobile (transactions) Biometric Identity
- To improve social security to all citizens – PM Suraksha Bima Yojana and PM Jeevan Jyoti Bima Yojana.

Financial Inclusion

- Atal Pension Yojana – guaranteed monthly pension to the subscriber
- To expand ATM network, the RBI has allowed Non-Bank entities to start white label ATMs
- Banks are deploying micro-ATMs in rural areas.
- Ru-Pay cards have significantly increased its market share.
- SHG-Bank linkage programme
- Financial Literacy Centres have started by commercial banks at the request of the RBI
- Financial inclusion of women through the implementation of its biometric identification system "Aadhar".
- UPI platform built by NPCI.
- Priority Sector Lending (PSL)
- Establishment of MUDRA bank
- Financial literacy centres were launched by commercial banks at the request of the RBI.
- National Centre for Financial Education was established in 2017 to implement the National Strategy for Financial Education.

Financial Inclusion

National Strategy on Financial Inclusion (2019-24)

- The RBI released the National Strategy for Financial Inclusion 2019-2024 on January 10, 2020.
- It sets forth the vision and objectives of financial inclusion policies in India.
- The strategy was prepared by the RBI with inputs from the central government and financial sector regulators – PFRDA, SEBI, IRDA, etc.
- The report refers to financial inclusion as the process of ensuring access to financial services, and timely and adequate credit for vulnerable groups and low-income groups at an affordable cost.

Challenges to Financial Inclusion In India

- In India, where nearly 1/4th of population is illiterate and below poverty line, ensuring financial inclusion is challenging task
- Due to this, ensuring deposit operations in the Jan Dhan account is challenge.
- High volume of frauds due to financial literacy
- Money lenders continue to account for nearly 30 percent of total banking business.

Financial Inclusion

- Most of commercial banks operate in commercial and urban areas. Hence, rural population finds difficult to access financial services.
- Lot of hidden banking charges have demotivated and disincentivised poor customers.
- Making banks accessible for peoples with disabilities
- Lack of credible, low-cost and high-quality financial advice.
- Difficulty in understanding different product offerings, financial terms, and conditions.
- The rising level of Non-Performing Assets (NPAs) of banks due to the large corporates makes it difficult to improve financial inclusion situation in India.
- Gender inequality = Most women are being excluded from the formal financial system.

Way Forward

- A financial inclusion strategy sensitive to regional, demographic and gender related factors need to be carefully crafted.
- Digitization of land record Bringing SHGs into financial main streams

Financial Inclusion

- Proper financial inclusion regulation in the country to access financial services.
- Financial inclusion is necessary before comprehensive success of mobile wallets.
- Financial services must be made accessible for people with disabilities at par with non-disabled persons.
- NABARD has an extensive presence across country; it should be made the nodal and accountable agency for financial inclusion.
- Requires grass root level research as to why people prefer to go to money lenders, despite a network of banks, cooperatives, MFIs and SHGs.
- As India uses Aadhar to advance goal of financial inclusion the government must examine.

Budget And Taxation

Fiscal Policy

Meaning

- Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.
- Using fiscal policy, Govt influences the savings, investment and consumption in an economy, to accomplish certain national goals such as income redistribution, socioeconomic welfare, economic development and inclusive growth.
- It is the sister strategy to monetary policy through which a central bank influences a nation's money supply.
- Fiscal policy is result of several component policies or mix of policy instruments. These include, policy on taxation, subsidy, welfare expenditure, etc; investment or disinvestment strategies; and debt or surplus management.

Types of fiscal policy

Contractionary (restrictive) Fiscal policy

- Policy involves raising taxes or cutting govt spending, so that Govt spending is less than Tax revenue. It cuts up on the aggregate demand and to reduce the inflationary pressures in the economy

Expansionary Fiscal Policy

- Policy is generally used for giving stimulus to the economy. i.e. to speed up the rate of GDP growth or during a recession when growth in national income is not sufficient enough to maintain the present standards of living.
- A tax cut and/or an increase in government spending would be implemented to stimulate economic growth and lower unemployment rates. This is not a sustainable policy, as it leads to budget deficits and thus, should be used with caution.

Objectives of fiscal policy

Full Employment

- Through rural employment programmes like MGNREGA and various similar employment schemes.

Budget And Taxation

To Fight Inflation

- Higher Income tax will reduces disposable income which will result into curbing demand. To fight deflation, we need to reduce direct and indirect taxes to boost demand.

To Boost Economic Growth

- Provide income tax benefits on household savings in LIC/Mutual Fund etc. this will ensure new investible capital to industries which will help in factory expansion, jobs, GDP growth.

Inclusive Growth

- Higher taxes on rich could enable use of taxed money for health, education, women, poverty removal programs.

To Boost Regionally Balanced Growth

- Give tax benefits to industrialists for setting up factories in North East, Left-wing Extremism (LWE) & other backward areas.

Exchange Rate Stability

- Give tax benefits to exporters to boost exports; while impose higher taxes on imported items to reduce imports which will help containing Current Account Deficit (CAD).

Budget And Taxation

Budget (Annual Financial Statement) - Art. 112

Meaning

- Budget is an annual financial statement (Art. 112) containing estimated revenues and expenditures for the next financial year.
- Budget is the primary tool used by Govt to implement its fiscal policy.

Three Documents related to Budget

Annual Financial Statement (AFS) Article 112

- AFS containing receipt and expenditure of last year (and projections for the next year).
  - The revenue expenditure must be shown separately from other expenditures.
  - No compulsion to show railway budget separately from general budget.
  - No compulsion to show plan expenditure separately from non-plan.

Finance Bill Art. 264

- To obtain Parliament's permission to collect taxes.

Budget And Taxation

- Parliament can reduce or abolish a tax proposed by the Govt. but Parliament cannot increase tax beyond what Government has proposed in the Finance bill.

Appropriation Bill Art. 114

- To obtain Parliament's permission to spend money from Consolidated Fund of India (Art-266). Such expenditure can be of two types:
  - The expenditures 'charged' upon the Consolidated Fund of India e.g. Judges salaries. They can be discussed but they are non-votable & automatically approved.
  - The expenditure 'made' from CFI. They are discussed and voted upon

Budget And Taxation

Vote on Account

- Vote on account is the process by which an incumbent govt. obtains votes from Parliament to spend money on various items for a part of the year.
- The Constitution does not mandate any specific date for presentation of the Budget, but it is presented to the Lok Sabha on such day as the President directs.
- But in between, on 31st March, the financial year will be over so previous year's Appropriation Act's validity will be over.
- Then government cannot withdraw money from the consolidated fund of India even for the routine expenditure like staff salary, administrative bills etc.
- So, to avoid such crisis, government will put a motion for vote on account.
- Here, parliament (practically Lok Sabha) will allow the govt to spend some money from the CFI, till the (next) Appropriation Act for next financial year is passed.
- Vote on Account is generally granted for two months for an amount equivalent to one-sixth of the total budget estimation.

Budget And Taxation

Economic Survey

- It is a document prepared by the Chief Economic Adviser (CEA) in the finance ministry.

Chief Economic Advisor

- Falls under Department of Economic affairs, Ministry of Finance.
- Usual tenure 3 years, reappointment possible, but not a constitutional or statutory body.
- CEA has control over Indian Economic Service (IES)

Types of budgets

Revenue budget

- It is associated with the income and expenditure that are of temporary in nature (1 year or less), and/or do not result into creation of permanent / capital / physical / financial assets.
- Taxation, revenue from selling goods and services, interest payment on previous loans, salaries, pension, subsidies and other nondevelopmental expenditure.

Budget And Taxation

Capital Budget

- Capital budget is associated with the income and expenditure that are of long term nature and/or results into creation of permanent / capital /financial assets, such as land, buildings, machinery, equipment, shares, bonds, G- sec.
- Borrowings, disinvestment, and expenditure on assets creation.

Q. Which of the following is/are included in the capital budget of the Government of India? (Asked in CSE-2016)

1. Expenditure on acquisition of assets like roads, buildings, machinery, etc,
2. Loans received from foreign governments
3. Loans and advances granted to the States and Union Territories

Ans Codes:

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Budget And Taxation

Plan Vs Non-Plan Expenditure Budget

- This budgeting is a method of classifying the expenditure side of budget.

Plan (expenditure) Budget	Non-Plan (Expenditure) Budget
• Central Plans (the Five-Year Plans) • Central assistance for State Five Year Plans. • It is further subdivided into revenue expenditure (e.g. teachers salary under Sarva Shiksha Abhiyan) and capital expenditure (e.g. new school buildings to be constructed under Sarva Shiksha Abhiyan)	• Expenditure related to general, economic and social services of the government; Interest payments, defence services, subsidies, salaries and pensions. • It is also further subdivided into revenue expenditure (e.g. soldier salaries) and capital expenditure (e.g. Building new aircraft carrier).

Budget And Taxation

Balanced, Surplus and Deficit Budget

Balanced Budget

- A government Budget is assumed to be balanced if the expected expenditure is equal to the anticipated receipts for a fiscal year.

Surplus Budget

- A Budget is said to be surplus when the expected revenues surpass the estimated expenditure for a particular business year. Here, the Budget becomes surplus, when taxes imposed, are higher than the expenses.

Deficit Budget

- A Budget is in deficit if the expenditure surpasses the revenue for a designated year.

Budgeting

Traditional / Line-item Budgeting

- In this type, simply calculating the income and expenditure without measuring the underlying benefit or performance
- For instance, Allot INR 100000 to buy a new computers in government department .

Budget And Taxation

Performance Budgeting

- Calculating the income and expenditure tied with underlying benefit or performance
- Allot INR 50,000 to buy a new computer with target that it should result in 30% the faster clearance of RTI-applications compared to pen and paper based office system.
- Such budgeting helps measuring cost : benefit and efficiency.

Zero based budgeting

- In a traditional budgeting, the approach is "automatic and incremental" e.g. "Last year we allotted INR 100000 crore to educational schemes, so this year we should allot 55,000 crores, lest the opposition parties create controversy."
- Whereas in Zero Based Budgeting the budget is viewed as a fresh exercise from zero base. So, each department has to justify its budget demands to finance ministry. E.g. if last year ₹ 50,000 crores given to education schemes but still 60% of class 5 kids cannot read class 2 books, then we will delete / modify that scheme.

Budget And Taxation

Gender based budgeting

- This system was started from Budget-2005.
- It is not a separate budget but rather within the general budget, Finance Ministry will put a separate expenditure document showing women specific schemes, targets, and commitments- in two parts:
    - Part A - Women Specific Schemes, i.e. which have 100% allocation meant for women. E.g. Nai Roshni scheme (Minority Affairs Ministry) for leadership development in Minority Women.
    - Part B - Pro Women Schemes, i.e. atleast 30% allocation meant for women. E.g. Samagra Shiksha (Min of HRD) for pre-nursey to Class12 both boys & girls covered.

Sunset Budgeting

- In a traditional budgeting, once a scheme is launched it runs perpetually, even after regime change e.g. MNREGA, Mid-day Meal.
- In a zero based budgeting, schemes are reviewed every year and then they may get discontinued or continued (withor without modifications).
- In Sunset Budgeting, scheme are announced with deadline. e.g. MEITY to give MDR subsidy for a

period of two years starting from 1/1/2018. Thus, this scheme will self-destruct after deadline just like the sun will set after the sunset time.

Taxation in India

- Tax is the money paid by the taxpayers to the government. Tax is compulsory payment and not voluntary payment or donation made by the taxpayers.
- It is compulsory as it is extracted by the government through legislation. If taxpayers fails to pay.

Distribution of Taxation Power

- Article 246 (schedule VII) of the Indian Constitution, distributes legislative powers including taxation, between the Parliament and the State Legislature. Schedule VII provides for the three lists:
- List – I: It provides for areas on which only parliament is competent to make laws
- List – II: It provides for areas on which only parliament is competent to make laws
- List – III: the areas on which both the Parliament and the State Legislature can make laws upon concurrently

Budget And Taxation

- Art 248 mentions that the residual powers of Legislation are vested in the Parliament. It means that Parliament has exclusive power to make any law with respect to any matter not enumerated in list II and III. Such power shall include the power of making any law imposing a tax not mentioned in either of those lists.

Direct Tax Vs. Indirect Tax

Direct Tax	Indirect Tax
• Direct tax is imposed directly on the taxpayer. Also, it is paid directly to the government by the person on which it is imposed. Direct tax cannot be shifted by the taxpayer to someone else. Thus, in case of Direct tax, the incidence of tax, and impact of tax is on the same person.	• An indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the customer). An indirect tax is one that can be shifted by the taxpayer to someone else.

Budget And Taxation

Direct Tax	Indirect Tax
• Examples of Direct Tax – Income tax, Corporate tax etc.	• Thus in case of Indirect tax, the incidence of tax and impact of tax do not lie on the same person.
• Incidence and impact of tax fall on the same person.	• Incidence and Impact of tax fall on two different persons.
• It is levied on the income. E.g. – Income tax, Corporate tax etc	• It is levied on goods and services. E.g.- GST etc
• It is progressive in nature- higher taxes are levied on persons earning higher income	• It is regressive in nature i.e. all persons (rich and poor) will bear the same taxes on goods and services, irrespective of their capability to pay.

Budget And Taxation

Direct Taxes

Direct Tax	Union govt	State govt
On income	• Corporation Tax, • Minimum Alternate Tax (MAT) • Income Tax • Capital Gains Tax (CGT) • Dividend Distribution Tax (DDT) (Abolish)	• Agriculture Income tax • Professional Tax (Constitutional ceiling of max ₹2500 per year)
On assets transactions	• Securities Transaction Tax • Commodities Transaction Tax • Wealth Tax (Abolished) • Banking Cash Transaction Tax (Abolished) • Estate Duty (Abolished)	• Land Revenue • Stamp or Registration duty • Property tax in urban areas

Budget And Taxation

Direct Tax	Union govt	State govt
On Expenditure	• Hotel Receipt Tax (Abolished) • Gift Tax (Abolished) • Fringe Benefit Tax (Abolished) i.e. When the employer give benefits to employee apart from salary.	

Union Tax, Cess And Surcharge

Union Tax

- Computed on taxable income, profit, transaction. Union tax goes to Consolidated Fund of India. Later divided between Union and states as per the finance commission formula. (except if IGST: divided on GST Council's formula.)

Surcharge

- Computed on Tax amount. So, it is a 'tax on tax'. This amount will also go to CFI. It is not shared with States using Finance Commission Formula.

Budget And Taxation

Usually cess does not have any clear objective in 'prefix' so it may be used for any purpose.

- Exception is 10% Social Welfare Surcharge on the custom duty on imported goods. This will specifically use for social welfare schemes of the union.

Cess

- A cess is a tax on tax, levied by the govt. for a specific purpose. It is levied on the tax payable and not on the taxable income.

Corporation Tax

- Also known as Corporate Income Tax (CIT), levied on Company's profit, under the Income-tax Act, 1961.

Budget-2019

- Additional tax benefits to companies producing solar power, electric batteries, computer server, laptop etc. in any part of India. Companies operating from GIFT-city-IFSC given 100% exemption from Corporation Tax for 10 years.

Budget And Taxation

Budget-2020

- Tax holiday for developers of affordable housing extended till 31 march 2021.
- If a Sovereign Wealth Fund invests in Indian infrastructure projects → Tax holiday for them. E.g. Abu Dhabi Investment Authority

Equalisation Levy / Google Tax

- Equalization Levy (Direct Tax) was introduced in India in 2016, with the intention of taxing the digital transactions i.e. the income accruing to foreign e-commerce companies from India.
- It is aimed at taxing business to business transactions.
- If a foreign company makes profit in India, they have to pay 40% Corporation Tax.
- If an Indian businessman purchases digital advertisement slots in google-ad sense or facebook then those (foreign) e-ad companies are making profit. But earlier, they did not pay tax on that profit, claiming their business activity (of displaying digital-ads) is done outside India on global servers.

Budget And Taxation

- Budget-2016 imposed 6% tax on such income of foreign technology companies.
- Officially called "Equalisation Levy", not part of "Income Tax" or "Corporation Tax" under the Income Tax Act 1961, but a separate levy altogether imposed by the Finance Bill 2016.
- Foreign Company cannot escape it saying we are protected under the Double Taxation Avoidance Agreement (DTAA) in our home country.

Q. With reference to India's decision to levy an equalization tax of 6% on online advertisement services offered by non-resident entities, which of the following statements is/are correct? (CSE-2018)

1. It is introduced as a part of the Income Tax Act.
2. Non-resident entities that offer advertisement services in India can claim a tax credit in their home country under the "Double Taxation Avoidance Agreements".

Answer Codes:

a) 1 only

b) 2 only

c) Both 1 and 2

d) Neither 1 nor 2

Budget And Taxation

Minimum Alternate Tax (MAT)

- Some industrial houses use tax-deduction exemptions depreciations and accounting tricks to become "Zero Profit Companies" & escape paying Corporation Tax.
- Budget-1996 introduced 18.5% MAT on book profit using a different type of formula.

AMT (Alternative Minimum Tax)

- Concept similar to MAT but for Non-Corporate assesses e.g. Individual or Hindu Undivided Family (HUF) or Cooperative Society who are earning more than INR "x" lakh but not paying direct tax. Both MAT and AMT subjected to the surcharge and cess.

Dividend Distribution Tax (DDT)

- FM Chidambaram in 1997 started to levy DDT on a shareholder's dividend income.
- In reality, company (source) will cut that much income portion from shareholders' dividend, and directly deposit that particular amount to the govt, as DDT.
- Shareholder did not have to pay Income tax on it.

DDT Rate → 15% + cess + surcharge = 20.56% on dividend paid.

Capital Gains Tax (CGT)

- When an owner makes profit by selling his capital assets such as non-agro-land, property, jewellery, paintings, vehicles, machinery, patents, trademarks, shares, bonds & other securities- then he has to pay CGT.
- Depending on how long did the owner keep that asset before selling it, he will pay:
  - Either short capital gains tax (LCGT) or
  - Long capital gains tax (SCGT)
- In practice, the buyer will deduct that much amount from the payment to seller, and deposit to the govt.

Budget And Taxation

Q. In which of the following circumstances may 'capital gains' arise? (CSE-12)

1. When there is an increase in the sales of a Product.
2. When there is a natural increase in the value of the property owned.
3. When you purchase a painting and there is a Growth in its value due to increase in its popularity.

Answer Codes:

a) 1 only

b) 2 and 3 only

c) 2 only

d) 1, 2 and 3

Financial Transaction Taxes (FTT)

Tobin Tax (Robinhood Tax)

- Nobel recipient American economist James Tobin proposed (1970s) a small tax every time currency is converted into another currency (e.g. from Dollar to Rupee and vice versa).
- Such tax will discourage short term speculative investment and flight of capital from one country to another.

Budget And Taxation

- Tobin tax helps stabilizing the global economy and currency exchange rates.
- In India, foreign currency conversions are subjected to (previously Service Tax) & now GST

Securities Transaction Tax (STT)

- SST is levied on the sale and purchase of shares, ETF-units, derivatives and other securities at stock-exchanges.
- It's rate (0.001%-2%) varies as per the nature of the securities.

Indirect Taxes

- An indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the customer).
- In the indirect taxes, tax incidence and tax impact does not fall on the same person. E.g. Customs Duty on import and export, Excise duty on manufacturing of goods, Service tax on services, Sales Tax, Value Added Tax (VAT), and Goods and Services tax (GST).

Budget And Taxation

- Indirect taxes fall under the Ambit of Finance Ministry, Central Board of Excise and Customs (CBEC)
- Budget-2018 renamed it as Central Board of Indirect Taxes and Customs (CBIC).

Source of Indirect tax revenues for the Union	Source of Indirect tax revenue for the states
• Customs Duty • Central Excise Duty • Central Sales tax • Service Tax • GST	• Sales Tax • Excise duty on alcoholic liquors • Taxes on luxuries, entertainments, amusements, betting and gambling • Electricity Tax • Entry Tax

Pigouvian TAX

- Pigouvian tax is the one used/imposed in order to diminish the negative fallouts of externalities. For instance, it is generally imposed on high polluting industries which not only causes harm to environment but poses health risks to the people living nearby.

Budget And Taxation

- An externality is a positive or negative consequence of an economic activity experienced by unrelated third parties. E.g. Cement company, whereas unrelated third parties (local community, flora and fauna) are harmed by cement company's air pollution.

Budget And Taxation

Goods and Service Tax

- It is a tax levied when a consumer buys a good or service. It is meant to be a single, comprehensive tax that will subsume all the other smaller indirect taxes on consumption like service tax, etc
- It is a single tax on the supply of goods and services, right from the manufacturer to the end consumer.
- This is how it is done in most developed countries. More than 160 countries have implemented this system of taxation.

Why we need GST regime?

- Poor compliance rate → leads to less revenue realisation due to tax avoidance, lack of technical intervention and dismal database management.
- Narrow taxation base
- Multiplicity of taxes results into confusion and complexity. This also increases operational and compliance cost.
- Lack of single market and single tax hinders ease of doing business in india
- High human interface in taxation system → harassment, license and inspector raj and high level of corruption.

Budget And Taxation

- Pre-GST indirect taxation system had cascading effect → results into multiple layers of taxation, inflation and economic in inequality.
- Lack of quantifiable and verifiable taxation data pertaining to poor integration and database management.
- Lack of use of technology → poor assessment and compliance rate. More vulnerable to frauds, fake claims etc.
- Lack of cooperative federalism in fiscal regime → envisaged in GST in terms of GST Council.
- Lack of uniformity in returns, refunds, registrations and procedures for registration of taxpayers,
- Uncertainty in system of classification of goods and services, refunds and taxation rates.

Objectives of GST

- To establish the highest standards of co-operative federation in the functioning of the Council.
- Evolving by a process of wider consultation, a GST structure, which is information technology driven and user friendly.

Budget And Taxation

- The Council is to be guided by the need for a harmonised structure of GST and the development of a harmonised national market for goods and services.

Evolution of GST in India

2004

- Vijay Kelkar Task Force on Fiscal Responsibility and Budget Management (FRBM) recommends GST.

2006

In Budget speech, P. Chidambaram announces the launch of GST from 2010.

2011

- UPA government introduces 115th Amendment Bill 2011 to implement GST but it lapsed with the dissolution of 15th Lok Sabha.

2014-16

- Modi govt. introduces 122nd Constitutional Amendment Bill 2014 in 16th Lok Sabha. Since GST aimed to change federal financial relations, so under Art.368, this constitutional bill required:
  - Lok Sabha and Rajya Sabha each: 50% majority of the total membership, and 2/3rd majority of all members present and voting.

Budget And Taxation

- State Vidhan Sabha: approval by majority of state assemblies (i.e. 15Vidhan-Sabhas of India at that time) Ultimately, it was passed & became 101st Constitutional Amendment Act, 2016.

GST Council

Composition	
Union representatives (2)	States' representatives (total 31)
• Finance Minister as the Chairman • Union Minister of State for finance or revenue.	• Each state government (including UT with legislature: J&K, Delhi & Puducherry) can nominate one minister to GST council- it may be their minister of finance or Dy.CM or any other minister as per their wish. • One of them will be selected as the Vice Chairman of GST council.

Budget And Taxation

Composition	
Union representatives (2)	States' representatives (total 31)
Voting power – 1/3rd	• Voting power – 2/3rd

Note

- If all members do not unanimously agree over a proposal then it will be put for voting. However in such case, minimum 3/4 votes required to pass the proposal.

Quorum

- Council Meetings to proceed only with quorum of 50% of total membership

Functions of GST Council

- The GST Council shall make recommendations to the Union and the States on
- The taxes, cesses and surcharges levied by the Union, the States and the local bodies which may be subsumed in the goods and services tax;
- The goods and services that may be subjected to, or exempted from the tax;

Budget And Taxation

- Model GST Laws, principles of levy, apportionment of GST levied on supplies in the course of inter-State trade or commerce under Art. 269A and the principles that govern the place of supply;
- The threshold limit of turnover below which goods and services may be exempted from goods and services tax;
- The rates including floor rates with bands of goods and services tax;
- Any special rate or rates for a specified period, to raise additional resources during any natural calamity or disaster;
- Special provision with respect to the States of Arunachal Pradesh, Assam, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh and Uttarakhand;
- Any other matter relating to the GST, as the Council may decide.
- Compensation to the states for their revenue loss in switching from VAT to GST regime (through Cess mechanism):
- Dispute settlement between Union vs state(s), state(s) vs state(s).

Budget And Taxation

Compensation To States

- GST is a destination-based tax, therefore industrialized states are not happy with it. Consider a Nano car manufactured in Tata's Plant in Gujarat and sold in Uttar Pradesh. (Destination) UP gets SGST, While (Source) Gujarat gets nothing.
- Although reverse is also true- UP's bicycle sold in Gujarat, then Gujarat will earn SGST and UP will get nothing. But the industrialized states such as Gujarat, Maharashtra, Tamil Nadu, Haryana feared they'd get less SGST revenue in absolute terms compared to erstwhile VAT regime.
- For the Union govt, largest source of tax collection were corporate tax and personal income tax. Both are direct taxes and therefore kept out of the GST regime.
- For the state governments, VAT was largest source of tax income, but it is to be subsumed under GST, along with other indirect taxes, cess and surcharges levied by the states. Therefore, states were afraid their revenue income will decrease.

Budget And Taxation

Finance Commission (Art. 280)

- Fiscal Federalism refers to the division of responsibilities of-
  - Taxation
  - Expenditure between the different levels of the government.
- While the 7th schedule assigns many responsibilities to the States, but their taxation power is relatively lower than Union's. So, Finance Commission plays a key role in transferring union's revenue resources to the state.

Article 280

- President of India forms a Finance Commission (a quasi-judicial body) every 5th Year or earlier, with 1 chairman and 4 members. Eligible for re-appointment. Recommendations are not binding on the government but usually not rejected.

Budget And Taxation

Vertical Tax Devolution From Union To states

- Finance Commission recommends the vertical devolution from the 'divisible pool' of union taxes. (Here IGST, Cess, Surcharge not counted.)

Finance Commission	Chairperson	States Share
12th (2005-10)	C. Rangarajan	30.5%
13th (2010-15)	Vijay Kelkar	32%
14th (2015-20)	VY Reddy	42%
15th (2020-21)	NK Singh	41%

Budget And Taxation

Horizontal Tax Devolution Among States

Parameter	Weightage
Population: as per Census 1971	17%
Demographic Change as per Census 2011 (To consider the migration angle.)	10%
Income-Distance: Based on per capita income of a state (GSDP ÷ its population). Accordingly, poorer states get more weight	50%
Area: more area more weight	15%
Forest-Cover: more forest cover more weight because of Opportunity cost (State can't allow industries there, else it could have obtained some taxes)	8%

15th FC horizontal distribution formula components

Income Distance: State GSDP divided by its Population = per capita GSDP. For most states, Haryana's per capita GSDP is taken as benchmark. How poorer is your state compared to Haryana that much more rupee state will get.**	45%

Budget And Taxation

Area More area then more rupee	15%
Population (as per Census-2011): More population will transfer more rupee.	15%
Demographic Performance States that have reduced Total Fertility Rate (TFR), will get more rupee.	12.5%
Forest and Ecology More forest will result into more rupee.	10%
Tax efforts States who have improved their per capita (State) tax collection in the last 3 years will get more ₹₹	2.5%
Total	100%

Grants From Union To States

- Apart from the tax devolution, FC would also suggest Union to give grant to the states (grant are different from loans, grants need not return with interest).

Budget And Taxation

Terminologies related to taxation and black money

Tax Evasion

- When person hides income or transaction from tax authorities, and thereby evades paying taxes. It is illegal and punishable offence.

Tax Avoidance

- When person discloses his income and transactions to tax authorities but uses legal loopholes to avoid paying taxes. It may not be illegal in every case, but still unethical.

Tax Haven

- It is a country that demands little taxes from foreigners and offers legal loopholes for Tax Avoidance & opportunities for Tax Evasion. E.g. Mauritius, Marshall Islands, Cayman Islands, Panama etc. These countries are geographically small, & without viable economy. So they offer such mechanism to attract foreign investors and foreign tourists.

Budget And Taxation

Money laundering

- Money laundering is the process of disguising the source of money, as if it came from a legitimate activity, & then channelize it into banks, share market and other financial intermediaries.
- When drug trafficking, ransom, corruption and other criminal activity generates substantial profits, the criminal tries to spend/ invest/ hide the money without attracting attention.

Hawala

- Hawala is an illegal money transfer or remittance system. Money is paid to an agent who instructs an associate in the relevant country or area to pay the final recipient.
- Although used by Indian workers in middle east because lower commission than post office/bank transfers. Hawalashave better network in remote areas.

National and International organisations dealing with Black money

Enforcement Directorate

- Ministry of Finance (Department of Revenue) → ED is a Specialized financial investigation agency to enforce following laws Foreign Exchange Management Act,1999 (FEMA) Prevention of Money Laundering Act, 2002 (PMLA).

Directorate of Revenue Intelligence (DRI)

- Ministry of Finance (Department of Revenue) → CBIC → DRI is an agency against Customs, Narcotics, Wildlife, Arms related smuggling & illegal activities.

Financial Intelligence unit (FIU-2004)

- It analyses the suspected financial transactions in domestic and crossborder levels & reports directly to the Economic Intelligence Council (EIC) headed by the FM.

Financial Action Task Force (FATF-1989)

- FATF is a brainchild of G7, Combating Money laundering and terror finance. HQ - Paris. India became member in 2010.
- Grey list → Nations that safe haven for terror financing and money laundering. E.g. Pakistan, as of Jan2020.
- Blacklist → Nations that are not cooperating in the global fight against money laundering, terrorist financing. Iran and N. Korea.

Budget And Taxation

Org. For Eco. Coop. & Development OECD (1961)

- Works for International cooperation in the matters of economy and taxation. Known for Base erosion and profit shifting (BEPS) Norms. India is not a member of OECD, yet. HQ - Paris

Base Erosion & Profit Shifting (BEPS)

- When MNCs shift profit from its source country to a tax-haven to avoid / reduce paying taxes, its known as "BEPS".
- 2019-July: India ratified the OECD's joint Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (commonly referred to as MLI)
- Multinational Company (MNC) "A" opens fast food outlets in India & makes ₹ 50 crores profit. By default, it should be subjected to 40% Corporation tax in India.
- But then MNC shows its Indian outlets had taken loan / raw material / patented technology from MNC's shell firm in Singapore (where Corporation tax is 0-2%). So, after deducting these operating costs, it has zero profit, so in India, it will pay only 18.5% Minimum Alternative Tax (MAT), instead of 40% Corporation tax.

Budget And Taxation

General Anti Avoidance Rule (GAAR)

- Till now we learned how Indians and foreigners avoid tax payment in India through loopholes like DTAA, POEM, BEPS, Transfer Pricing etc.
- So, UPA Govt setup economist Parthasarathi Shome panel who suggested General Anti Avoidance Rules (GAAR), they were incorporated in Income Tax Act in 2012.
- GAAR empowers Income Tax officials to send notices to both Indians and foreigners for suspected Tax Avoidance. For Tax evasion, we have separate laws- PMLA, UFIA, BTPA.
- However, critics alleged GAAR will result in tax terrorism, harassment, no ease of doing business. So successive Budgets kept delaying the GAAR implementation. Finally done on 1/4/2017.

Angel Tax on Startup Investments (2012)

- Angel investors are the rich people who occasionally invest equity-capital in start-up companies. (Whereas Venture Capital Companies do the same thing but on regular & serious basis)
- Startup Entrepreneur Sunder Yadav registers a phony "Sunder Construction" as an (unlisted) Public Limited Company with ₹ 10 Face Value Shares, and

sells them to Angel Investor Sadhu Yadav at a premium price of ₹ 1,000 per share.

- But, even construction sector's (listed) public limited companies like DLF's shares are selling around for ₹ 230.
- Thus, Sundar-startup's shares are above 'fair market price'. So, this is not a genuine "Angel investment" but rather a facade for laundering Sadhu Yadav's money from construction, corruption or extortion business.

Misc. Terms w.r.t. Taxation

Laffer Curve

- American economist Arthur Laffer → if (direct) tax rates are increased above a certain level, then tax revenue collection will fall because higher tax rates discourage people from working and/or encourage them to engage in tax evasion and tax avoidance).
- So, tax-cuts could lead to higher tax revenue collections.
- Budgets from 2017 onwards → The lowest Income Tax slab was cut from 10% to 5%; The corporation tax on small sized companies was also

Budget And Taxation

brought down from 30 % to 25% in a phased manner.

- Budget-2020 → new optional Income tax slabs.
- USA Budget-2017 →Corporation tax cut down from 35% to 15%

Tax buoyancy

- If GDP grew by x%, then how much % Income tax collection will grow?
- E.g. if income tax collection growth rate is 11% when GDP growth rate is 10%, then Income Tax's tax buoyancy is 1.1

Tax elasticity

- If first income tax slab increased from say 5% to 15%, then in absolute terms how much more IT-revenue will be generated?

Types of Deficits

- A deficit occurs when a resource, money, in particular, is less than the amount required. A budget deficit and a trade deficit are the two main types of deficits. A deficit adds to one's debt, which most do not consider financially healthy.

Budget And Taxation

Deficit	Formula	Budget-2020
Revenue Deficit	Revenue expenditure minus Revenue Receipts	2.7% of GDP
Effective Revenue Deficit	Revenue Deficit minus Grants for creation of capital assets	1.8% of GDP
Budget Deficit	Budget expenditure minus Budget Receipt	
Fiscal Deficit	Budget Deficit plus Borrowing	3.5% of GDP
Primary Deficit	Fiscal Deficit minus interest to be paid on previous loans	0.4% of GDP

Budget And Taxation

Q. Find Correct Statement(s) (CSE-2017)

1. Tax revenue as a percent of GDP of India has steadily increased in the last decade.
2. Fiscal deficit as a percent of GDP of India has steadily increased in the last decade.

Codes:

a) 1 only
b) 2 only
c) Both 1 and 2
d) Neither 1 nor 2

Fiscal Deficit

- Fiscal Deficit = Budget Deficit + Borrowing.
- This borrowing includes internal borrowing [such as through Small Savings Scheme, and the G-Secs subscribed by Banks/NBFCs + Borrowing from RBI] + External Borrowing.
- As per Sukhmoy Chakravarti Committee report, it was implemented in 1997-98.

Primary Deficit

- Primary Deficit = Fiscal deficit minus the interest to be paid on the previous loans.
- Mentioned in Finance Minister Manmohan Singh's budget speech of 1993.

Budget And Taxation

- If the government continues to borrow year after year, it leads to accumulation of debt and the government has to pay more and more interest.
- These interest payments themselves add more burden to borrow next year.
- So, to get a clearer picture of how much is the government borrowing for new programs, they look at another indicator, known as primary deficit.

Deficit Financing

- When the revenue of the government is shorter than its expenditure then this situation is dealt by printing more currency, buying from public and foreign institution. This temporary arrangement of the money is known as the deficit financing.
- Taxes cannot be increased beyond a point because it may force people to evade taxes / discourage their motivation to work (Laffer Curve).
- It is worth to mention that deficit financing is equal to fiscal deficit of the country.

Sources of Deficit Financing

- Printing new currency notes.
- Borrowing from internal sources (RBI, General Public, Ad-hoc Treasury Bills & government bonds)

Budget And Taxation

- Borrowing from External Sources (like borrowing from developed countries and International institutions like World Bank, IMF, etc.)

Purposes of Deficit Financing

- To overcome the problem of lack of funds for speeding up the country's development.
- Promote additional investment in the country to side away the adverse impacts of depression period of the country.
- To arrange fund for ensuring the holistic development of the country.
- To arrange fund for the unforeseen events and arrange resources for wartime expenditure.
- To upgrade the infrastructure of the country so that the taxpayers of the country are convinced that the tax paid by them is spent on the right things.

Negative Consequences of Deficit Financing

- Increase in deficit which leads to increased borrowing by Govt.
- Adverse Impact on Saving - Deficit financing leads to inflation and inflation affects the habit of voluntary saving adversely.

Budget And Taxation

- Increase in inflation due to the increase in the supply of money in the economy.
- Decrease in average consumption level due to higher inflation.
- Increase in income disparities, because rich get more opportunities due to higher supply of money in the economy. In fact it is not possible for the people to maintain the previous rate of saving due to rising prices.
- Adverse Impact on Investment - Deficit financing effects investment adversely. When there is inflation in the economy trade unions/employees demand higher wages to survive.
- Economist David Ricardo argued that during high deficits, people save more, because they become precautious about future hike in taxes. It's called "Ricardian equivalence" (and if people begin to spend less and save more, then companies will face unsold inventories, a new problems for economy)
- If government borrows more money from households & financial intermediaries (LIC, EPFO, Banks via SLR), then that much less money will be available for loans to private corporate borrowers → Crowding Out Effect • Financial repression of the households - If Government forces SBI, LIC,

EPFO to buy its Gsec using public deposits and thereby depriving households of the optimal return.

- Erosion of operational freedom - Govt (forcing) NABARD to buy its ₹ 15,000 crore Swachh Bharat Mission (Gramin) Bonds with maturity period of 10 years. Govt (forcing) RBI and others to pay higher dividend.
- High level of fiscal deficit - International Credit Rating Agencies will downgrade the sovereign rating for India. Investors will demand more interest from govt for buying new G-Sec, if unsold then RBI forced to buy G-Sec (and print more Money to give to Govt). It is called "Monetization of Deficit". It can result in hyperinflation.

Fiscal Consolidation (Fiscal Prudence)

- Fiscal Consolidation refers to the policies undertaken by Governments (national and subnational levels) to reduce their deficits and accumulation of debt stock. It is not aimed at eliminating fiscal debt.

Budget And Taxation

- Fiscal Consolidation involves reduction in government expenditure to control its Fiscal Deficit. Such as:
    - Reducing the leakages of subsidies and funds
    - Reducing the quantum of subsidies
    - Shutting down loss making PSU
    - Privatization of loss making PSU and PSBs

Q. There has been a persistent deficit budget year after year. What can be done by the government to reduce the deficit? (CSE-2015)

1. Reducing revenue expenditure
2. Introducing new welfare schemes
3. Rationalizing subsidies
4. Expanding industries

Answer:

a) 1 and 3 only
b) 2 and 3 only
c) 1 only
d) 1, 2, 3 and 4

Fiscal Stimulus

- When government reduces taxes and/or increases public procurement to boost the demand & growth in economy, it is called "Fiscal Stimulus".

Budget And Taxation

Q. Which one of the following statements appropriately describes the "fiscal stimulus"? (CSE2011)

1. It is a massive investment by the Government in manufacturing sector to ensure the supply of goods to meet the demand surge caused by rapid economic growth.
2. It is an intense affirmative action of the Govt. to boost economic activity in the country.
3. It is Govt's intensive action on financial institutions to ensure disbursement of loans to agriculture and allied sectors to promote greater food production and contain food inflation
4. It is an extreme affirmative action by the Government to pursue its policy of financial inclusion

Fiscal Discipline

- Fiscal Discipline refers to a state of an ideal balance between revenues and expenditure of government, in an economy.
- If the fiscal discipline is not maintained, then the government expenditure exceeds government receipts.

Budget And Taxation

- Under this condition, the government would have to borrow funds or incurred deficit financing from the central bank. This may depreciate the currency and create inflation in an economy.

Fiscal drag

- Fiscal drag happens when government's net fiscal position (minus taxation) fails to cover the net savings desires of the private economy, it is also called the private economy's spending gap.
- The resulting lack of aggregate demand leads to deflationary pressure, or drag, in the economy, essentially due to lack of state spending or to excessive taxation.
- One cause of fiscal drag is bracket creep, where progressive taxation increases automatically as taxpayers move into higher tax brackets due to inflation. This leads to moderation of inflation, and can be characterized as an automatic stabilizer of the economy. Fiscal drag can also be a result of a hawkish stance towards govt. finances.

Budget And Taxation

Fiscal Slippage

- For instance, if government has targeted to keep the fiscal deficit within 3.3% percent of GDP, but if it crosses that limit, it is called as fiscal slippage.

FRBM Act 2003

- Fiscal Responsibility and Budget Management Act aims to make the Central government responsible for ensuring intergenerational equity in fiscal management and long-term macro-economic stability.
- Originally it required Union and States to control their deficits with following targets:

By 2008	Reduce Fiscal Deficit to 3% of GDP (for Union) and 3% of GSDP (for States).
By 2008	Eliminate Revenue deficit i.e. make it 0% of their respective GDP or GSDP.

- While some of the state governments achieved them, but successive union governments struggled to meet these targets so they kept amending the act to extend the deadlines and targets.

Budget And Taxation

- E.g. Amendment 2012: No need to have 0% Revenue deficit. Instead it required 0% Effective Revenue Deficit by 2015. These deadlines were extended even further in subsequent Finance Bills.

FRBM Review Panel under N.K. Singh (2016-17)

Budget-2016

- Jaitley felt FRBM Act targets were too rigid and did not allow any room for the government to address any crisis e.g. farm loan waivers during drought period or unemployment allowance during global financial crisis are not possible if government strictly wants to control fiscal deficit at 3% of GDP.
- So, he constituted a panel under NK Singh (former IAS, 15th FC chairman) to review the FRBM act. RBI Governor Urjit R. Patel & CEA Arvind Subramanian were also in the committee.

Recommendations FRBM Panel:

- Replace the existing FRBM act with a new act, with an "Escape clause" i.e. During a war, drought or economic crisis, the government should be temporarily allowed to cross breach targets. Govt. amended FRBM act for this.

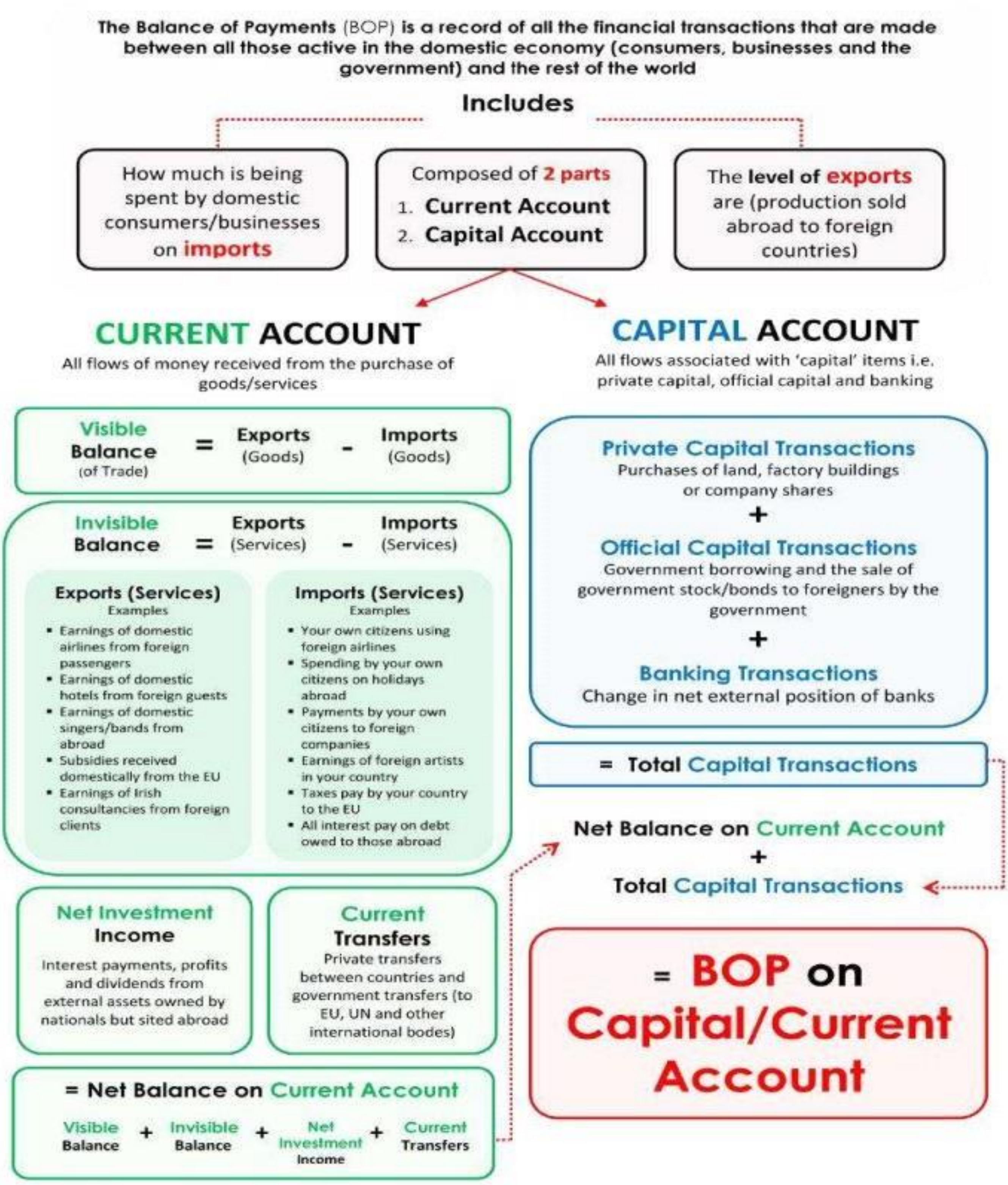
Budget And Taxation

- Set up an independent "Fiscal Council" for monitoring. Yet to setup such council.
- Adopt a fiscal road map for the union from 2017 to 2023 gradually reduce Union Debt to GDP, Fiscal Deficit and Revenue Deficit So, citing NK Singh report (as an excuse), Budget 2018 amended the FRBM targets.

FRBM Act: Documents

- FRBM Act requires the Union Government to present 3 documents along with the budget:
  - Fiscal Policy Strategy Statement
  - Macroeconomic Framework Statement
  - Medium-term Fiscal Policy Statement

Balance of Payments



Balance of Payments

Balance of Payments

- It is a systematic record of all economic transactions made between the residents and nonresidents of a country for a specific time period, usually a year.
- Central Banks of each country prepare BoP records as per the format given in IMF's BPM-6 manual, all the figures are expressed in Dollar ($).
- BoP is further sub classified into two parts → Current Account and Capital Account, based on the nature of transactions.

RBI'S Method of Classifying BOP

Current Account	Capital Account
• Goods and services • Primary Income: wages, dividend, interest • Secondary income: remittance, gift, donation	• Direct Investment (FDI) • Portfolio Investment (FPI) • Loans / ECB • Non-resident's investment in Bank, Insurance, Pension Schemes • Forex Reserves

Balance of Payments

BOP - Current Account

Component	Amount in billion dollars (2018-19)	Net Incoming
Visible	Trade in Goods: $330 billion worth goods exported vs $510 worth imported. Compared to last 3 years, trade deficit has increased.	-180
Invisible	Trade in Services (Highest export: Software services > Business Services > Travel > Transport). $208 Export - $126 Import= +82 Billion surplus. Our Surplus has increased in last 3years	+82
	Income: Profit, Interest, Dividend.	-28
	Transfer: Remittance, Gift, Grants, Donations. Subtypes: Pvt transfers > Govt.	+70

Balance of Payments

Balance of Trade (BoT)

- It is the difference between the value of import and export (of goods and services).
- Export (+330 Goods + 208 Services) MINUS Import (-510 Goods – 126 Services) = MINUS (-) 98 billion.
    - If +ve = Trade Surplus (i.e. Export > Import);
    - If -ve = Trade Deficit (i.e. Import > Export)

Net Terms of Trade

$$NTT = \frac{Value\ of\ export}{Value\ of\ import} * 100 = for\ India\ it's < 100.$$

Meaning ($ or value) wise we are importing more and exporting less.

Balance of Payments

Goods

Goods: Top Imports (in Decreased share)	Top Exports (in Decreased share)
• Petroleum: Crude (22%) • Gold (6%) • Pearl, Precious, Semi Precious Stones • Petroleum Products • Coal, Coke And Briquettes, etc.	• Petroleum Products (14%) • Pearl, Precious & Semi Precious Stones • Drug Formulations, Biologicals • Gold and other Precious Metal Jewellery • Iron And Steel
Other notable: Telecom Instruments, Electronics Components, Organic Chemicals, Iron And Steel, Industrial Machinery	Other notable: Organic Chemicals, Cotton, Motor Vehicle/Cars, Electric Machinery

Balance of Payments

Services

Services: Top Imports (in Decreased share)	Top Exports (in decreased share)
• Business service • Travel (Indian going on foreign trip) • Transport (of cargo/goods) • Software Service	• Software service • Business service • Travel • Transport

India's top trading partners for 2018-19 were as following

Top Import sources Decreased share)	Top Exports destinations (decreased)
• China (14%) • USA • UAE • Saudi Arab • Iraq	• USA (16%) • United Arab Emirates • China • Hong Kong • Singapore
Other notables: Switzerland, Hong Kong, S. Korea, Singapore, Indonesia	Other notables: UK, Bangladesh, Germany, Netherland, Nepal

Balance of Payments

India's top five trading partners

- India have largest amount of import and export relations with following five nations - USA, China, UAE, Saudi Arabia and Hong Kong

Remittance: World Bank's Remittance Report

- According to 2018's data, India receives largest amount of remittance (about USD 80bn).
- In quantitative figures too India received more amount compared to previous years.
- Because higher oil prices → Arabian Sheikhs are earning more and spending more → Indian workers in middle east are earning more overtime → more remittance to India.

Balance of Payments

Foreign Portfolio Investors (FPI)

- It is a foreign entity registered with SEBI, and who buys upto 10% in equity / shares of an Indian Company.
- For Corporate Bonds and G-Sec these percentages are different.
- Originally, these were called Foreign Institutional Investor (FII) and Qualified Foreign Investors (QFIs), but in 2013 SEBI merged them all into a single category- FPI, based on the recommendations of K.M. Chandrasekhar committee.
- FPI's primary objective is make money from buying and selling of shares through the capital market / share market. They even help the SEBI non-registered foreign investors by issuing them Participatory notes (P-Notes).
- FPIs are not involved in the actual operations / production / management / business policy making of a company (unlike Walmart is for Flipkart).
- If FPI investor is hopeful to get better returns in the other countries' share/bond market, he may quickly sell his Indian securities and run away.

Balance of Payments

- The flight of such money is called 'hot money', It results into weakening of Indian Rupee and falling of Sensex.

Foreign Direct Investment (FDI)

- FDI is the (more than 10% equity / share) investment made by a foreign entity into an Indian company, with the objective to getinvolved in the management / production of that Indian company.
- E.g. 2018: Walmart-USA bought 77% stakes in Flipkart at $16 billion.
- Foreign Investment is prohibited in atomic energy, railway operations (except Metro & infra dev.); Tobacco Products, Real Estate Business, Farm Houses, Chit Funds, Nidhi Companies, Betting Gambling Casino & Lottery.
- For the remaining sectors, Foreign Investment is permitted either through:
  1. Automatic Route
     - Foreign entity doesn't require Indian Govt's approval.
  2. Government Route
     - Prior to investment, they've to get approval from the Govt of India's respective Administrative Ministry/ Department (and Commerce Ministry).

Balance of Payments

Differences Between FDI and FPI		
Parameters	**FDI**	**FPI**
Definition	FDI refers to the investment made by foreign investors to obtain a substantial interest in the enterprise located in a different country.	FPI refers to investing in the financial assets of a foreign country, such as stocks or bonds available on an exchange.
Role of investors	Active Investor	Passive Investor
Type	Direct Investment	Indirect Investment
Degree of control	High Control	Very low control
Term	Long term investment	Short term investment
Management of Projects	Efficient	Comparatively less efficient
Investment has done on	Physical assets of the foreign country	Financial assets of the foreign country
Entry and exit	Difficult	Relatively easy
Leads to	Transfer of funds, technology, and other resources to the foreign country	Capital inflows to the foreign country
Risks Involved	Stable	Volatile

Exchange Rate System

- The exchange rate of any currency is determined by the supply and demand for the country's currency in the international foreign exchange market.
- For example, the value of Indian rupee with respect to the dollar is determined by the demand of dollar against the Indian rupee. If the demand for dollar increases, its value increases, and dollar appreciate while Indian rupee depreciates with respect to the dollar.
- The price of one currency in terms of the other currency is called exchange rate.

Factors Affecting The Exchange Rate Of India

1. Intervention of The Reserve Bank of India
   - During high volatility in the exchange rate, RBI intervenes to prevent the exchange rate going out of control.
   - For example, the RBI sells dollars when Indian rupee depreciates too much, while it purchases dollars when the Indian rupee appreciates beyond a certain level.

Exchange Rate System

2. Inflation rate

- The increase in inflation rate can increase the demand for foreign currency which can negatively impact the exchange rate of the national currency.
- For example, an increase in the inflation level of petroleum oil can increase the demand for foreign currency leading to the depreciation of Indian rupee.

3. Interest rate

- Interest rates on government securities and bonds, corporate securities etc affect the outflow and inflow of foreign currency.
- If the interest rates on government bonds are higher compared to other country forex markets, it can increase the inflow of foreign currency, while lower interest rates can lead to the outflow of foreign currency. This affects the exchange rate of Indian rupee.

4. Exports and imports

- Exports and imports affect exchange rate as exports earn of foreign currency while imports require payments in foreign currency.

Exchange Rate System

- Thus, if the overall exports increases, the national currency appreciates, while increases in imports leads to the depreciation of the national currency.
- Apart from above, the Indian foreign exchange market is also affected by factors such as the receipts in the accounts of exports in invisibles in the current account, inflow in the capital account such as FDI, external commercial borrowings, foreign institutional investments, NRI deposits, tourism activities etc.

Exchange Rate Regimes in India

1. Floating or Flexible

- In floating or flexible exchange rate is determined by the market forces of demand and supply.
- Under the floating exchange rate regime, the market forces determine the value of domestic currency on the basis of the forces of demand and supply of the domestic currency.
- In this system, neither the government nor the central bank intervenes and the market functions freely to determine the real value of domestic currency.

Exchange Rate System

- The floating exchange rate regime establishes trust among the foreign investors which can help in the increase in foreign investment in the domestic economy.
- This system ensures that a country can get easy access to loans from the IMF and other international financial Institutions.
- So if there are more number of Indian people wanting to import crude oil, gold, iPhone; Compared to the number of Americans interested to buy Indian goods, services; / coming to vacation in Kerala, then, demand for dollars will be more than that of rupees. So, \$1 = 50 → \$1= 70
- In this system, if rupees weakens, it is called "Depreciation" (e.g. 50 → 70); Makes the export look cheaper to the foreign buyer if ₹ strengthens it is called "Appreciation" (e.g. 70 → 50)

2. Fixed or Pegged

- Under the fixed exchange rate regime, the government or the central bank has complete intervention in the determination of the currency's exchange rate. This is achieved by linking the domestic currency to the value of gold or with other major currencies such as US dollar etc.

Exchange Rate System

- For instance, when the central bank of a country itself decides the exchange rate of local currency to foreign currency e.g. People's Bank of China (PBC) $1 = 6 Yuan.
- If excess dollars are entering in their market, the central bank will print more Yuan to buy and absorb the excess dollars, to ensure Yuan doesn't strengthen against Dollar ($1 = 6 → 5 Yuan). As a result their forex reserve will get large build-up of dollars, due to central bank's purchase.
- In future, if less dollars are entering in their market, the central bank will sell the (previously acquired) dollars from its forex reserve to ensure Yuan doesn't weaken (₹ 1= 6 → 7 Yuan)
- In this system, if Yuan is weakened by Central Bank's official notification, it is known as 'devaluation' (e.g. $1=6 → 7); usually done when it doesn't have enough dollars in reserve to play the game and / or when it wants to deliberately weaken Yuan to encourage exports.

3. Managed floating exchange rate

- It is the middle path between the fixed exchange rate regime and the floating exchange rate regime.

Exchange Rate System

- In the system, the exchange rate of domestic currency is allowed to move freely based on the market forces of demand and supply.
- However, during difficult circumstances, the central banks intervene to stabilize the exchange rate of the domestic currency.
- RBI will not decide the exchange rate (unlike the fixed system). In the ordinary days, RBI will let the market forces of supply and demand decide the exchange rate.
- But if there is too much volatility, then RBI will intervene to buy / sell $ to keep the volatility controlled.
- Similarly, People Bank of China will not intervene in ordinary circumstances. They will intervene during volatility i.e. if $ to Yuan value changes more than "x%" up or down compared to previous day's exchange rate.

Currency Convertibility

- Presently, India has managed floating exchange rate system wherein, currency exchange rate is determined by the market forces of supply and demand, however, during high level of volatility RBI will intervene to buy / sell ₹ or $ to stabilize the exchange rate.

Exchange Rate System

- But if people are allowed to convert the local and foreign currency in an unrestricted manner, this will led to so much volatility that RBI will not be able to manage.
- So, RBI puts certain restrictions on the convertibility of Indian rupee.

Convertibility on Capital Account Transactions

External Commercial Borrowing (ECB)

- RBI's External Commercial Borrowing (BoP → Capital Account → Borrowing → ECB) ceiling is up to $750 million (or equivalent other currency) per year for Indian Companies. That means even if Bank of America was willing to lend $1500 million to Reliance, it can't bring all those dollars (or its converted rupee equivalent) in India. If he tries through illegal methods like Hawala, then Enforcement Directorate (ED) will take action for FEMA violation.

Foreign Portfolio Investors (FPI)

- An Foreign Portfolio Investors (BoP → Capital Account → Investment → FPI) can't invest in more than 5% of available government securities in the

Indian market and more than 20% of the available corporate bonds in the Indian market. So, even if Morgan Stanley or Franklin Templeton investment fund has billions of dollars they can't bring them all to India because of above restrictions.

Foreign Direct Investment (FDI)

- Similar restrictions on Foreign Direct Investment (FDI) as well. Govt decides FDI policy and RBI mandates the forex dealers accordingly to convert or not convert foreign currency into Indian currency. E.g. Las Vegas's Flamingo Casino company can't convert $ into ₹ to invest in Goa's Casino (Because FDI prohibited in Casino). If they manage to 'smuggle' rupees through Hawala / Mafia boats then again ED will take action for FEMA violation.

Conclusion

- Thus, Indian rupee is not fully convertible on capital account transactions.

Convertibility on Current account transactions

- During 2013 to 2014, RBI's 80:20 norms mandated min. 20% of the imported gold must be exported back.

Exchange Rate System

- Until then Jeweller/bullion dealers will not get permission to (convert their rupees into dollars/foreign currency) to import next consignment of gold.
- However, if we disregard such few rare examples/restriction, Indian rupee is considered fully convertible on current account transactions (i.e. Import and export, remittance, income transfer gift and donations) since 1994.

Quantitative Easing

- Subprime crisis in USA (2007-08:) → Borrowers unable to repay the home loans → American Banks and NBFCs' bad loans / NPA / toxic assets increased → to help them, US Federal Reserve printed new dollars & used it to buy those toxic assets → increased dollar supply in the system. Known as "Quantitative Easing".

Fed Tapering

- 2013: US Federal Reserve gradually cut down its toxic asset purchasing program → less new dollars issued → called "Fed Tapering".

Exchange Rate System

Purchasing Power Parity (PPP)

- Hypothetical concept that tries to compare two currencies' exchange rate through their purchasing power in respective countries.
- So, If 1 cup of coffee in India = ₹ 20 whereas 1 cup of coffee costs $2 in USA then Dollar to Rupee exchange rate (PPP) should be $1 = ₹ 10. (According to OECD, exact figure is $1=₹ 17 at PPP).
- This (hypothetical) exchange rate can happen in real life, if both the countries have Floating Exchange Rate without any intervention of the respective Central banks; and if the bilateral trade is free of protectionism (i.e. without tariff or non-tariff barriers).
- GDP is the total market value of all goods and services produced in a country within a year. When we convert these GDP values from local currencies into PPP $ exchange rates, the largest economies of the world (GDP, PPP wise) are:

Exchange Rate System

Q. Find correct statement(s) (CSE-2019)

1. Purchasing Power Parity (PPP) exchange rates are calculated by the prices of the same basket of goods and services in different countries.
2. In terms of PPP dollars, India is the sixth largest economy in the world.

Solution:

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Effective Exchange Rates

NEER and REER

- Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) are the indicators of external competitiveness.
- Five-country and thirty six-country indices are being constructed by the Reserve Bank of India to help the researchers and analysts.

Exchange Rate System

NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign Currencies	REER is the weighted average of nominal exchange rates adjusted for relative price differential between the domestic and foreign countries, relates to the purchasing power parity (PPP) hypothesis.

- In real life we are not just trading with USA but other countries, using foreign currencies other than US dollars (such as Euro, Pound, Yen, Yuan etc).
- Therefore, only tracking $1=60 or $1=70 will not give a full picture. So, RBI also calculates geometric average of rupee's exchange rate against upto 36 types of foreign currencies.
- The formula will give weightage to each of those 36 foreign currencies depending on their trade volume with India. The result is called "Nominal effective exchange rate (NEER)"
- When NEER is mathematically adjusted as per the CPI-inflation levels in India and those foreign countries, it's called "Real effective exchange rate (REER)"

Exchange Rate System

- REER interpreted as the quantity of domestic goods required to purchase one unit of a given basket of foreign goods.
- NEER vs REER values help analysing whether a currency is really weakening (depreciating) against the foreign currencies or not, thus helps to know our international competitiveness in exports.

Devaluation of a currency

- Under the fixed rate regime, the central bank or the government decides the value of the currency with respect to other foreign currencies. The central bank or the government purchases or sells its currencies to maintain the exchange rate. When the government or the central bank reduces the value of its currency, then it is known as the devaluation of the currency.
- For instance, in 1966 when the India was following the fixed exchange rate regime, the Indian Rupee was devalued by 36 %.

Depreciation of a currency

- In the floating exchange rate regimes, the value of a country's currency is determined by the market forces of demand and supply. The exchange rate of the currency changes on daily

Exchange Rate System

basis as per the demand and supply of that currency with respect to foreign currencies. A currency depreciates with respect to foreign currency when the supply of currency in the market increases while its demand falls.

Devaluation vs depreciation

Devaluation	Depreciation
Devaluation is the official reduction in the value of a currency.	Depreciation refers to an unofficial decline in the currency's value.
Devaluation is the phenomena associated with fixed exchange rate regime.	Depreciation of a currency is associated with the floating or managed floating exchange rate regime
Devaluation of the currency is done purposely by the central bank or the government	The market forces of demand and supply are responsible for the depreciation of a currency.

Exchange Rate System

Devaluation	Depreciation
The impact of currency devaluation is for short term,	The depreciation of currency can affect the economy for a longer time
Devaluation of currency is done occasionally by the central bank.	Depreciation and appreciation of currency occur on a daily basis.

Revaluation

- Revaluation refers to an upward adjustment to the country's official exchange rate the relative to either price of gold or any other foreign currency.
- Revaluation increases the value of the domestic currency with respect to the foreign currency.
- Revaluation is a feature of the fixed exchange rate regime, where the exchange rate is determined by the central bank or the government.
- Revaluation is opposite to devaluation, which is a downward adjustment.

Exchange Rate System

Currency Appreciation

- Currency appreciation refers to the increase in the value of one currency with respect to other foreign currencies.
- Currency appreciation is the unofficial increase in the value of any currency.
- It is a feature associated with floating or managed floating exchange rate regimes.
- Appreciation of a currency takes place when the supply of the currency is lesser than its demand in the foreign exchange market.

International Organisation

Bretton Woods Institutions (World Bank Institutions) (Washington, 1945)

- World bank originally focused on reconstructing war-torn European countries. After 1950s focusing on poor countries of Asia and Africa.
- WB works with country governments, the private sector, civil society organizations, regional development banks, think tanks, and other international institutions on issues ranging from climate change, conflict, and food security to education, agriculture, finance, and trade.

World Bank Group

International Bank for Reconstruction and Development (IBRD)

- Commonly known as the world bank. Gives development loans with interest.

International Organisation

International Development Association (IDA)

- Assists the poorest countries via interest- free long-term loans ("Concessional Loans" or "soft loans").

International Finance Corporation (IFC)

- Supports enterprise of developing countries. Known for its Masala Bonds.

Multilateral Investment Guarantee Agency (MIGA)

- Offers (foreign) investors insurance against noncommercial risk (such as political instability, regime change etc.). This helps 3rd world nations attract foreign investment.

International Centre for the Settlement of Investment Disputes (ICSID)

- Helps in dispute resolution related to foreign investment / foreign companies in 3rd world countries. India is not a member of this organization.

International Organisation

Aim Of World Bank

- End extreme poverty - reducing share of global population that lives in extreme poverty to 3 percent by 2030.
- Promote shared prosperity - by increasing the incomes of the poorest 40 percent of people in every country.
- Provide sustainable development.

World Bank is known for Reports?

- World Development Report,
- Ease of doing business Index,
- Remittance & Migration Report,
- Global Economic Prospects report
- International Debt Statistics
- World Development Indicators

Non-Bretton Woods : Multilateral Development Banks

BRICS Bank New Development Bank (NDB)	AIIB: Asian Infrastructure Investment Bank
Started in 6th BRICS Summit in Fortaleza (2014) members signed treaty	Started in 2015-16

International Organisation

Members - Brazil, Russia, India, China South Africa	Members - China, India, UK, Switzerland etc. more than 70 nations as of 2019.
Voting power - Each member is given equal 20% voting power.	Voting power - Based on share capital provided. China about 27%, India about 7%. Asian countries control about 75% voting.
HQ- Shanghai, China	HQ – Beijing, China
COVID-19 loan to India → $1 billion. (2020-Apr)	COVID-19 loan to India → $750 million (2020-June)

International Organisation

Other Multilateral Development Banks

BIS: Bank for International Settlements

- Its committee on banking supervision set norms in 1988 (I), 2004 (II), 2011(III) to ensure global financial stability.

African Development Bank

- 1964: setup in Abidjan in Ivory Coast
- India is a member, also gets loans.

Asian Development Bank (ADB)

- 1966: setup in Manila, Philippines
- India is a member, also gets loans.

European Bank for Reconstruction & Development (EBRD)

- 1991: setup at London.
- India became member (shareholder) in 2018. India will not be eligible for loans from EBRD but India can initiate joint loan proposals for Asian, African, European nations for its soft-diplomacy.

International Organisation

IMF, Washington (1945)

- IMF was conceived at a UN conference in Bretton Woods in July 1944.
- The International Monetary Fund (IMF) is an organization of 189 member countries, each of which has representation on the IMF's executive board in proportion to its financial importance, so that the most powerful countries in the global economy have the most voting power.
- International Monetary Fund (IMF) helps in global currency exchange stability, helps against balance of payment crisis.
- Acts as a reservoir of the currencies of all the member countries, from which a borrower nation can borrow the currency of other nations- using the Special Drawing Rights (SDR) mechanism.
- It thus strives to provide a systematic mechanism for foreign exchange transactions in order to foster investment and promote balanced global economic trade.
- IMF important decisions need to be passed with 85% majority. USA has 16.52% voting power so it can effectively block/veto it.
- 2020-May: IMF wanted to issue $500 billion fresh Special Drawing Rights (SDR) to help

member countries combat the corona crisis. But USA blocked it. India also supported the USA. India has 2.6% voting rights.

Q. Recently, which one of the following currencies has been proposed to be added to the basket of IMF's SDR? (CSE-2016)

a) Rouble
b) Rand
c) Indian Rupee
d) Renminbi

Facilities of IMF to lend money

Stand-by agreement

- Offers financing of a short - term balance of payments, usually between 12 to 18 months.

Extended fund facility (EFF)

- It is a medium-term arrangement by which countries can borrow a certain amount of money, typically over a three- to four-year period.

Poverty reduction and growth facility (PRGF)

- As the name implies, it aims to reduce poverty in the poorest of member countries while laying the foundations for economic development. Loans are administered with especially low interest rates.

Emergency Fund

- The IMF also offers emergency funds to collapsed economies, as it did for Korea during the 1997 financial crisis in Asia. The funds were injected into Korea's foreign reserves in order to boost the local currency, thereby helping the country avoid a damaging devaluation. Emergency funds can also be loaned to countries that have faced economic crisis as a result of a natural disaster.

Notable reports by IMF

- Global Financial Stability Report
- World Economic Outlook

Q. 'Global Financial Stability Report' is prepared by __________(CSE-2016)

a) European Central Bank

b) International Monetary Fund

c) International Bank for Reconstruction and Development

d) Organization for Economic Cooperation and Development

International Organisation

Q. Which of the following organizations brings out the publication known as 'World Economic Outlook'? (CSE-2014)

a) The International Monetary Fund
b) UN Development Programme
c) The World Economic Forum
d) The World Bank

General Agreement on Tariffs and Trade (GATT)

- It all began with trade in goods.
- From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important rules, particularly nondiscrimination.
- Since 1995, the updated GATT has become the WTO's umbrella agreement for trade in goods. General Agreement on Trade in Services (GATS)
- The General Agreement on Trade in Services (GATS) requires most- favoured-nation Treatment, market access commitments and national treatment.
- GATS was agreed upon at the end of the Uruguay Round negotiations with the participation of all Member nations including developing countries.

International Organisation

- The GATS covers a wide range of service industries such as financial services, transport and shipping, communications, construction, and distribution.

World Trade Organization

How WTO can help the world

- Stimulate economic growth and employment.
- Cut the cost of doing business internationally.
- Encourage good governance
- Help countries in development
- Support the environment issues
- Contribute to peace and stabilit

Principles of WTO:

- Most Favoured Nation (MFN)
- Treating other people equally
- National Treatment: Treating locals and foreigners equally
- Free trade: Gradually through negotiation
- Predictability: through binding and transparency. With stability and predictability, investment is encouraged
- Promising fair competition

International Organisation

- Encouraging Development and Economic Reform
- Special and differential treatment

WTO → Functions

- Today all countries try to protect domestic industries against foreign imports by creating two types of barriers against the international trade:

Tariff Barriers against international trade

- Increasing the taxes, duties, cess, surcharge, on imported goods and services e.g. Trump imposed 25% custom duty on imported steel.

CVD (Countervailing Duties)

- Two scenarios when foreign goods will appear cheaper to Indians than domestic goods:
- If foreign country is giving subsidies to their exporters and / or If Indian government imposes higher amount of taxes, cess or surcharge on the locally manufactured products then Indian Govt tries to protect local (domestic) industry by imposing Countervailing Duty (CVD), Special Countervailing Duty, Additional Customs Duty on imported items on imported items.

International Organisation

- These duties have been removed in India. Now imported items are subjected to [Basic Customs Duty + Social Welfare Surcharge on it] + IGST
- If China exports goods to India at a price below their normal price in domestic Chinese market or at a price below their cost of production- then it is termed as “Dumping”
- Then, India's commerce ministry → Directorate General of Trade Remedies : (DGTR) investigates → recommends.

Anti-Dumping Duty

- Finance ministry to impose “Anti-Dumping Duty” on such imported items.
- E.g. $185 on every one tonne of imported Chinese Steel, Then its prices will become equivalent to India Steel, thus Indian steel industry will be protected.
- Not yet abolished in India. They’re imposed subjected to WTO norms.

International Organisation

Non-Tariff Barriers against international trade

- If USA does not increase import taxes but plays other tricks like:

Subsidies to domestic industries

- Giving free electricity to Detroit car manufacturers. or USA govt. giving tax benefits & free car-insurance to American residents for buying American made cars.

Public Procurement

- Making rule that only American companies can fill up tender for supplying stationery, school bags etc. in government schemes.

Technical Barriers to Trade

- e.g. imported mango must have 0% pesticides residue, imported cars must have airbags for each passenger.

Quota system

- e.g. not more than 50 metric tonnes of steel can be imported from a single foreign country.

International Organisation

WTO Disputes Involving India Vs USA

India's Solar procurement preference

- USA argued India's Jawaharlal Nehru Solar Mission gave public procurement preference & subsidy to India - made solar panels thus creating a non-tariff barrier for American solar panels.
- India lost the case at WTO & forced to withdraw such barriers (2017).
- However, USA still alleges that India is playing mischief in solar schemes by giving preference to local manufacturers over American-made products (2018)

Ban on American Poultry

- In 2007, India had imposed the ban on American poultry under the Indian Livestock Importation Act, 1898 stating avian influenza / bird flu danger in India.
- USA claimed there was no scientific basis - India merely banning us to protect local poultry' business interest.
- WTO ruled in favour of USA (2016). But India has only allowed partial import of poultry from selected states of USA so, USA has demanded

$450 million compensation from Indian Govt. at WTO (2018).

India's export incentive schemes

2018

- USA complained to the WTO's Dispute Settlement Body (DSB) that India is running various export incentive schemes such as:
  - Merchandise Export from India Scheme (MEIS)
  - Export Oriented Units (EOU)
  - Export Promotion Capital Goods (EPCG).
  - Electronics Hardware Technology Parks (EHTP)
  - Special Economic Zone (SEZ)
- Under such schemes India gives tax reliefs / subsidies to its exporters. So, it is creating tariffs and non-tariff barriers against American companies, & thus India is violating the WTO Agreement on Subsidies and Countervailing Measures (SCM).

International Organisation

Q. In the context of which of the following do you sometimes find the terms 'amber box, blue box and green box' in the news? (CSE-2016)

a) WTO affairs

b) SAARC affairs

c) UNFCCC

d) India-EU negotiations

Q. The terms 'Agreement on Agriculture', 'SPS Agreement and 'Peace Clause' are in the context of affairs of the__________(CSE-2015)

a) Food and Agriculture Organization

b) UN Framework Conference on Climate Change

c) World Trade Organization

d) United Nations Environment Programme

Manufacturing And Industries

Importance Of Manufacturing

- Manufacturing industries not only help in modernising agriculture, which forms the backbone of our economy.
- Industrial development is a precondition for eradication of unemployment and poverty from our country.
- Export of manufactured goods expands trade and commerce, and brings in much needed foreign exchange.
- India's prosperity lies in increasing and diversifying its manufacturing industries as quickly as possible.

Contribution of Industry to National Economy

- Over the last two decades, the share of manufacturing sector has stagnated at 28 percent of GDP - out of a total of 28 per cent for the industry which includes 10 per cent for mining, quarrying, electricity and gas.
- This is much lower in comparison to some East Asian economies, where it is 30 to 35 per cent.

Manufacturing And Industries

Before LPG Reforms

1948

- First industrial policy by India's Minister for industries Shyama Prasad Mukherjee.

1956

- Industrial Policy Resolution. It focused on public sector led heavy industries (Oil, mining, shipbuilding, steel, chemicals, machinery manufacturing etc). PM Nehru presumed this will help in:
  - Employment generation
  - Self-reliance
  - Provide Raw material, intermediate goods and machinery to help other industries to produce consumer goods.

1991

- BoP crisis forces PM Narsimha Rao to launch New Industrial Policy with LPG reforms. Post LPG The contribution of secondary and tertiary in India's GDP & employment increased.

Manufacturing And Industries

Liberalization, Privatization And Globalization (LPG)

Liberalization

- Liberalization implies the withdrawal of controls and regulations by the government on the industries.

Till 1991

- Ministerial interference in the functioning of CPSEs led to fall in professionalism and inefficiency.
- License was mandatory for any private individual to start any industrial activity.
- Even on licensed industries, govt. would impose 'production quota'. Government would appoint inspectors to ensure the compliance.
- Outcomes - Delays, corruption, No ease of doing business.
- The big corporates were not allowed to enter in the sectors reserved for the Small Scale Industries (SSI) / MSME. For e.g. wax candles, glass bangles, steel almirah etc.

Manufacturing And Industries

After LPG Reforms

- Govt. signed Memorandum of Understanding (MoUs) with CPSEs granting them operational freedom through 'Ratna' status.
- Production quota & Inspector was abolished. Licenses required only for a selected number of industries. Namely,
    - Alcoholic drinks
    - Tobacco products
    - Electronic aerospace and Defence equipment
    - Industrial explosives, gun powder, nitrocellulose and matches;
    - Hazardous chemicals: Hydrocyanic acid, Phosgene, Isocyanates & their derivatives.
- For remaining sectors, a private entrepreneur can start the business by simplifying an Industrial Entrepreneur Memorandum (IEM) with Commerce Ministry (except for the industries reserved for public sector). The purpose of IEM is merely to collect data about investment, employment and industrial activities.
- Govt gradually shrunk this list. By the end of 2015, no item was reserved for SSI/MSME industries.

Manufacturing And Industries

Privatization

- Privatization implies allowing private sector to enter into the sectors which were previously reserved for public sector companies only;
- Converting public sector companies to private sector companies by reducing Government shareholding to below 50% (alternatively called as Strategic Disinvestment)

Till 1991

- Most of the industrial sectors were reserved for the public sector Industries only. This resulted into no competition, lack of innovation.
- Government would nationalise private sector industries in the national interest such as banking, insurance, aviation.

After LPG-reforms

- Only following industries are reserved for public sector undertakings:
  - Atomic Energy
  - Railway Transport
- Stopped the practice of nationalisation.

Manufacturing And Industries

- Private sector companies were allowed in Banking, Insurance, aviation, telecom and other sectors.

Globalization

- Globalization is a process in which nations allow free flow of goods, services, labour, capital investment, technology, ideas and innovations.

Till 1991

- Inward looking economy, Import substitution policy, variety of tariff and non-tariff barriers on the imported goods and services → problem of smuggling.
- Very strict controls on currency convertibility, foreign companies, and foreign investment.

After LPG-reforms

- India joined the WTO-regime, we gradually relaxed the tariff and non-tariff barriers on the imported goods and services.
- Norms were relaxed

Manufacturing And Industries

New Industrial Policy

- 1991 Our last industrial policy was made.
- 2017: Commerce ministry began formulating a New industrial policy for India focusing on the Fourth Industrial Revolution with six thematic areas viz.
  - Technology & Innovation: Govt to provide incentives for artificial intelligence, internet of things, and robotics.
  - Manufacturing & MSME,
  - Ease of Doing Business
  - Infrastructure & Investment
  - Trade & Fiscal Policy
  - Skills & Employability for Future
- 2019: This policy is awaiting cabinet approval.

National Investment & Manufacturing Zones (NIMZ):

- National Investment & Manufacturing Zones (NIMZs) are an important instrumentality of the manufacturing policy.
- The NIMZs are envisaged as integrated industrial townships with state of the art infrastructure; land use on the basis of zoning; clean and energy efficient technology; necessary social infrastructure; skill development facilities etc

to provide a productive environment for persons transitioning from the primary to the secondary and tertiary sectors.

- The policy is based on the principle of industrial growth in partnership with the States.
- The Central Government will create the enabling policy frame work, provide incentives for infrastructure development on a Public Private Partnership (PPP) basis through appropriate financing instruments, and State Governments will be encouraged to adopt the instrumentalities provided in the policy.

Industrial Corridors

- Industrial corridors offer effective integration between industry and infrastructure, leading to overall economic and social development.
- Industrial corridors constitute
  - High-speed transportation network – rail and road
  - Ports with state-of-the-art cargo handling equipment
  - Modern airports
  - Special economic regions/industrial areas

- Logistic parks/transhipment hubs
- Knowledge parks focused on catering to industrial needs
- Complementary infrastructure such as townships /real estate
- Other urban infrastructure along with enabling policy framework

- Commerce Ministry's National Industrial Corridor Development and Implementation Trust (NICDIT) is Nodal Agency.

Startup India (2016)

- Nodal Agency - Commerce Ministry.
- Startup company was defined originally as a company which is:
  - Not older than 7 years. (10 years if Biotech Company).
  - Doesn't have annual turnover above ₹ 25 crore.
  - Works towards innovation & development of goods / services.
- These norms were changed to 10 years for any company & upto 100 cr. Turnover in 2019-Feb.
- Under Startup India initiative such start-up companies are given 3 years exemption from Income Tax / Corporation Tax.

Manufacturing And Industries

- Self-certification permitted with respect to (WRT) EPFO act, ESIC Act etc.
- Relaxed norms in public procurement.
- Relaxed norms for exit i.e. winding up the companies.
- Govt established "Fund of Funds for Startups" (FFS) in Commerce Ministry. This fund will provide money to other startup related schemes.

Inflation

- Inflation is defined as a situation where there is sustained, unchecked increase in the general price level and a fall in the purchasing power of money. Thus, inflation is a condition of price rise. The reason for price rise can be classified under two main heads:
  - Increase in demand
  - Reduced supply.
- Deflation is inverse of above definition. Deflation occurs when the inflation rate falls below 0%.
- E.g. Suppose for Rs.100, last week you bought 10 pen. This means that the cost of 1 pen was Rs. 10. This week when you approached the same shop-keeper and paid Rs.100 to get 10 pen, he gave only 5 pen. He also explained that the price of pen has increased, and now the price of one pen is 20.

Inflation

Inflationary Gap

- It could have occurred because of:
  - ↑ Money supply
  - ↑ Propensity to consume
  - ↑ Investment expenditure
  - ↑ Fiscal deficit
  - ↑ NET exports
  - High growth → higher Aggregate demand → could lead to inflation

Deflationary Gap

- It could have occurred because of
  - ↓ Money supply
  - ↑ Propensity to save / Consumer delaying purchase with hopes of further fall in prices
  - ↓ Investment expenditure
  - ↑ Fiscal consolidation
  - ↓ Net exports
  - Depression / Recession that results into falling 'Aggregate demand'.

Inflation

Inflationary Spiral	When inflation increases, workers demand higher wages to keep up with the cost of living → firms pass these higher labor costs on to their customers → higher prices → more inflation → The cycle continues
Deflationary Spiral	Fall in prices → lower profit to firm → lower production, lower wages / workers laid off → lower demand → lower prices → and same cycle goes on

Inflation

Q. A rise in general level of prices may be caused by______________________________(CSE - 2013)

1. An increase in the money supply.
2. A decrease in the aggregate level of output.
3. An increase in the effective demand.

Answer:

(a) 1 only
(b) 1 and 2 only
(c) 2 and 3 only
(d) 1, 2 and 3

Q. Economic growth is usually coupled with______________________________(CSE - 2011)

a) Deflation
b) Inflation
c) Stagflation
d) Hyperinflation

Types of Inflation

Demand Pull Inflation

- It is "too much money chasing too much goods". Prices are rising because people have excess money → demands for goods and services exceeds the available supply.

Inflation

- MGNREGA, pay commission, PM KISAN scheme, Universal Basic Income (UBI) could result into this.

Monetary inflation

- When RBI printing of more money results in inflation.

Cost-Push Inflation

- Price rise due to increased cost of inputs e.g.
  - Expensive crude oil → higher costs for Transport Companies.
  - Trade / labour unions' protests / strikes → wage hike.
  - Natural disasters → Lower potato / chilly production → Chips

Profit - Push Inflation

- When Cartels / Monopolists / Oligopolists deliberately cut down the supply / production or hike the prices because of greed / profit motive.
- E.g. OPEC group oil production cut.

Inflation

Repressed Inflation

- During war, Govt imposes price controls and rationing to keep prices under check. But the moment such controls are withdrawn, prices will go up (because traders will want to cover up their previous losses by raising prices). This is called Repressed Inflation.

Stagflation

- Persistent high inflation, high unemployment and low growth resulting into a stagnant economy.

Skewflation

- Term to denote episodic price rise in one / small group of commodities while Inflation in the remaining goods and services remain usual.
- E.g. pulse / tomato / onion inflation in india.

Headline Inflation

- It is the measure of the total inflation within an economy, usually presented in the form of CPI or WPI.

Inflation

Core inflation

- Headline inflation minus inflation in food & energy articles. Accordingly, it can be CPI (Headline) or WPI (Headline).

Reflation

- Philip curve we learned that deflation → unemployment, so, RBI tries to stimulate economy by increasing the money supply, Govt tries to give 'fiscal stimulus' by reducing taxes / increasing public procurement
- Such actions take economy from deflationary path towards inflation path, this is process is 'Reflation'.

Structural Inflation

- Inflation that is part of a particular economic system. A complete change in economic policy would be needed to get rid of it.

Imported inflation:

- Country depends on imports has its prices rising due to exchange rate.

Inflation

Q. Which one of the following is likely to be the most inflationary in its effect? (CSE - 2013)

a) Repayment of public debt

b) Borrowing from the public to finance a budget deficit

c) Borrowing from banks to finance a budget deficit

d) Creating new money to finance a budget deficit

Base Effect of Inflation

- Suppose price of 1 kg tomatoes = 100 (2010), 110 (2011), 120 (2012). So, as such their price is increasing at the rate of ₹ 10 per year.
- However, the percentage rise in inflation over previous year is 10% for 2011 (110 vs 100), and 9.09% for 2012 (120 vs 110).
- Thus, the choice of base (denominator) could make the inflation look too high or too low even if the price rise has been same as the same.

Inflation

Q. A rapid increase in the rate of inflation is sometimes attributed to the "base effect". What is "base effect"? (CSE-2011)

a) It is the impact of drastic deficiency in supply due to failure of crops

b) It is the impact of the surge in demand due to rapid economic growth

c) It is the impact of the price levels of previous year on the calculation of inflation rate

d) None of the statements

Combating Inflation Or Deflation

Agency	Fighting inflation	Fighting deflation
RBI	Tight or dear Monetary Policy to make the loans expensive	Cheap or Easy to make loans cheaper
Govt	Tax deduction / exemption / subsidy benefits towards producers to decrease the cost of production. Curtailing Fiscal Deficit.	Tax deduction / exemption /subsidy type benefits to consumers to encourage purchase / consumption.

Inflation

Agency	Fighting inflation	Fighting deflation
Govt	Curtailing schemes and subsidies that are increasing money in the hands of beneficiary without increasing production. Ordering RBI to issue inflation Indexed Bonds, Sovereign Gold Bonds Essential commodities act, Stock limits, minimum export price, FCI's Open Market Sale Scheme, Operation Greens for TOP, Price stabilisation fund, Offering higher MSP to farmers to increase cultivation of a particular crop etc.	(e.g. cut GST on Television, Computers, Cars) Increasing the expenditure on public projects e.g. highway, dam etc. to boost demand in steel / cement industry → workers get money → demand → towards inflation

Inflation

Inflation Indices

Inflation Index	Agency	Base year
Consumer Price Index: • Rural • Urban • All India	NSO, MoSPI	2012
Consumer Food Price Index (CFPI)		2012
CPI Industrial Workers (IW)	Labour Ministry's Labour Bureau	2001
CPI Rural labourers (RL), Agri. labourers (AL)		1986
Wholesale Price Index (WPI)	Economic Advisor to DPIIT, Commerce Ministry	2011

Inflation

CPI (All India), NSO and Base Year: 2012

Monthly CPI Components in (All India) Index → (decreasing order)	Weight
Food & Beverages	45.86
Services: (Transport & communication > Health > Education > Recreation)	20.62
Housing	10.07
Fuel & Light	6.84
Clothing / footwear	6.53
Misc. Personal care (soap etc)	3.89
Household goods & Services	3.80
Pan Masala, Tobacco, Intoxicants	2.38
Total Weight	100

For Individual CPI for Urban and Rural areas, these weights are assigned differently.

E.g. CPI rural has zero weight to housing & 54.18 weight to food and beverages.

Headline CPI	The inflation figure arrived based on all of the above components of CPI (All India).
Core CPI	Headline CPI Minus Inflation in food & energy)

Inflation

Wholesale Price Index, EA-DPIIT, Base: 2011

Monthly WPI Components in descending order→	Wt.
Manufactured products: Processed Food, Edible Oil, Paper Products, Chemicals, Plastic, Cement, Metal Products, Transport Equipments etc.	~64%
Primary Articles: A. (Unprocessed) food articles, eggs, meat-fishes, oil seeds etc. (~19%) B. Crude Petroleum (~2%) C. Minerals (~0.8%)	~23%
Fuel & Power: High Speed Diesel (HSD) > Petrol > LPG	~13%
Total	**100%**

Index of Industrial Production (IIP)

- IIP is a monthly index prepared by CSO, Base Year 2011 and Laspeyres Index Formula. IIP measures production of 407 item groups related to
  1. Primary goods: Directly obtained from natural sources e.g. Ores, Minerals, Crude Oil; And energy goods such as Petrol, Diesel, Electricity (Both Renewable and Non-Renewable).

Inflation

2. **Capital goods:** Plants & machinery used for further production e.g. Boilers, Air & Gas Compressors, Engines, Transformers, Commercial Vehicles etc.
3. **Infrastructure/construction goods.** E.g. Paints, cement, cables, bricks and tiles, rail materials, etc.
4. **Intermediate goods** which goes as input in production e.g. Cotton yarn, Plywood, Steel Tubes/ Pipes, Fasteners, etc.
5. **Consumer durables:** Products directly used by consumers and having a longer durability (2 years or more). E.g. Pressure Cooker, TV, AC, Tyres, Telephone , Mobile, Cars, Motorcycles, Scooters, Jewellery, etc.
6. **Consumer non-durables:** Products that are directly used by consumers and can't be preserved for long periods. e.g. Soyabean Oil, Milk Powder, Maida, Rice, Biscuits, Sugar, Tea, Cigarettes etc.

Inflation

Q. In the 'Index of Eight Core Industries', which one of the following is given the highest weight? (CSE2015)

a) Coal production

b) Electricity generation

c) Fertilizer production

d) Steel production

Q. Which of the following are among the 8 Core Industries of IIP?________________(CSE-2012)

1.Cement

2.Fertilizers

3.Natural Gas

4.Refinery products

5.Textiles

Answer Codes

(a) 1 and 5 only

(b) 2, 3 and 4 only

(c) 1, 2, 3 and 4 only

(d) 1, 2, 3, 4 and 5

Unemployment

Unemployment

- Unemployment refers to a situation where a person of working age who is looking for work is unable to find employment.
- According to the Bureau of Labour Statistics, for someone to be termed as unemployed, they have to meet these three conditions
  - They do not have any job, not even a temporary or part-time job.
  - They are currently available for work.
  - They have actively searched for a job in the past four weeks.
- According to BLS (Bureau of Labor Statistics), people who have stopped looking for work are not regarded as unemployed.
- They are not even counted as part of the labor force.
- If, for example, an unemployed person wins some money through the lottery and stops looking for work as they enjoy their new found wealth, that person is not considered as unemployed.

Unemployment

Types of Involuntary Unemployment

Types	Features
Cyclical	• Economy goes through boom-bust cycles. • During bust / recession / depression when workers are laid off on mass scale. • Cyclical unemployment exists when individuals lose their jobs as a result of a downturn in aggregate demand (Total demand).If the decline in aggregate demand is persistent, and the unemployment long term, it is called either Demand Deficient Unemployment in general, or Keynesian unemployment. • E.g. Maruti removed 3000 workers in 2019- Aug because car sales are dip.
Frictional	• Frictional unemployment, also called search unemployment, occurs when workers lose their current job and are in the process of finding another one.

Unemployment

Types	Features
	• There may be little that can be done to reduce this type of unemployment, other than provide better information to reduce the search time. • This suggests that zero unemployment is impossible at any one time because some workers will always be in the process of changing jobs.
Disguised Unemployment	• It is a form of unemployment where it may seem that some people are employed, when in fact they are not. Also referred as hidden unemployment • Common in developing countries where increasing populations result in a surplus in the labor force, where employees are working in a redundant manner. • E.g. Farming family of 6 persons produces 400kgs of wheat, but even if you remove 3 persons still production remains at 400kgs of wheat.

Unemployment

Types	Features
Seasonal	• Labourers in Agriculture, Salt-pans, Sugar Mills, Ice- factory, Tourist spots, Marriage Catering-Orchestra etc.
Under employment or Educated unemployment	• Person is employed but not in a befitting position or salary corresponding to his qualification. • e.g. M.Com working as peon in MNCs, M. Tech working as Bank clerk etc.
Technological Unemployment	• Technological unemployment occurs when men are replaced with machines e.g. Textile / Automobile. • 2018-Sept: World Economic Forum released “Future of Jobs Report”. It says, by 2025, machines will do more work hours than humans in 12 industrial sectors. As a result, 75 million worker jobs may be lost, but 133 million new jobs may emerge in robot repair/robot software design etc. Hence urgently workers need to be reskilled.

Unemployment

Types	Features
Open / Structural Unemployment	• Structural unemployment occurs when certain industries decline because of long term changes in market conditions creates a mismatch between the skills needed by employers and the skills that workers possess. • Lack of jobs when person's skill/qualification is insufficient for the jobs available in the market • e.g. An IT Graduate knows machine design but demand is for Catia pro experts.

Unemployment

Q. Disguised unemployment generally means______ (CSE-2013)

a) large number of people remain unemployed
b) alternative employment is not available
c) marginal productivity of labour is zero
d) productivity of workers is low

Reasons For Unemployment

- Economic slowdown: Currently, sectors like auto, real estate, banking, construction, agriculture and MSMEs - which contribute a considerable amount towards India's GDP - are facing a sharp demand slowdown.
- Preference of voluntary unemployment: Voluntary unemployment is preferred over low paying jobs (i.e. adopting the 'wait-and-watch' policy for the right job profile and remuneration.
- Downgrading of employment i.e. hiring of candidates, with higher but superfluous qualifications, for elementary positions (e.g. news reports of PhD holders applying for peon vacancies).

Unemployment

- Lack of Industry-Academia cohesion: Disparity between colleges'/universities' curriculums and industry requirements/ expectations.
- Lack of vocational training which renders many unemployable.

Government Steps for employment generation

- MUDRA Bank Micro Units Development Refinance Agency (MUDRA) Bank
- Start Up India and Stand Up India Schemes
- Make in India Program profile and remuneration.
- The apparel and garments sector received a special package
- Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA)

Unemployment Rate (UR)

- Labour force → Those who are 'working' (or employed) and those 'seeking or available for work' (may called as involuntarily unemployed).
- Unemployment rate finds involuntarily unemployed persons via following formula:

$$U = \frac{\text{Unemployed People}}{\text{Labor Force}} \times 100$$

Unemployment

Current Weekly Status	• If not employed even 1hr work in a week.
Current Daily Status	• If not employed even 1hr work in a day in a given week.

Usual Status (US)	• It's further subdivided into:
	  ○ Principal Activity Status (PS)
	  ○ Subsidiary Economic Activity Status (SS)
	• If person's usual status (PP+SS) was "Unemployed" for majority of the year → he is deemed unemployed.
	• In official reports, this figure is given more prominence.
	• 2019-Jun: NSSO's periodic labour force survey (PLFS) says unemployment rate is 6.1% as per (US PS+SS: 2017) which is highest in last 45 years.

Unemployment

Worker Population Ration(WPR)

- It is the percentage of employed persons in the population

$$WPR = \frac{no.\,of\,employed/Persons}{Total\,population} X1000$$

Labour Force Participation Rate (LFPR)

- LFPR is the percentage of a persons in labour force (i.e. working or seeking or available for work) in the population.

$$LFPR = \frac{\begin{array}{c} no.\,of\,employed + \\ no.\,of\,unemployed\,persons \end{array}}{Total\,population} X1000$$

Infrastructure

- Infrastructure is the set of basic facilities that help an economy to function & grow such as energy, irrigation, roads, railway & telecommunication.
- Infrastructure is the 'lifeline' of an economy as protein is the lifeline of the human body.

Infrastructure : Mining And Basic Industries

- Basic industries are industries which supply their products to manufacture other goods.
- Examples: Iron and steel, copper, aluminium, chemical etc.

Capital goods industries

- Goods that are used in producing other goods
- E.g. textile machinery, conveyor belts, mining equipment etc.

Heavy industries

- Producing large and heavy products
- E.g. Ship building, bulldozers, industrial machinery, electric transformers etc.

Infrastructure

Investment Models

- Infrastructure projects require large amount of investment. Govt alone can't finance it due to fiscal deficit targets.
- Such projects also require the level of technical expertise, management skills and professionalism that may not be available in the traditional bureaucratic apparatus.
- Therefore, Infrastructure investment / development has to be done through:
  - PPP: BoT , BOOT
  - Non-PPP: such as EPC, Outsourcing (Contracting-Out)
  - Hybrid Annuity Model

PPP (Public Private Partnership)

- PPP is a long-term contract between a public sector organization (Union/State/Local Body/PSU) and a private sector company:
  - to build a public infrastructure (highway, ports etc.) or
  - to provide a public utility service (electricity, gas, water, transport, health etc.)

Infrastructure

- In such PPP contract the ownership, risks & rewards are shared in some fashion. (Unlike privatization where it's completely transferred from public sector to private sector)
- PPP can be
    - For a Greenfield project: e.g. GMR group building fresh new airport in Hyderabad. Or
    - for a Brownfield project e.g. Private companies upgrading the existing airports at Delhi and Mumbai.
    - Done by forming a Joint Venture (50:50) or Special Purpose Vehicle (SPV) company with equity from public and private sector.
    - Done by Govt granting 'Concession / lease / licence / permit' (a legal right) to private company (Concessionaire) to design, develop, finance, construct, operate, maintain a greenfield / brownfield infrastructure asset.

PPP (Greenfield) Models

- Build-Operate-Transfer(BoT)
- Design-Build-Finance-Operate(DBFO)

Infrastructure

PPP (Brownfield)

Build-Lease-Transfer (BLT)

- Usually associated with brownfield projects e.g. Govt owned existing airport is leased to private player for operation, he renovates it and charges user fees for same.
- After the contact period is over / investment recovered then govt again assumes operational responsibilities (or gets another private player). Thus Govt remains the owner in perpetuity.

Toll-Operate-Transfer (TOT)

- Private player pays upfront fees (e.g. ₹ 15000 crore) to the government to obtain the 'right to collect toll' on an existing road (brownfield) for a fixed period (e.g. 50 years).
- Advantages:
  - To Government: we got upfront money to finance schemes or build new roads; no need to pay salary of those toll-booth employees.
  - To private player: we will make profit depending on how much traffic comes
- 2018: NHAI award projects worth 680+ kms in Andhra Pradesh and Gujarat.

Infrastructure

Non-PPP

- In these models, the private player is not given ownership of infrastructure or right to collect toll/user fee at any point of time. So, they're not PPP. Notable examples are:
    - Engineering, Procurement and Construction (EPC)
    - Outsourcing or Contracting out

Parameters	PPP models	Non PPP models
Owner	Private player owns until contract time expired/ his investment recovered.	Govt owns in perpetuity.
Who is the responsible for maintenance?	Private player	Private player
Toll/Fees collecting Authority	Private player	Govt pays the private player. Govt itself will collect user fees.

Infrastructure

Government - Owned Contractor - Operated (GOCO) model

- GOCO model: private contractors operate the army's base workshops that repair equipment from guns and vehicles to tanks and helicopters.
- Government remains the owner of the ABW workshop or COD depot
- But a private player is given a contract to take over the operation or running of such a workshop or depot. He will be responsible for warehousing operations, transportation of material, repair, maintenance etc.
- He will have to absorb the existing civilian employees working there.
- Private player must be an Indian registered company with at least 10 years of working experience & "y" crore of turnover.

Hybrid Annuity Model (HAM)

- HAM is mix of PPP and Non-PPP models.
- 2016: Introduced for highway projects in India. Suppose the cost to build a new highway is INR 1000, then.

Infrastructure

- ₹ 400: Govt pays in phased manner (as road construction progresses).
- ₹ 600: private player arranges from his pocket and / or market borrowing.
- Once the highway is finished, Govt (NHAI) starts collecting toll → pay the private player at regular interval (called as annuity) till the private player recovers ₹ (60+some profit).

Swiss Challenge

- Without waiting for the government advertisement, suppose a private company sends a suo-moto or unsolicited proposal to develop a railway station.
- Government puts it online so other private companies can challenge it.
- In 2015, While Govt of India was considering to allow Swiss challenge method for infrastructure development, but Vijay Kelkar committee on PPP reforms suggested not to do it.
- Because there is a scope for non-transparency and collusion.

Infrastructure

Viability Gap Funding (VGF)

- Sometimes, the project is justifiable from social welfare and human development point of view but it's not financially profitable or viable e.g. solar panels in remote villages, or airport in Ladakh/Lakshadweep.
- Then, Union Government / Multilateral Bank may provide grant (not Loan) in the form of Viability Gap Funding (VGF).

National Investment and Infrastructure Fund (NIIF: 2015)

- Total Corpus is INR 40,000 crore. Out of that 49% from Dept of Economic Affairs (Finance Ministry), remaining by domestic & foreign investors & financial intermediaries.
- SEBI registered NIIF as Category II Alternative Investment Funds.
- NIIF is 'fund of funds' → gives funding to other funds. E.g. 2017: India & UK set up Green Growth Equity Fund (GGEF) to finance green infrastructure projects in India. So, from Indian side NIIF invested money in GGEF.

Infrastructure

National Infrastructure Pipeline (NIP):

- 15th Aug, 2019: PM Modi announced Rs.100 lakh crore would be invested on infrastructure over the next five years.
- 2019-Sept: Finance Ministry set up a task force under the Secretary of Dept of Economic Affairs (DEA). Based on its report,
- 2019-Dec: FM Nirmala S. announced NIP. It aims to mobilize 102 lakh crore worth infrastructure investment in the next five year (2019-20 to 2024- 25)
- This funding will be spread across Energy (24%), Roads (19%), Urban (16%), Railways (13%), Irrigation (7%) etc.
- Further, the Government will also initiate following reforms: Infra Finance Reforms