TEERTHANKER MAHAVEER UNIVERSITY
MORADABAD, INDIA

CENTRE FOR ONLINE & DISTANCE LEARNING

Accredited with NAAC A Grade

12-B Status from UGC

Programme: Bachelor of Commerce

Course: Money & Banking

Course Code: BCPCC203

Semester-II

SYLLABUS

Objective and Expected Outcome of the Course

This course aims to help students to understand the concepts, policy framework and environment of Money Market, Banking and International Trade.

UNIT I

Money: Meaning and definition, features, functions and kinds/forms of money; Supply of money: mechanics of money supply, Measures of money supply in India. Demand For Money: Factors determining demand for money, Fisher, Cambridge, Keynesian and Freidman theories of money. **Rate of Interest:** Meaning and Definition, Determination, Factors affecting the level and structure of Interest Rates. An overview of interest rate structure in India. **Introduction to Money Markets**, Type of money market securities traded in India, Characteristics of Indian Money Market, its strengths and weaknesses.

UNIT II

Banking: Introduction, Types of banks, Functions, safety-liquidity-profitability trade off; **Central Banking:** Functions and techniques of credit control. Monetary policy: Objectives, Targets and indicators. **Reserve Bank of India: Role and Functions**. Commercial Banking in India; structure and functioning; Role of Commercial Banks in Economic Development. **Banking Sector Reforms in India** and Latest Developments in Banking Sector in India. Prudential Norms for Income Recognition, Provisioning for Bad and Doubtful Debts, Capital Adequacy and concentration of credit/Investments.

UNIT III

Innovations in Banking: Internet Banking, E-Banking, Mobile banking, Wholesale and Retail Banking, Universal and Narrow Banking, Off-shore Banking. Asset. Classification, Non-Performing Assets. **International Trade:** Meaning, features, importance and implications for the developing countries. India's foreign trade policy during the post reforms. Composition and recent trends in foreign trade with special reference to India. Balance of payments situation during the post reform period. Recent changes in India's export and import policies. Organizations and institutions involved in export and import management.

UNIT IV

Regulation of International Trade in India. EXIM Policy and Foreign Exchange Management

Act (FEMA), 1999. Introduction to General Agreement on Tariffs and Trade (GATT)/World Trade Organisation (WTO): Trade Related Investment Measures (TRIMS) and its implications; Agreement on Agriculture (AOA) and its implications ; General Agreement on Trade in Services (GATS) and its implications; Trade Related Intellectual Property Rights (TRIPS) and its implications with special references to India. Recent Development under the Ministerial Conferences.

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Chapter 1- Introduction to Money

Structure

1.1 Objectives

- ❖ To understand the concept of Money and its features worldly desires
- ❖ To study the concept of money supply and its mechanism
- ❖ To understand the measures of money supply in India

1.2 Introduction

Anything which has the power to buy goods and services and is generally accepted in exchange of an economic transaction is known as Money. The world does exist with the necessities and desires. Necessities refer to the basic requirements to live a life while desires indicate a hunger for having more. These both are the features of materialistic world. In a materialistic world, everybody is doing economic transaction for their objectives. A business is selling goods and services, a teacher is teaching in an institution, a professional is rendering his services, workers are working in factory, all office work is being carried out by the people are some of its examples. If you identify, these all examples are common in a way that they all are striving to get something which could fulfill their necessities and desires. This 'something' should have a feature of global acceptability, power to exchange all type of goods and services and store of value in order to serve the individual in his future. The world knows this 'something' with the name called 'money'.

1.3 Evolution of Money

The word 'money' has been derived from the Latin word 'Moneta' which represents the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in ancient times. Even the primitive man was having some sort of money and in every age, the type of money depended on the nature of its livelihood. For example hunting society used the skins of wild animals, the agricultural society used grains and foodstuffs and where as the pastoral society used livestock as money. The Greeks used coins as money. Thus, in every period three was something which can be used as exchange and termed as money. The origin of money is deep rooted in antiquity as there is no recorded information regarding development of money. It is one of the most significant inventions of mankind. But the development of money has passed through various stages in accordance with the growth of human mankind.

The world witnessed various forms of this money. At one time exchange of goods and services was exchange took place through barter system. Barter means exchange of goods for purchasing other goods. Thus, barter system means exchanging of goods without the money. For example, apple may be exchanged for orange, building for horse, etc. Thus, in the barter system one has to give up some kind of goods in order to get some other kind of good. With the development of society, direct exchange between various commodities created difficulties. The first most requirement of barter system is double coincidence of wants. It means that two persons can have barter exchange only if they both desire to exchange goods coincide. Such requirement cannot be possible in developing society. Moreover there is no common measure of value or unit of account.

This led to emergence of use of another form of money in which one commodity like gold for the exchange. As the society begins to grow, exchange through these two methods started becoming more and more difficult. In the case of exchange, the people did need a particular good which the other party did not have. On the other hand, using a commodity as medium of exchange found its own problems like scarcity, quality, and safety of that particular commodity. Over all, the above two methods lacked the basic features like global acceptability, power to exchange and store of value. This all led the materialistic world to identify a unique solution of this problem.

This all gave birth to paper money. All efforts were made to add the basic features in it.

1.3.1 Stages in the evolution of money

Depending upon the progress of human civilization at different times and places the evolution of money has passed through the following five stages:

1. Commodity money

Various types of commodities have been used as money from the beginning of human civilization. In the period of hunting society, Stones, spears, skins, bows and arrows, and axes were used as money. The pastoral society used cattle as money where as the agricultural society used grains and food stuffs as money. Depending upon the place and standard of the society precious stones, tobacco, tea shells, fishhooks and many other commodities served as money at different times.

2. Metallic money

With the development of human civilization and with the increase in trade relations by land and sea, metallic money was preferred over the place of commodity money. Many nations started using metallic money, i.e. silver, gold, copper, tin, etc. But metal was an inconvenient thing to accept, weigh, divide and assess in quality. Observing this weakness of metallic money, King Midas of Lydia in the eighth century B.C. innovated gold coins which were of predetermined weight. Thus coins came to be accepted as convenient method of exchange. But as the price of gold began to increase, instead of used them as money, people start melting them in order to earn more by selling them as metal. Since the intrinsic value of gold coins might be more than their face value, this led governments to mix copper or silver in gold coins. As gold became costlier and scarce, silver coins were used as metallic money, first in their pure form and later on mixed with alloy or some other metal.

3. Paper money

The development of paper money started with goldsmiths who kept strong safes to store their gold. People started keeping their gold with them for safe custody As goldsmiths were thought to be honest merchants, In return, the goldsmiths issued a receipt to the depositor promising to return the gold on demand. These receipts were further used by the buyer of commodities to make payment to sellers. Such receipts were backed by gold and thus can be easily converted into gold on demand. This ultimately led to the development of bank notes which were issued by the central bank of the country. With the rise in the demand for gold and silver, their prices also increased. Thus during the beginning and after the First World War in all the countries of the world, the convertibility of bank notes into gold and silver was gradually given up. Since then the bank money has ceased to be representative money and is simply 'fiat money' which is inconvertible and is accepted as money because it is backed by law.

4. Credit money

The use of the cheque as money is another stage in the evolution of money in the modern world. The cheque is like a bank note in that it performs the same function. It refers to means of transferring money or obligations from one person to another. But a cheque is different from a bank note as in cheque specific sum is made and it expires once the transaction is finished where as paper currency cannot get expired. It is simply a written order to transfer money. However, in the present times, large transactions are made through cheques and bank notes are used only for small transactions.

5. Near money

The final stage in the evolution of money is near money. Near money is highly liquid which can be easily converted into cash as and when required. Examples of near money are bills of exchange, treasury bills, bonds, debentures, savings certificates, etc. They refers to close substitutes for money and are liquid assets. Thus, in the final stage of evolution of money, money became intangible as it's ownership is only transferred simply by book entry.

In short, the character of money has undergone a drastic change during the long process of evolution. In the present times, paper money, credit money and near money used everywhere. As commodity money and metallic money due to their drawbacks have been obsolete and are rarely existed in the present world. But the evolution of money is a continuous process and shall continue to be so.

1.4 Meaning of Money

Money is an important and indispensable element of modern times. In ordinary language, Money refers to ***<u>What we use to pay for things</u>***. For a layman, in India, the *rupee* is the money. Similarly in the America, *Dollar* is the money. But for economist, rupee, dollar are just the different units of money. Thus, Money is anything which is generally acceptable as a medium of exchange that has both legally and socially accepted by people with regards to making payment for buying commodities or receiving services.

1.4.1 Definition of Money

It is very difficult to give a precise definition of money. Various authors have given different definition of money.

According to **Crowther,** "Money can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value".

Professor **D H Robertson** defines money as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations.

From the above two definitions of money two important features can be highlighted about it. First, money has been defined in terms of the functions it performs as some economists defined money as "money is what money does". Second, an essential requirement of any kind of money is that it must be acceptable to every member of the society. General acceptability refers to a social phenomenon which is conferred upon a good when the society by law or convention adopts it as a medium of exchange. Money has a value for 'X' only when he thinks that 'Y' will accept it in exchange for the goods. And money is useful for 'Y' only when he is confident that 'Z' will accept it in settlement of payment.

1.4.1 Approaches to the Definition of Money:

The following four approaches to the definition of money are discussed below:

1. **Traditional Approach:** This approach considers money as a medium of exchange. Money has the characteristics like spending, liquidity, etc.

   As per this approach, money includes:

   $$M=C+DD$$

   C: Currency with the public which includes notes and coins of all denominations in circulation excluding cash in hand with banks (C) and;

   DD: Demand deposits with commercial and co-operative banks, excluding inter-bank deposits (DD)

2. **Monetarist Approach:** Friedman and other theorists like Anna J. Schwartz, Karl Brunner, Phillip D. Cagan, Harry G. Johnson and Allan H. Meltzer David Laidler gave this concept of money. According to them money can be defined as "a temporary abode of purchasing power." Temporary abode means

keeping your funds in near money and temporarily sacrificing your present purchasing ability. Thus, if one keeps fund in time deposits then that person has to first convert this deposit into cash and then only he/she can purchase. This definition includes time deposits with currency and demand deposits.

M=C+DD+TD

Thus, this definition includes traditional view plus time deposits (TD). Time deposit is an interest-bearing bank deposit that has a specified date of maturity.

3. **Liquidity Approach:** Liquidity means which can be converted into cash as and when required. Thus the focus of this approach is that it defines money in terms of liquidity. According to this approach, money supply included not only deposits of the commercial banks but also liabilities of non- banking intermediaries such as shares and bonds which plays an important role in liquidity of the economy.

   This definition defines money supply as:

   M=C+DD+TD+SB+S+B

   This definition comprises of monetarist's view plus saving bank deposits (SB), shares(S), bonds(B), etc. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company.

4. **The Central Bank Approach:** According to this approach, money includes monetarists view plus credit from non- banking financial institutions (NBFI) and credit from unorganized agencies (UA). This approach considered money as the total amount of credit extended by various modes and defines as:

   M=C+DD+TD+NBFI+UA

This definition has wider scope as compared to the monetarist approach and liquidity approach as they also added credit from unorganized agencies. These are the unincorporated private enterprises owned by individuals or households engaged in the financial services operated on a proprietary or partnership basis and with less than ten total workers.

Hence, this approach takes further step in increasing the scope of constituents of money.

1.5 Features of Money

For being known as money, it must carry some basic features in the absence of which, it would lose its status. The following are the features:

▪ **Divisibility —** Money must be easily divided into small units so that people can purchase goods and services at any price. People can use a Rs 1000 note to purchase chair or they can even use Re1 note to purchase candy. According to their requirement, they can divide the money

▪ **Transportability —** Money serves the feature of transportability or portability in the terms of easiness to carry. When people went to the market to buy something, then they need to bring with their money. But to "bring with their money" they obviously need to have money. That is, the money must be transportable.

▪ **Acceptability —** Money serves a medium of exchange as it is universally accepted by the public. This acceptance is for the purpose of the exchange of money for goods and different types of services.

▪ **Durability —** Money stays the same in shape and size over the long period and hence serves the characteristic of durability. Because of its durability, individuals are willing to take it as a form of payment as it can be further use for purchasing another goods or services.

▪ **Stability —** Money's value must remain relatively constant over long periods of time.

1.6 Functions of Money

The major functions of money can be classified into three broad groups. These are: The primary functions, secondary functions and contingent functions.

I. Primary functions of money

The primary functions of money are;

- Medium of exchange and
- Measure of value

1. Medium of exchange

The most important function of money is that it serves as a medium of exchange or means of payment. To be successful medium of exchange, money can be accepted by all people to be used for exchange of goods and services. In the barter period, people used to exchange commodities for commodities. But the barter system had experienced many difficulties with regard to the exchange of goods and services. One of the common difficulties is requirement of 'double coincidence of wants' to undertake any exchange. Money overcomes this problem.

Now a person X can sell his goods to Y for money and then he can use that money to further buy the goods that he wants from others who have these goods. There will be no difficulty in the process of exchange, as long as money is generally acceptable.

2. Measure of value

Another important function of money is that the money serves as a common measure of value in terms of which the value of all goods and services is measured and expressed. Another difficulty of barter system was that there was no common measure of value and the value of different goods were measured and compared with each other. Money has again removed this difficulty and serves as a basis for measuring the value of goods and services.
As the value of all goods and services are measured in terms of money, their relative values can be easily measured and compared.

II. Secondary functions

The secondary functions of money are as follows:

1. Standard of deferred payments

Money serves the function of standard for deferred payments. Deferred payments are those payments which are to be made in future. Let us suppose that, Mr. X has taken a loan today, and then he would be paid back after a period of time. It means that a person who has taken loan today is obliged to pay that loan in future. Thus it is essential to measure the amount of loan in some common unit and then payment is also made equivalent to that measure. So the amount of loan is measured in terms of money and it is paid back in money. Being the value of money remains more or less stable, thus it performs this function of standard of deferred payments. With the change in prices, the value of money also changes. For example, fall in price leads to increase in value of money and as a result, the creditors will gain in real terms and the debtors will lose. On the contrary, rise in prices leads to fall in value of money and as a result creditors will be the losers and debtors will be the gainers. Thus, value of money must remain stable to serve as a fair and correct standard of deferred payments.

2. Store of value

Money serves the function of store of value. Money is the most liquid asset among all assets and thus it is a convenient form store wealth. Money is used to store wealth without causing deterioration or wastage. Being the characteristic of most liquid, it gives the advantage to an individual or a firm that they can buy with it anything at any time. But this feature is not in the case with other assets like buildings, shares, etc. These have to be sold first and then they converted into money and only then they can be used to buy anything.

In short, money has overcome the difficulties of barter system, which were- lack of double coincidence of wants, lack of measure and store of value and lack of a standard of deferred payment.

III. Contingent functions

The important contingent functions of money are as follows;

1. Basis of credit

Credit is an important requirement for any economy. People deposit their money in banks and on the basis of these deposits, bank create credit. Thus, with the development of money market the credit market began to flourish.

2. Distribution of national income

Money, being a common measure of value, facilitates the distribution of the national income among the four factors of production.

3. Transfer of value

Through money, value can be easily transferred from one place to another like bank draft, NEFT, RTGS, etc.

4. Medium of compensations

Money also serves as a medium of compensation as compensation can be paid to damages of Accidents and carelessness in terms of money.

5. Liquidity

Money is the most liquid form among all assets. Liquidity means the individual can purchase anything at any time without converting into any other instrument. Being the feature of general acceptability, it provides the ready purchasing power to any commodity.

6. Money guide in production and consumption.

While studying production and consumption function, we expressed utility of goods and services in terms of money. Thus money directs the production and consumption as it become the base of measurement.

1.7 Forms of money

In the modern times, money can be broadly classified into three main forms:

a) Metallic money
b) Paper money
c) Credit money

But Economists classify form of money into many other forms. Important classifications of money are explained below:

a) Money of account

Money of account is basically the currency of the country. It is the monetary unit in terms of which the transactions of a country are recorded and settled, ie., in which general purchasing power, debts and prices are expressed. For example, the rupee is our money of account. Sterling is the money of account of Great Britain and similarly mark is of Germany. However, Money of account need not be equivalent to money circulating in the country. In India, money of account, i.e. rupee is issued in two forms- metallic money and paper money. When we talk about notes then it is paper money and when we talk about coins then it is metallic money.

b) Metallic Money

The money made of metal is called metallic money. It refers to the coins made out of various metals like gold, silver, bronze, nickel, etc. A coin is a piece of metal of standardized size, shape, weight and fineness whose value is approved by government. Metallic money is of two types:

i) Standard money

Standard money is one in which the value of goods as well as all other forms of money are measured. In India prices of all goods are measured in terms of rupees. Moreover, the other forms of money such as half-rupee notes, one rupee notes, two rupee notes, five rupee notes etc. are expressed in terms of rupees. Thus rupee is the standard money of India. Standard money is always made the unlimited legal tender money. Standard money is full bodied money whose face value is equal to its intrinsic value. But this was in old days. Now-a- days standard money is only a ***token money*** whose intrinsic value is very much less than the face value written in it.

ii) Token money

Token money is a form of money in which the intrinsic value of which is much less than its face value. In India, rupees and all other coins are all token money.

c) Limited and unlimited legal tender

Money which is enforced by law is called legal tender money. So its acceptance is compulsory for all individuals. It is an offence, if anyone, refuses to accept payment in legal tender money. Thus a legal tender currency is one in which one can paid debts legally.

Unlimited legal tender is that money which has to be accepted as a medium of payment upto any amount. In other words, a currency is unlimited legal tender when debts upon any amount can be paid through it. For example, rupee coins and rupee notes are examples of unlimited legal tender in India. Any amount of transaction can be made by using these denominations. But coins of 25 or 50 paisa are only limited legal tender (up to Rs.25/-). One can refuse to receive beyond this amount.

d) Paper Money

The money made of paper is called paper money. It consists of currency notes issued by State Treasury or the Central Bank of the Country. In India, one rupee notes are issued by Ministry of Finance of the Government of India and all other currency notes of higher denominations are issued by Reserve Bank of India.

e) Credit money

With the development of banking activity, credit money is being widely used. Demand deposits of banks which can be withdrawn through cheques and these cheques can also be transferred to party for means of payment. But it should be noted that cheques itself is not a money, it is near money and it gets expired once transaction got completed. Thus it is only a credit money which performs the function of money.

1.8 Introduction to supply of money

Money is an asset that has to be held by the public. As a result, it has its demand and supply and also a market. The demand for money refers to the money comes from the general public. The supply of money is made by its producers, i.e. government and banking system. The study of the nature and determinants of demand and supply of money is essential because of the fact that changes in demand and supply tend to influence the price level, interest rate and the real income. Thus money supply is a key variable in policy formulations.

1.8.1 The Supply of Money

The supply of money at any particular point of time is the total amount of money in the economy. In a broad sense, money supply refers to the total stock of money held by the individuals and business firms in the economy. However, the cash balances held by the central bank and commercial banks do not form the part of money supply being money creating agencies.

The supply of money is a stock concept, though it conveys the idea of a flow over time. When money supply is viewed at a point of time, it is a stock and on the other side, when viewed over a period of time, it is a flow. Thus, money refers to the total currency notes, coins and demand deposits with the banks held by the public.

1.8.2 Approaches to the Definition of Money Supply There are different views regarding the definitions or measures of money supply. They are as follows:

1. Traditional View:

The most common view is in line with the traditional and Keynesian thinking which considered money as the medium of exchange. As per this view, money supply is defined as currency with the public and demand deposits with the commercial banks. Demand deposits are savings and current accounts of depositors in a commercial bank. They are highly liquid form of money as depositors can draw cheques for any amount lying in their accounts at any banking time and the bank has to make immediate payment on demand.

2. Monetarist View:

The second definition is broader and is in line with the modern quantity theorists given by Friedman. Prof. Friedman defines the money supply at any point of time as “literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credit at banks or dollars they have to their credit at banks in the form of demand deposits, and also commercial bank time deposits”. Time deposits are fixed deposits of customers for a fixed period in a commercial bank which carries a fixed rate of interest. Money can be withdrawn before the expiry of that period by paying a penalty rate of interest to the bank. Thus time deposits are liquid in nature and hence included in the money supply by Friedman. Thus the definition includes traditional view of money supply plus time deposits of commercial banks in the supply of money. This definition stresses money as a function of the store of value.

3. Gurley and Shaw View:

The third function is in line with Gurley and Shaw approach and it is the broadest definition of supply of money. They include in the money supply, monetarist view plus deposits of saving banks, building societies, loan associations, and deposits of other credit and financial institutions.

4. Radcliffe Committee View:

It is also known as liquidity approach and provides much wider view of the concept of money supply. This approach viewed concept of money supply in terms of liquidity of the economy which is relevant to the spending decisions of the commodity. But spending alone is not limited to the amount of money in existence rather it is related to the amount of money people want to hold either by receipts of income or disposal of assets or by borrowing. Hence as per this approach, concept of money is viewed in terms of general liquidity which includes cash, all types of bank deposits, deposits with other institutions, near money assets and borrowing facilities available to the people.

1.8.3 Factors influencing Money Supply

Various factors influencing the money supply are discussed below:

1. **Monetary Base:**

Magnitude of the monetary base is the important determinant of size of money supply. Monetary base implies supply of funds available for use either for cash or for reserves of the central bank. There is direct relation between the monetary base and size of money supply. Monetary base is affected by the change in government policy and hence influenced the money supply.

2. **The Reserve Ratio:**

The reserve ratio is a significant determinant of the money supply. Reserve ratio refers to the percentage of liabilities in the form of deposits that every commercial bank is required to keep a certain percentage of these reserves with the central bank of the country. With the increase in the required reserve ratio, supply of money with commercial banks reduces and with decrease in required reserve ratio money supply with the commercial bank increases.

3. **Money Multiplier:**

Money multiplier has direct and positive influence upon the money supply. With the increase in size of multiplier, money supply increases and with the decrease in size of multiplier, money supply decreases.

4. **Interest Rate:**

Interest rate and multiplier have positive relation. So with the increase in interest rate, size of multiplier increases and hence money supply increases and vive-versa.

5. **Confidence in bank Money:**

General economic conditions prevailing in the economy affects the confidence of people in bank money and there by influencing money supply. During the period of recession, confidence of people in bank money is low and as a result deposits will be low which affect the creation of credit in the economy and hence negatively influencing the money supply. During the prosperity, people have confidence in banks, deposits will be high which leads to generation of more credit in the economy and hence positively influencing the money supply.

6. **Monetary Policy:**

Monetary policy is the way through which government can regulate the supply of the money in the economy. If the reserve requirements are raised, supply of the money increases and vice-versa.

7. Seasonal factors:

Seasonal factors have negative effect on the money multiplier and hence on money supply.

These are the various factors which influencing the money supply in the economy. In the next part, we will see how these factors affect the working of money supply.

1.9 Mechanics of Money Supply

In India, there are two sources of money supply- Central Bank and Commercial Banks. Money supply from both sources is linked as the high powered money multiplies itself in the process of monetary transactions between people and banks. High powered money includes the currency held by people (C) and demand deposits (D) and other deposits of the RBI (R). The analysis of how money supplies by central bank multiply itself in the process of monetary transactions is the theory of money supply. The working of money supply is discussed below:

We defined the stock of money, M, as being equal to the currency held by public C and sum of the amount of deposits, D, in our commercial banking system,

Thus, $$M = C + D$$

It is assumed that people usually want to hold some part of their assets in the form of cash and some in the form of deposits at their banks. So, the desired amount of assets they wish to hold is proportional to their deposit. Thus credit multiplier is:

$$C = cD.$$

As discussed above, "High-powered" money, H, was defined as equal to the stock of currency, C, plus the reserves, R, held by commercial banks at the Central Bank:

$$H = C + R$$

Like people, commercial banks also wish to hold some part of the deposits made at their institution in the form of reserves held at the Central Bank. Consequently deposit multiplier is: R=rD.

The theory of money supply assumes the relationship between the stock of money and the stock of high-powered money so that:

$$M=mH.$$

Where, m= money multiplier

We can rewrite as: $m=M/H$

Substituting value of M and H from above, we get:

$$m=[C+D]/[C+R]$$

Now, divide the above equation by D, the stock of deposits:

$$m=[(C/D)+(D/D)]/[(C/D)+(R/D)]$$

or, $m=[(C/D)+1]/[(C/D)+(R/D)]$

Put c= C/D (credit multiplier)

And r= R/D (Deposit multiplier)

Thus, $m=[c+1]/[c+r]$.

$$\mathbf{M=mH=[(c+1)/(c+r)].H}$$

The above expression links the supply of money to the behaviour of the public that determines

a) the amount of cash people wish to hold as deposits which depends upon their confidence in the banking system
b) the amount of reserves that bank wish to hold which depends upon how good the investment opportunities are in the economy and how much they have to pay to acquire deposits.

From the above expression, it can be concluded that an increase in H causes the money stock to increase; and increase in r causes the money stock to decrease, and an increase in c also causes the money stock to decrease. This point will become clearer through the following example:

A numerical example:

Assume initially that c=.05, r=.05 and H=100. So the value of M=[1.05/.10].100=1050.

Now if c increase from 0.05 to 0.10. with the increase in value of c, M reduces and the new value of M =[(1.10)/(015)].100=733.

1.10 Measures of Money Supply in India

In India, presently there are five measures of money supply which are denoted by M0, M1, M2, M3, and M4. This classification was introduced in April, 1977 by Reserve Bank of India (RBI). Before this till March, 1968, the RBI published only one measure of money supply, M which denotes the currency and Public demand deposits in the bank. This concept was in accordance with the traditional and Keynesian views of the narrow measure of money supply. From April, 1968 the RBI also started publishing another measure of the money supply which is called Aggregate Monetary Resources (AMR). This included coins and currency plus time deposits of banks held by the public and demand deposits. This concept was in line with Friedman's view of broad measure of money supply. From April, 1977 onwards, the present system has following measures of the money supply which are cited below;

1) **M0** – This measure of money supply includes:
    - Currency in Circulation- includes notes and coins of all denominations in circulation excluding cash in hand with banks
    - Bankers' Deposits with RBI- includes all the deposits of all banks with RBI
    - 'Other' Deposits with RBI- include current deposits of foreign central banks, financial institutions and quasi-financial institutions such as IDBI, IFCI, etc. RBI (OD)

   M0 is also known as reserve money

2) **M1** – The first measure of money supply M1 includes:

$$\mathbf{M_1=C+DD+OD}$$

- C: Currency with the public which includes notes and coins of all denominations in circulation excluding cash in hand with banks (C);
- DD: Demand deposits in all banks which includes India's deposits with IMF, World bank, Foreign Government etc; and
- OD: 'Other deposits' with RBI which include inter bank deposits.

M1 represents narrow measure of money supply.

3) **M2** – The second measure of money supply M2 represents

M1 + post office savings bank deposits

- Post office savings bank deposits: Like regular banks, Post office also offers their time savings account, recurring deposit account, time deposit account. Here the Post office savings are also included.

In this measure, savings bank deposits of both commercial and co-operative banks are included in the money supply. Post office saving bank deposits is also included in the measure as the majority of people in rural and urban have preference over post office deposits with respect to safety viewpoint than bank deposits.

4) **M3** – The third measure of money supply in India M3 consists:

M1 + time deposits with commercial and cooperative banks

- Time deposits with commercial and cooperative banks: Time deposit is an interest-bearing bank deposit that has a specified date of maturity. It includes Fixed deposits and recurring deposits but **excluding interbank time deposits.** Recurring deposits and a part of the saving deposits on which interest is allowed are also included in time deposits.

M3 represents broad measure of money supply and also called money aggregate.

5) **M4** – The fourth measure of money supply M4 consists:

M3 + total post office deposits

- Total post office deposits: includes both time deposits and demand deposits but excludes national savings certificates.

This is the broadest measure of money supply but having the lowest liquidity as variety of "TIME DEPOSITS." It takes time to "BREAK" those deposits and takeout cash. Hence lowest liquidity among the given.

Out of the four inter-related money supply discussed above, M3 is of special significance as Government takes M3 as a measure of money supply while formulating macroeconomic objectives of the economy every year.

1.11 Conclusion

Money is basically a medium which can be used for exchange of goods or services. It is generally accepted by all people. In India, there are four measures of money supply where M1 and M2 represents the narrow measure of money supply and M3 and M4 represents broad measure of money supply.

1.12 Check Your Progress

1. Who regulates the money circulation in India?

a)State Bank Of India b)Reserve Bank Of India

c) NABARD d)Commercial Banks

2. Consider the following assets

1. Cash held by public 2. Equity shares of banks

3. Deposits of banks 4. RBI bonds

Which of the above assets are considered as part of money supply?

(a) 1 and 2 (b) 1 and 3

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

3. Suppose, due to an open market purchase of government securities, reserves in the commercial banks increase by Rs. 1,000. If the reserve ratio is 20 percent, what will be the increase in money supply?

(a) Its. 5,000 (b) Rs. 4,000

(c) Rs. 2,000 (d) Rs. 1,000

4. Consider the following components of money supply in India

1. Currency in circulation.
2. Banker's deposits with the RBI
3. Other deposits with the RBI
4. Demand deposits of banks

Which of the above are the components of Reserve Money?

(a) l and 3 (b) l, 2 and 3.

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

Answers: 1b-2b-3c-4b)

1.13 Glossary

- **Barter period:** It is a period of exchange where goods or services are directly exchanged for purchasing another goods or services.
- **Time deposits:** It is a deposit in which a person deposits its money for particular time period and it cannot be withdrawn before a set date or for which notice of withdrawal is required.
- **Coincidence of wants**: It means when two people who have goods or services they want to trade with one another. In such case, needs of both must be arise so that they will exchange each other goods or services.

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1.16 Model Questions

1. Define money. What are the functions of money?
2. Define various approaches to the definition of money supply.
3. What are the various measures of money stock adopted in India?
4. Explain the mechanism of money supply in India.

Chapter-2
Demand for Money

Structure

1.1 Objectives

- To understand the concept of demand for Money and various factors affecting it.
- To study the various Theories of demand for money.

1.2 Introduction

Money is anything which has the power to buy goods and services and is generally accepted in exchange of an economic transaction. Everyone needs money to satisfy his necessities and desires. Student need money to pay his fees, a homemaker needs money to purchase grocery, a tourist needs money to pay his food bills are some of examples of needs and desires. If you identify, these all examples are common in a way that they all are striving towards the need of money which could fulfill their necessities and desires. This need generates the demand for money. The demand for money refers to the money comes from the general public. For this, the money must be in circulation and that circulation is known as supply of money.

The supply of money at any particular point of time is the total amount of money in the economy. In a broad sense, money supply refers to the total stock of money held by the individuals and business firms in the economy. The supply of money is made by its producers, i.e. government and banking system. The study of the nature and determinants of demand and supply of money is essential because of the fact that changes in demand and supply tend to influence the price level, interest rate and the real income. The present chapter deals with the various theories of the demand for money

1.3 Demand for Money

The demand for money is the desire of the people to hold financial assets in the form of money: that is, cash or bank deposits. The demand for money is affected by various factors which are discussed below:

1.4 Factors affecting Demand for Money

The factors affecting demand for money are as follows:

i) **The price level:** The quantity of money measured in current currency is called the *nominal* money supply. The quantity of nominal currency demanded is proportional to the price level. If prices increases, the demand for nominal money also increases and vice-versa. Thus in the end, it matters the *real* money demanded but not the nominal money. Real money is nothing but is the purchasing power. Thus, if prices go up by 20% and income goes up 20%, it means only nominal money has increased but real money remains the same. Thus, inflation tends to decrease the value of money over time. The higher the rate of inflation, the more will be the demand for nominal money.

ii) **Interest rates:** Like all commodities, the price of money too have an opportunity cost. If its price increases, consumers and producers will tend to substitute less expensive alternatives. The price of money is the interest rate. The higher the interest rate the money will becomes dearer and the less will be demanded. Thus, an alternative to holding money (the opportunity foregone) is to buy an interest-earning asset.

iii) **Real GDP:** It is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation). The higher the level of real income (or inflation in the economy) , the more is the transactional demand for money, *i.e.,* the larger the inflation in the economy the greater will be the number of transactions and thus the transactional demand for money increases.

iv) **Financial innovation:-** Financial Innovation refers to the act of creating and then popularizing new financial instruments as well as new financial technologies, institutions and markets. With the increase in financial Innovations like ATMs, debit and credit cards, the demand for money reduces. Now people don't require to keep hard cash, they make payment either through debit card, credit card, internet banking, or through any other financial innovative instruments.

1.5 Theories of demand for money

Why do people have demand for money is an important issue in macroeconomics? The level of demand for money not only determines the rate of interest but also the level of prices and national income of the economy . The demand for money arises from two important functions of money. The first is that money acts as a medium of exchange and the second is that it is a store of value. Accordingly, there are two different concepts of the demand for money, one is classical and the other is Keynesian.

According to Classical Approach, money serves as medium of exchange and Keynesian approach explains the store of value concept of the demand for money. The both approaches are explained below:

1.6 Classical Approach:

Classical economists stress the 'medium of exchange function' of money in considering the demand for money. In other words, money is demanded by people in order to carry out their economic transactions over a period of time. The demand for money therefore depends upon the quantity of money people want to hold for their transactions. Thus the classicists considered the demand for money as a flow of money required for transaction purposes over a period of time.

In the classical analysis of the demand for money, there are two distinct views:

a) The Fisherian View-the transaction balance version
b) The Cambridge Economists View – the cash balance version

These views are explained below:

1.6.1 FISHER'S QUANTITY THEORY OF MONEY

According to Fisher, the demand of money relates to the amount of money which people want to hold for a given volume of transactions over a period of time. Thus, the Quantity Theory of Money stresses on the quantity of money as the main determinant of the price level or the value of money. Any change in the quantity of money brings an exactly proportionate change in the price level. According to Fisher, "other things remaining the same, as the quantity of money in circulation goes up, the price level also goes up in direct proportion and the value of money reduces and vice versa". If the quantity of money doubled, the price level would also double and the value of money will be one half. On the other hand, if the quantity of money is reduced by one half, the price level will also be reduced by one half and the value of money will be double.

Fisher has explained his theory in terms of his equation of exchange, also known as Cash-Transactions equation:

$$MV = PT$$

Where, M=the quantity of money in circulation

V = transactions velocity of circulation

P = average price level.

T = the total number of transactions.

According to Fisher, the stock of money M is fixed by the Central Bank of the country and hence treated as an exogenous variable which is assumed to be given quantity in a particular period of time. Further, the number of transactions in a period is a function of national income; the higher the national income, the greater will be the number of transactions required to be made. Since Fisher assumed full-employment in the economy, thus the volume of transactions T is fixed in the short run.

Fisher extended the equation by including the credit money. Credit money refers to any future monetary claim against an individual that can be used to purchase goods and services. There are many forms of credit money, such as IOUs, bonds and money market accounts. That is;

$$PT = MV + M^IV^I$$

Where, M^I = total quantity of credit money

V^I = the velocity of circulation of credit money

This equation equates the demand for money (PT) to the supply of money ($MV + M^IV^I$). Demand for money is the total volume of transactions multiplied by the price level.

According to Fischer, $PT = \sum PQ$. In other words, total demand for money is the price level (P) multiplied by quantity bought (Q) by the community ($\sum$). This equals the total supply of money in the community which includes the quantity of total money M and its velocity of circulation V plus the quantity of credit money M^I and its velocity of circulation V^I. Thus total value of purchases (PT) in a year is measured by $MV + M^IV^I$. Thus equation of exchange is $PT = MV + M^IV^I$. In order to find out the effect of the quantity of money on the price level, or the value of money, we write the equation as;

$$P = \frac{MV + M^1V^1}{T}$$

Fisher points out that the price level (P) varies directly with the quantity of money ($M+M^I$), provided the volume of trade (T) and velocity of circulation (V, V^I) remain unchanged. This implies that if M and M^I doubled, while V, V^I and T remain constant, P is also doubled, but the value of money (1/P) is reduced to half.

Criticisms of the theory

Fischer's quantity theory of money has been subjected to the following criticisms.

1. **Truism.** According to Keynes, "the quantity theory of money is a truism" as it states that the total quantity of money paid for goods and services ($MV + M^IV^I$) must equals to their value (PT). But it cannot be accepted in the present times that a certain percentage change in the quantity of money leads to the equal percentage change in the price level.
2. **Other things not always same.** The assumption of 'other things remaining the same' cannot be true in the real world. In real life, V, V^I and T are not constant. Moreover, they are dependent of M, M^I and P.
3. **Constants relate to different time.** Prof. Halm criticizes quantity theory of money on the ground that Fisher multiplies M and V where M relates to a point of time (static concept) and V to a period of time (dynamic concept). Thus, one cannot multiply these two non-comparable factors as it is technically inconsistent.
4. **Unable to measure value of money.** Fisher's equation measure only cash transactions, i.e. the volume of business transactions of all kinds. It does not measure the purchasing power of money. But value of money actually means transactions for the purchase of goods and services for consumption. Hence, the theory does not measure the value of money.
5. **Weak theory.** According to Crowther, the quantity theory has many deficiencies. Firstly, it cannot explain the reason for fluctuations in the price level in the short run. Second, it gives more importance to the price level as changes in prices are the only important phenomenon of the economic system. Third, it places a wrong emphasis on the quantity of

money as the principal cause of changes in the price level during the trade cycle. Low prices during the period of depression are not caused by shortage of quantity of money, and similarly, high prices during the period of prosperity are not caused by abundance of quantity of money.

6. **Neglects interest rate.** Another main weakness of Fisher's quantity theory on money is that it neglects the role of the rate of interest which is one of the most important causative factors between money and prices. Fisher's equation of exchange is related to an equilibrium situation where rate of interest is independent of the quantity of money.

1.6.2 Cambridge Approach

A group of classical economists in Cambridge, England, which included Alfred Marshall and A.C. Pigou differs from the Fisher's Quantity theory of Money. Although their analysis led them to an equation almost similar to Fisher's money demand equation, their approach differed significantly. Fisher studies the demand for money by looking only at the level of transactions and the institutions that affect the way people conduct transactions as the key determinants; where as in Cambridge model, individuals are allowed some flexibility in their decisions to hold money. Hence it is not completely bound by institutional constraints such as use credit cards to make purchases.

The classical Cambridge economists assumed that two properties of money make people want to hold it: (1) its utility as a medium of exchange (2) its utility as store of wealth. Cambridge economists agreed with Fisher that demands for money is related to the level of transactions and hence demand is proportional to nominal income. As far as money functions as a store of wealth, the Cambridge economists suggest that the level of people 's wealth also affects the demand for money. They believed that wealth in nominal terms is proportional to nominal income. Cambridge economist expressed the demand for money function as

$$M^d = kPY$$

Where k is the constant of proportionality

Although the Cambridge economists often treated as k as constant and agreed with fisher that nominal income is determined by the quantity of money, the Cambridge approach allowed flexibility to individuals in choosing how much money they wished to hold. Thus, this approach allowed for the possibility that k could fluctuate in the short run.

1.7 The Keynesian Approach

The classical quantity theory of money explained that there is a direct relationship between the quantity of money and prices. In other words, if money supply is doubled, the price level will also gets doubled and the value of money will get halved and vice versa. Keynes in his *General Theory* (1936) criticized the classical theory on the ground that there is no direct, simple and predictable relationship between the quantity of money and its value or prices. Keynes provided the causal approach by which changes in the quantity of money brings changes in the price level.

Keynes used the term 'Liquidity Preference' for demand for money. Liquidity Preference means How much of his income or resources will a person want to hold in the form of ready money (cash or non-interest paying bank deposits) and how much he want to part with or lend. In other words, *Liquidity preference means the desire of the public to hold cash or to part with*.

Motives for Liquidity preference

Liquidity preference of a particular individual depends upon several basis. The question is why should the people desire to hold their resources as liquid or in the form of ready cash when they can get interest by investing such money or lending? The desire for liquidity arises because of three motives.

(i) The transactions motive

(ii) The precautionary motive and;

(iii) The speculative motive.

(i) The Transactions motive for money

The transactions motive refers to the demand for money for the current transactions of individuals and business firms. Individuals hold cash in order to bridge the gap between the receipt of income and its expenditure. In other words, people hold money for transactions purposes as payments and receipts of money do not always occurs at same time. Some people receive their income weekly or monthly while the expenditure is a routine day part. Thus, a certain amount of ready cash is always required to make current payments. The amount of money here depends upon the individual income. A person who has more income will demand more money as compared to the person who has low income.

Like individuals, the businessmen and the entrepreneurs also have to keep some part of their resources in money form in order to meet daily expenditure of various kinds. The need of the money arises all the time in order to purchase raw materials and transport services, to pay wages and salaries and to cover other current expenses incurred by any business organization. It is clear that in the business firm, the amount of money depend to a very large extent on the turnover. The more the turnover, the more will be the amount of money needed to meet current expenses. It is also important to note here that in case of money demand for transactions motive, demand for money arises primarily because of the use of money as a medium of exchange.

According to Keynes, the transactions demand for money depends only on the real income because people hold money for the purpose of buying goods and services and is not influenced by the rate of interest.

The demand for money in case of transaction motive can be expressed as:

$$D_m=f(Y)$$

Where, D_m= Demand for Money

And Y= Income

Thus, demand of money in case of transaction motive is the function of income. The more income will leads to more demand of money

(ii) Precautionary motive for money

Precautionary motive refers to the desire of the people to hold money for future uncertainties like unemployment, sickness, accidents, and the other uncertain perils. It is also important to note here that in case of money demand for precautionary motive, demand for money arises primarily because of the use of money as store of value. The amount of money demanded for this motive will depend on the individual's psychology and the conditions in which he lives. Like transaction motive, demand for money under precautionary motive is having positive relation with the income and can be expressed as:

$$D_m = f(Y)$$

Where, D_m= Demand for Money

And Y= Income

Thus, demand of money in case of precautionary motive is the function of income. The more income will leads to more demand of money

(iii) Speculative demand for money

The speculative motive of the people refers to the desire of the people to hold money in liquid form in order to take advantage of market dynamics regarding the future changes in the rate of interest (or bond prices). The aim of holding money for speculative motive was a new and revolutionary Keynesian idea. Money held under speculative motive serves the function of store of value of money as money held under the precautionary motive does. The basic idea of cash held under this motive is used to make speculative gains by dealing in those financial securities whose prices fluctuate. If bonds prices are expected to increase, which, in other words, means that the rate of interest is expected to decrease, businessmen will purchase bonds to sell at high prices in near future. If, however, the bond prices are expected to decrease, i.e., the rate of interest is expected to increase, businessmen will sell bonds to avoid capital losses.

Given the expectations about the fluctuations in the rate of interest in future, less money will be held under speculative motive at higher current rate of interest and more money will be held under this motive at a lower current rate of interest. Thus demand for money under speculative motive is having inverse relation with the current rate of interest, increasing as the rate of interest falls and decreasing as the rate of interest rises. This can be expressed as:

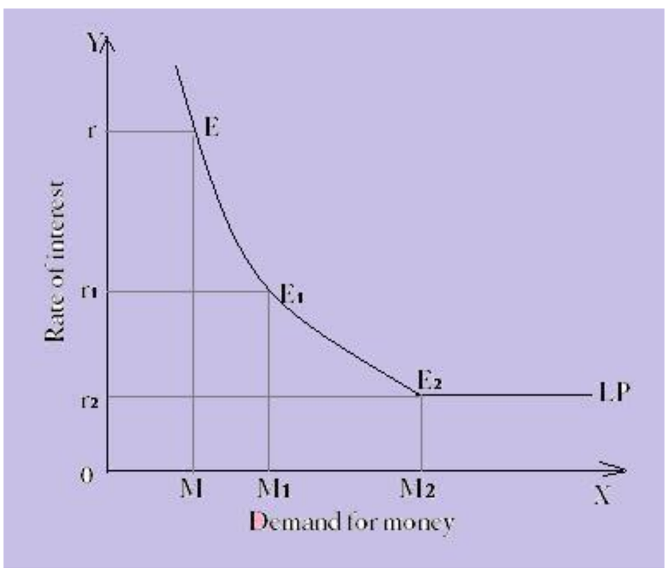
$$D_m = f(I)$$

Where, D_m= Demand for Money

And I= Rate of Interest

Thus, demand of money in case of speculative motive is the function of income but have inverse relationship. The low rate of Interest will leads to more demand for money.

The same function is also shown in the following figure.



In the figure, X-axis shows speculative demand for money and Y-axis shows the rate of interest. The liquidity preference curve LP is a downward sloping towards the right which implies that the greater the rate of interest, the lesser the demand for money for speculative motive, and vice versa. Thus, at a high rate of interest 0r, the demand for money for speculative motive is a very small amount 0M. This is because at a high rate of interest, money is used either for lending or used for buying bonds and therefore less money would be kept as current cash balances. If the rate of interest falls to 0r then a greater amount

$0M_1$ is demanded under speculative motive. With the further decrease in the rate of interest to $0r_2$ money demanded under speculative motive increases to 0M2.

Liquidity Trap

It can be seen from the above figure that the liquidity preference curve LP becomes horizontal, i.e., perfectly elastic at a very low rate of interest which implies that people have no desire to lend money and will keep the whole money with them. It is a horizontal line beyond the point E2 towards the right which shows the perfectly elastic portion of liquidity preference curve. This portion of liquidity preference curve with absolute liquidity preference is called *liquidity trap*. Liquidity trap implies that any expansion in money supply gets trapped in this sphere and hence it cannot affect rate of interest and therefore the level of investment.

Total Demand for Money

Keynes formulated the following demand for money equation, known as the liquidity preference function, which implies that the demand for real money balances M^d/P is a function of i and Y:

$$\frac{M^d}{P} = f(\underset{-}{i}, \underset{+}{Y}).$$

Where M^d/P= real demand for money (means demand for money after adjusting price changes)

i = Interest

and Y= income

Here the minus sign below i in the liquidity preference function shows that the demand for money balances is negatively related to the interest rate, and plus sign below Y shows that the demand for money balances is positively related to income Y. Keynes believed that the demand for money is related not only to income, but also to interest rates.

As the transactions motive and precautionary motive demand for money is positively related to real income Y, speculative motive demand for money is negatively related to interest rate i, hence, the demand for real money balances M^d/P can be rewritten as

$$\frac{M^d}{P} = L_1(Y) + L_2(i)$$

Where L_1 means the transactions demand for money; L_2 means the speculative demand for money. Total demand for money curve (L Curve) can be derived by the horizontal summation of L_1 curves and L_2curves. The L curve indicates the money demanded for all the three motives (i.e. transactions, precautionary and speculative) as a function of the rate of the rate of interest.

1.8 Friedman's Restatement of the Quantity Theory of Money

After the publication of Keynes's General Theory of Employment Interest and Money in 1936, economists criticized the traditional quantity theory of money. But at the University of Chicago, the quantity theory continued to be a central and important part of discussion throughout 1930's and 1940's. At Chicago, Milton Friedman, Henry Simons, Lloyd Mints Frank Knight and Jacob Viner taught and developed 'a more subtle and new version' of the quantity theory of money in which the quantity theory was connected and integrated with general price theory. The foremost exponent of the Chicago version of the quantity theory of money who led to the so-called "Monetarist Revolution" is Professor Friedman. In his essay "The Quantity Theory of Money – A Restatement" published in 1956, he set down a particular model of quantity theory of money.

Friedman's Theory

In his reformulation of the quantity theory, Friedman explains that "the quantity theory is the first theory of demand for money. It is not a theory of output, or of money income, or of the price level rather it is a wealth theory of demand. He explains the amount of real cash balances (M/P) as a commodity which is demanded because it yields services to the person who holds it. Thus money is an asset or capital good. Hence, the demand for money forms part of capital of wealth theory.

For ultimate wealth holders, the demand for money, in real terms, is a function primarily of the following variables:

$$M/P = f(Y, w, R_m, R_b, R_e, g_p, u)$$

Where M is aggregate demand for money

P is the price level

Y is the total flow of income

w is the ratio of wealth in non-human form

R_m is the expected nominal rate of return on money

R_b is the expected rate of return on bonds including expected changes in their prices

R_e is the expected nominal rate of return on equities, including in expected changes in their prices.

$g_p = (1/P)\ (dP/dt)$ is the expected rate of change of prices of goods and hence the expected nominal rate of return on physical assets and

u stands for variables other than income that may affect the utility attached to the services of money.

1. *Total wealth*. Individual's demand for money directly depends on his total wealth. - Indeed, the total wealth of an individual represents an upper limit of holding money by an individual and is similar to the budget constraint of the consumer in the theory of demand. According to Friedman income is a surrogate or wealth. The greater the wealth of an individual, the more money he will demand for transactions and other purposes. As a country, becomes richer, its demand for money for transactions and other purposes will increase. Since as compared to non-human wealth, human wealth is much less liquid, Friedman has argued that as the proportion of human wealth in the total wealth increases, there will be a greater demand for money to make up the liquidity of human wealth.
2. *The division of wealth between human and non-human forms*. The major source of wealth is the productive capacity of human beings which is

human wealth. But the conversion of human wealth into non-human wealth or the reverse is subject to institutional constraints. This can be done by using current earnings to purchase non-human wealth or by using non-human wealth to finance the acquisition of skills. Thus the fraction of total wealth in the form of non-human wealth is an additional important variable. Friedman calls this ratio of wealth to income as 'w'.

3. *The expected rates of return on money and other assets*. These rates of return are the counter parts of the prices of a commodity and its substitutes and complements in the theory of consumer demand. The nominal rate of return may be zero as it generally is on currency, or negative as it sometimes is on demand deposits, subject to net service charges, or positive as it is on demand deposits on which interest is paid, and generally on time deposits. The nominal rate of return on other assets consists of two parts: first any currently paid yield or cost, such as interest on bonds, dividends on equities and costs of storage on physical assets, and second, changes in the price of these assets which become especially important under conditions of inflation or deflation.
4. *Other variables*. Variables other than income may affect the utility attached to the services of money which determine liquidity proper. Tastes and preferences of wealth holders, trading in existing capital goods by ultimate wealth holders are other variables determine the demand for money along with other forms of wealth. Such variables are noted as 'u' by Friedman.

Broadly speaking, total wealth includes all sources of income or consumable services. It average expected yield on wealth during its life time. Thus *Wealth can be held in five different forms: money, bonds, equities, physical goods, and human capital*. Each form of wealth has a unique characteristic of its own and a different yield.

1. *Money* is taken in the broadest sense to include currency, demand deposits and time deposits which yield interest on deposits. Thus money is a luxury good. It also yields real return in the form of convenience, security, etc. to

the holder which is measured in terms of the general price level (P).

2. *Bonds* are defined as claim to a time stream of payments that are fixed in nominal units.
3. *Equities* refers to the claim to a time stream of payments that are fixed in real units.
4. *Physical goods or non-human goods* are inventories of producer and consumer durable.
5. *Human capital* is the productive capacity of human beings

Therefore, each form of wealth has a unique characteristic of its own and a different yield either explicitly in the form of interest, dividends, wages and salaries, etc. or implicitly in the form of services of money measured in terms of P, and inventories.

The demand function for money leads to the conclusion that a increase in the expected yields on different assets decreases the amount of money demanded by a wealth holder, and that a rise in wealth increases the demand for money. The income to which cash balances (M/P) are adjusted is the expected long term level of income rather than the current income being received. Empirical evidence suggests that the income elasticity of demand for money is greater than unity which means that income velocity is decreasing over the long run. This means that the long run demand for money function is constant. In other words, the interest elasticity of the long run demand function for money is negligible.

Thus Friedman presents the quantity theory as the theory of the demand for money and the demand for money is assumed to depend on asset prices or relative returns and wealth or income. He shows how a stable demand for money becomes a theory of prices and output.

1.9 Conclusion

In nutshell it can be concluded that demand for money refers to the desire of the people to hold money either in cash for transaction motive, precautionary motive or speculative motive. When we talk about transaction motive, then money serves as medium of exchange and when we talk about precautionary motive and speculative motive then money serves as store of value. Thus the money serves the both function medium of exchange and store of value.

1.10 Check Your Progress

1. J.M. Keynes assumed that supply of money as a function of rate of interest is

(a) Perfect elastic (b) highly elastic

(c) Unitary elastic (d) perfectly inelastic

2. Which one of the following equations was used by Fischer to exp the Quantity Theory of Money?

(Symbols have their usual meanings)

(a) MV= PT (b) MP = VT

(c) MP = PT (d) PV = MT

3. Which one of the following is the most important determinant of speculative demand for money?

(a) Income (b) Interest rate

(c) Profits (d) Prices

4. When interest elasticity of demand for money is zero the L - M curve is :

(A) Vertical Parallel to Y-axis

(B) Horizontal Parallel to X-axis

(C) Positive Sloping straight line

(D) Negative Sloping straight line

Answers: 1a-2a-3b-4b)

1.11 Glossary

- **Real Money:** It is the quantity of money measured as a constant (e.g. the value of the rupees in 1997).

  Therefore: Real Money = Nominal money/Price Level, where Real Money is the quantity of money measured in terms of what it will buy. Thus, Rs 22 at the new price level will buy the same amount of goods as Rs 20 at the original price level.

- **Nominal Money:** It is the quantity of money measured in a particular currency and is directly proportional to the price level.
  Nominal money = Price level * Real money.

1.12 References

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1.14 Model Questions

1. What is Demand for money? What are the factors affecting Demand for money?
2. Define various approaches to the theories of Demand for Money.
3. Define the term liquidity Trap.
4. Critically examine the Fisher’s theory of Demand for Money.

Chapter-3
Rate of Interest

3.1 Objectives
3.2 Meaning
3.3 Definition
3.4 Concept of Interest
3.5 Determination of interest rates
3.6 Factors affecting the level and structure of Interest Rates
3.7 Overview of interest rate structure in India.
3.8 Conclusion
3.9 Check Your Progress
3.10 Glossary
3.11 References
3.12 Suggested Readings
3.13 Model Questions

3.1 Objectives

- ❖ To understand the concept of Interest and various factors affecting it.
- ❖ To study the theories of determination of Interest rates
- ❖ To study the overview of interest rate structure in India

3.2 Meaning of Interest rates

In the common language, interest refers to the payment paid for the use of capital. Interest is the payment made by the borrower to the lender for the use of money. The person who lends money is known as lender (creditor) and the person who borrows money is known as borrower (debtor). In other words, Interest is charged by lender from the borrower for the money that he lends it as a loan. It is usually calculated on the principal of the amount and can be expressed as an annual rate in terms of money.

But in the real economic sense, interest is defined differently. According to economists, interest refers to the return to capital as a factor of production. Interest is the price paid for the productive services rendered by capital. The capital means machines, raw material, buildings, cash or money. But the payment made for all these services are not termed as interest. It means the payment made only for the use of money. Thus, interest is the price of the loan, i.e. capital, which may be borrowed either for production or even for consumption.

3.3 Definition of Interest Rates

According to Carver, "Interest is the income which goes to the owner of capital."

According to Keynes, "Interest is a purely monetary phenomenon and payment for the use of money". It is the reward for parting the liquidity of money".

According to Mc Connell, "Interest is the payment for the use of money or the use of loanable funds."

3.4 Concepts of Interest

Gross and Pure Interest

The payment which the debtor makes to the creditor excluding the principal is gross interest. It is a composite item which includes the following payments:

Net interest

It is the payment for the use of capital only. This is interest in the pure economic sense.

Gross interest = Net interest + reward for risk taking + reward for inconvenience + reward for management.

or

Net interest = Gross interest – (reward for risk taking + reward for inconvenience + reward for management).

Reward for Risk Taking

When lender lends his money then he remains deprived of its use, he has to sacrifice of his money or liquidity and return he earned for this sacrifice is known as reward for risk taking.

Reward for Inconvenience

When a lender lends money, he deprived its use for the period of the loan. His money is locked up and cannot be used for more profitable purposes and even if he needs this amount for his own use, he will have to bear the inconvenience of arranging it from some another source. While fixing interest rates, the lender includes in it the reward for such inconveniences.

Reward for Management

The lender has to incur expenditure in maintaining proper accounts of the borrowers. He purchases account books and even maintains staff. He has to remind debtors and sometimes has to file a case against them for the recovery of payment. The payment that the lender receives from the debtor also includes the expenses for management.

3.5 Determination of Interest rates

Interest is the price paid for the use of money. Like price determination, interest is also determined by the interaction of the forces of demand and supply. A number of theories have been developed to explain the determination of rate of interest. These are:

(1) Classical theory of interest
(2) Neo Classical theory of interest
(3) Liquidity preference theory of interest
(4) Modern theory of interest

3.5.1 Classical theory of Interest

Ricardo, J.S. Mill Marshall and Pigou developed the classical theory of interest. According to the classical theory, interest is the real phenomenon and arises because of real factors such as productivity, thrift, abstinence, etc. The theory is based on the general equilibrium theory that the rate of interest is determined by the intersection of the forces of demand and supply of capital.Thus, an equilibrium rate of interest is determined at a point where the demand for capital equals to its supply.

(1) Demand for Capital:

Demand for capital comes from businessmen who wish to invest in capital goods industries. In fact, demand for capital refers to the demand for savings. Investor agrees to pay interest on the use of capital because the projects which will be undertaken by them with the use of this capital will be so productive that the returns on investment realized will be greater of the cost of borrowing, i.e., interest.

In short, capital is demanded because it is productive, i.e., it has the power to generate an income even after covering its cost, i.e., interest. Hence, the demand curve for capital is determined by the marginal productivity curve of capital.

Indeed the marginal productivity curve obeys the law of diminishing marginal returns. While deciding about an investment, the invetor, however, compares the marginal productivity of capital with the prevailing market rate of interest.Given marginal productivity, when the rate of interest reduces, the investor will be induced to invest more till marginal productivity of capital is equal to the prevailing rate of interest.

Thus, investment demand increases when the interest rate decreases and it falls when the interest rate increases. Thus, investment demand is as an inverse relationship with the rate of interest. In symbolic terms:

$$I = f(r)$$

Where, I = investment demand and r = rate of interest

(2) Supply of Capital

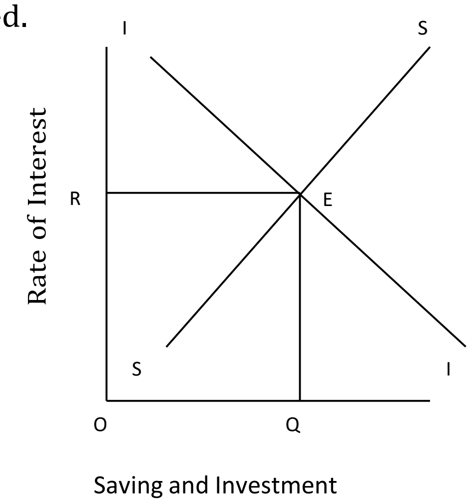
Supply of capital depends on the availability of savings in the economy. Savings emerge out of the people's willingness and capacity to save. According to this theory, supply of savings is influenced by real factors such as abstinence from consumption, time preference, etc which further depends upon the rate of interest. The classical economists believed that the rate of saving is the direct function of the rate of interest.That is, savings rises with the increase in the rate of interest and, when the rate of interest reduces, savings falls. In symbolic terms, the saving function may be stated as follows:

$$S = f(r)$$

Where, S = volume of savings and r = rate of interest.

Equilibrium Rate of Interest:

The equilibrium rate of interest is determined at that point where both demand and supply of capital are equal. In other words, at the point at which investment is equal to savings, the equilibrium rate of interest is determined.



OR is the equilibrium rate of interest which is determined at the point at which the supply of savings curve equals the investment demand curve, so that OQ amount of savings is supplied as well as invested.

Criticisms:

Major criticisms against the classical theory are as follows:

1. Interest is a real phenomenon

According to Keynes, interest is purely a money phenomenon which means the payment paid for the use of money and the rate of interest is a reward for parting with liquidity rather than a return on saving. Thus Keynes criticizes the classical view on the basis that interest is the reward for saving. It is not necessary that one can get interest only if he saves money but one can also get interest on the saving inherited from one's forefathers.Similarly, if a man saves his money in cash, he earns no interest. Thus interest is a monetary phenomenon and not the real phenomenon.

2. Indeterminate

According to Keynes, the classical theory of interest is indeterminate and confounding. Hence, one cannot know the rate of interest until knowing the savings and investment schedules, which again, cannot be known unless the rate of interest is known. Thus, the theory fails to give a determinate solution.

3. Ignores the function of money as a store of money

The classical theory focuses upon money merely as a medium of exchange. It does not take into account the role of money as a store of value.

4. Equality between savings and investment

Classical economists asserts that equality between saving and investment was brought about by changes in the rate of interest but Keynes criticize that it is the level of income and not the rate of interest which brought equality between savings and investment.

5. Narrow Scope

Classical interest theory is narrow in scope as it focuses only the capital meant for investment. It makes no consideration for consumption loans.

3.5.2 Loanable Funds Theory or Neo-Classical theory

The neo-classical theory of interest or loanable funds theory of interest is originated by the Swedish economist Knut Wicksell. Later on, economists like Ohlin, Myrdal, Lindahl, Robertson and **J.** Viner had considerably contributed to this theory.According to this theory, rate of interest is determined by the demand and supply of loanable funds. This theory takes into consideration both monetary factors such as hoarding and dishoarding of money and bank credit and real factors such as saving and investment. Thus, this theory is more realistic and broader than classical theory of interest.

Demand for Loanable Funds:

According to this theory demand for loanable funds is made for the following three purposes viz.; Investment, hoarding and consumption:

1. Investment (I):

The main source of demand for loanable funds is the demand for money for investment. Investment refers to the expenditure for the procurement of new capital goods including inventories. For the purpose of these investments, the price of obtaining such funds depends on the rate of interest. An entrepreneur compares the expected return from an investment with the rate of interestwhile deciding upon the investment. Lower the rate of interest, the higher will be the demand for loanable funds for investment purposes and vice- versa. This shows that there is a negative relationship between the demands for loanable funds for investment to the rate of interest.

2. Hoarding (H):

The demand for loanable funds is made by those people who want to hoard it. The demand for loanable funds for hoarding purpose is a decreasing function of the rate of interest. At high rate of interest demand for loanable funds for hoarding will be less and vice-versa.

3. Consumption (C):

When people spend beyond their current income, then they have to borrow money and thus make demand for loanable funds. Like hoarding it is also a decreasing function of interest rate.At high rate of interest demand for loanable funds for consumption will be less and vice-versa.

Demand for loanable funds = I+H+C

(Where I is Investment, H is Hoarding and C is Consumption.)

Supply of Loanable Funds:

The supply of loanable funds depends upon the following sources such as savings, dishoarding, disinvestment and bank credit.

1. Savings (S):

Savings forms the most important source of the supply of loanable funds. Savings is the difference between the income and expenditure. Since, income is assumed to be constant, so the amount of savings changes with the change in rate of interest. More savings will be made by Individuals as well as business firms at a higher rate of interest and vice-versa.

2. Dishoarding (DH):

Dishoarding is another important source of the supply of loanable funds. It means that money hoarded by people is given as a loan. Generally, people may dishoard money from the past hoardings at a higher rate of interest. Thus, the past balances which were idle become the active balances at present and hence available for investmentat a higher interest rate. On the contrary, if the rate of interest is low, dishoarding will be less.

3. Disinvestment (DI):

Disinvestment is non- replacement of existing machines. It occurs when the existing capital equipment is allowed to wear out without being replaced by new capital equipment. At higher rate of interest, Disinvestment will be high as the present interest rate provides more returns in comparison to present earnings. On the contrary, if the rate of interest is low, disinvestment will be less.

4. Bank Credit (BC):

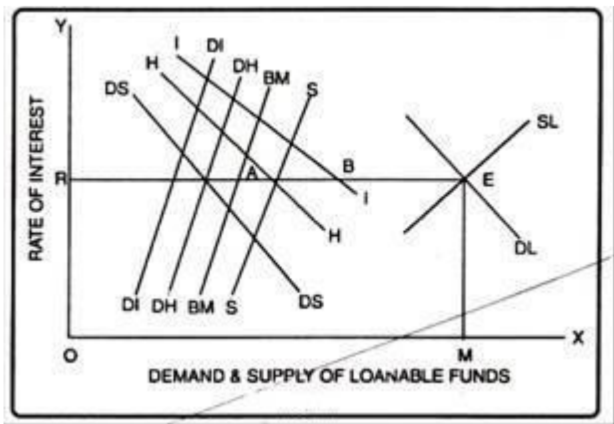
Banking system constitutes another source of the supply of loanable funds. Through the process of credit creation, the banks advance loans to the businessmen. The money created by the banks adds to the supply of loanable funds. At higher rate of interest, bank will give more credit and vice-versa.

Supply of loanable Funds = S+DH+DI+BC

(Where S is savings, DH is dishoarding, DI is disinvestment and BC is Bank Credit.)

Determination of Rate of Interest:

According to loanable funds theory, equilibrium rate of interest is at that point where demand for and supply of loanable funds are equal.



The rate of interest is determined at the point where the two curves—the demand for loanable funds curve; DLequatesthe supply of loanable funds curve (SL). Figure shows that the EM is the equilibrium rate of interest where the demand for and supply of loan able funds are equal i.e. OM.

Criticism:

Although, loanable funds theory is more realistic and superior to classical theory, yet, some economists had criticized it on the following grounds:

1. Full Employment:

Loanable funds theory is based on the unrealistic assumption of full employment. Hence, like classical theory, this theory also suffers from the defects.

2. Indeterminate:

Loanable funds theory is also indeterminate like classical theory as this theory assumes that savings and income both are independent. But in the practical world, savings depend on income. With the change in income, savings also changes and hence the supply of loanable funds also changes.

3. Impracticable:

This theory assumes that interest rate affects savings, hoarding, investment etc. But in actual practice investment is not only affected by interest rate but also affected by the marginal efficiency of capital whose affect has been ignored.

4. Unsatisfactory Integration of Real and Monetary Factors:

This theory while determining interest rate makes an attempt to integrate the monetary as well as real factors. But, in actual practice, these factors cannot be integrated in the form of the schedule as is evident from the frame work of this theory.

5. Constancy of National Income:

Loanable funds theory assumes that the level of national income remains constant. But in actual practice, with the change in investment, income level also changes accordingly.

Improvement over the Classical Theory:

Loanable funds theory is considered to be an improvement over the classical theory on the following aspects:

1. Loanable funds theory takes hoarding into consideration as a factor affecting the interest rate which the classical theory has completely overlooked.
2. Loanable funds theory links together monetary factors such as liquidity preference, quantity of money and real factors such as savings and investment whereas classical theory takes only real factor into consideration.
3. Loanable funds theory recognizes the importance of bank credit which acts as a very important source of loanable funds.

3.5.3 Keynes' Liquidity Preference Theory of Interest

Keynes defines the rate of interest as the reward for parting with liquidity for a specified period of time. According to him, the rate of interest is determined by the demand for and supply of money.

Demand for money: Keynes used the term 'Liquidity Preference' for demand for money. Liquidity Preference means How much of his income or resources will a person want to hold in the form of ready money (cash or non-interest paying bank deposits) and how much he want to part with or lend. In other words, *Liquidity preference means the desire of the public tohold cash or to part with*.

According to Keynes, there are three motives behind the desire of the public to hold liquid cash: (1) the transaction motive, (2) the precautionary motive, and (3) the speculative motive.

(i) The Transactions motive for money

The transactions motive refers to the demand for money for the current transactions of individuals and business firms. Individuals hold cash in order to bridge the gap between the receipt of income and its expenditure. In other words, people hold money for transactions purposes as payments and receipts of money do not always occurs at same time. Some people receive their income weekly or monthly while the expenditure is a routine day part. Thus, a certain amount of ready cash is always required to make current payments. The amount of money here depends upon the individual income. A person who has more income will demand more money as compared to the person who has low income.

According to Keynes, the transactions demand for money depends only on the real incomebecause people hold money for the purpose of buying goods and services and is not influenced by the rate of interest.

Thus, demand of money in case of transaction motive is the function of income. The more money will leads to more demand of money and it can be expressed as:

$$D_m = f(Y)$$

Where, D_m= Demand for Money

And Y= Income

Thus, demand of money in case of transaction motive is the function of income. The more income will leads to more demand of money

(ii) Precautionary motive for money

Precautionary motive refers to the desire of the people to hold money for future uncertainties like unemployment, sickness, accidents, and the other uncertain perils. It is also important to note here that in case of money demand for precautionary motive, demand for money arises primarily because of the use of money as store of value. The amount of money demanded for this motive will depend on the individual's psychology and the conditions in which he lives. Like transaction motive, demand for money under precautionary motive is having positive relation with the income and can be expressed as:

$$D_m = f(Y)$$

Where, D_m= Demand for Money

And Y= Income

Thus, demand of money in case of precautionary motive is the function of income. The more income will leads to more demand of money

(iii) Speculative demand for money

The speculative motive of the people refers to the desire of the people to hold money in liquid form in order to take advantage of market dynamics regarding the future changes in the rate of interest (or bond prices). The aim of holding money for speculative motive was a new and revolutionary Keynesian idea. Money held under speculative motive serves the function of store of value of money as money held under the precautionary motive does. The basic idea of cash held under this motive is used to make speculative gains by dealing in bonds whose prices fluctuate. If bonds prices are expected to increase, which, in other words, means that the rate of interest is expected to decrease, businessmen will purchase bonds to sell when their prices actually increases. If, however, the bond prices are expected to decrease, ie., the rate of interest is expected to increase, businessmen will sell bonds to avoid capital losses.

Given the expectations about the fluctuations in the rate of interest in future, less money will be held under speculative motive at higher current rate of interest and more money will be held under this motive at a lower current rate of interest. Thus demand for money under speculative motive is having inverse relation with the current rate of interest, increasing as the rate of interest falls and decreasing as the rate of interest rises. This can be expressed as:

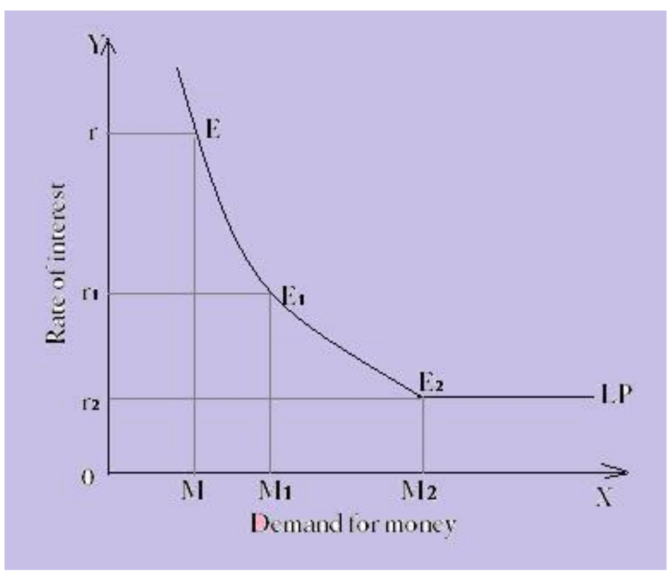
$$D_m=f(I)$$

Where, D_m= Demand for Money

And I= Rate of Interest

Thus, demand of money in case of speculative motive is the function of income but have inverse relationship. The low rate of Interest will leads to more demand for money.

The same function is also shown in the following figure.



In the figure, X-axis shows speculative demand for money and Y-axis showsthe rate of interest. The liquidity preference curve LP is a downward sloping towards the right which implies that the greater the rate of interest, the lesser the demand for money for speculative motive, and vice versa. Thus at a high rate of interest 0r,the demand for money for speculative motive is a very small amount 0M. This is because at a high rate of interest, money is used either for lending or used for buying bonds and therefore less money would be kept as current cash balances. If the rate of interest falls to 0rthen a greater amount $0M_1$ is demanded under speculative motive. With the further decrease in the rate of interest to $0r_2$ money demanded under speculative motive increases to 0M2.

Liquidity Trap

It can be seen from the above figure that the liquidity preference curve LP becomes horizontal, i.e., perfectly elastic at a very low rate of interest which implies that people have no desire to lend money and will keep the whole money with them. It is a horizontal line beyond the point E2 towards the right which shows the perfectly elastic portion of liquidity preference curve. This portion of liquidity preference curve with absolute liquidity preference is called *liquidity trap*. Liquidity trap implies that any expansion in money supply gets trapped in this sphere and hence it cannot affect rate of interest and therefore the level of investment.

Total Demand for Money

Keynes formulated the following demand for money equation, known as the liquidity preference function, which implies that the demand for real money balances M^d/P is a function of i and Y:

$$\frac{M^d}{P} = f(\underset{-}{i},\underset{+}{Y}).$$

Where the minus sign below i in the liquidity preference function shows that the demand for money balances is negatively related to the interest rate, and plus sign below Y shows that the demand for money balances is positively related to income Y. Keynes believed that the demand for money is related not only to income, but also to interest rates.

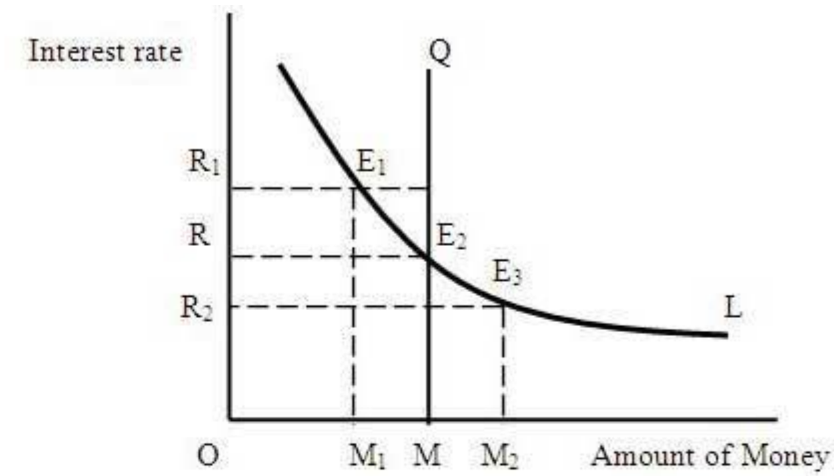
As the transactions motive and precautionary motive demand for money is positively related to real income Y, speculative motive demand for money is negatively related to interest rate i, hence, the demand for real money balances M^d/P can be rewritten as

$$\frac{M_d}{P} = L_1(Y) + L_2(\mathrm{i})$$

Where L_1 means the transactions demand for money; L_2 means the speculative demand for money. Total demand for money curve (L Curve) can be derived by the horizontal summation of L_1 curves and L_2curves. The L curve indicates the money demanded for all the three motives (i.e. transactions, precautionary and speculative) as a function of the rate of the rate of interest.

Supply of Money: The supply of money is the total quantity of money in circulation and in bank deposits in the country. Money in circulation is determined by the central bank of the country. Though the supply of money is a function of the rate of interest as increase in the supply of money lowers the rate of interest and vice-versa yet it is considered to be fixed by the monetary authorities. Hence the supply curve of money is taken as perfectly inelastic represented by a vertical straight line.

Determination of the Rate of Interest: The rate of interest is determined at the level where the demand for money equals the supply of money. In the following figure, the vertical line QM shows the supply of money and L represents the total demand for money curve. Both the curve intersectseach other at E2 where the equilibrium rate of interest OR is established.



At the point E_1, the rate of interest is OR_1, the demand for money OM1 is less than the supply of money OM. Consequently, the rate of interest will start falling from OR_1 till it reaches the equilibrium rate OR. Similarly at OR_2 level of interest rate, the demand for money OM_2 is more than the supply of money OM. As a result, the rate of interest OR_2 will start increasing till the equilibrium rate of interest OR is reached. Thus, If there is any deviation from the equilibrium position E_2, an adjustment will take place through the rate of interest, which brings the equilibrium to regain its position, i.e. E_2.

It may be noted that, if the supply of money is increased by the monetary authorities, but the liquidity preference curve L remains the same, the rate of interest will fall. If the demand for money increases and the liquidity preference curve sifts upward, given the supply of money, the rate of interest will rise.

Criticisms: Keynes theory of interest has been criticized on the following grounds:

1. More emphasis on Monetary factors

Keynes taken into consideration only the monetary factors and ignored real factors. According to Keynes, the rate of interest is purely a monetary phenomenon. But in actual practice, real forces like productivity of capital and thriftiness or saving by the people also play an important role in the determination of the rate of interest.

2. Liquidity Preference as only factor affecting rate of interest

Keynes gives importance to Liquidity preference as the only factor affecting the rate of interest. But there are several other factors which affect the rate of interest and hence affecting the demand for and supply of investible funds.

3. Ignores Saving

Keynes ignores saving or waiting as a means or source of investible fund. According to Hazlitt, without any saving, parting with liquidity is meaningless. Saving is an essential source of investable funds.

5. More emphasis on short run

The Keynesian theory only explains interest in the short-run period. It completely ignores the rates of interest in the long run.

6. Indeterminate

According to this theory, demand and supply of money is determined by rate of interest. But liquidity preference depends on both rate of interest and level of income. So liquidity preference cannot be known unless rate of interest is known and which cannot be known until the level of income is known. Thus, like the classical and loanable funds theories, Keynes theory of interest, is also indeterminate.

3.5.3 Modern Theory of Interest Rate

Neo-Keynesian economists like Hicks, Lerner and Hansen combined the loanable funds formulation and the Keynesian liquidity preference formulation and formulate an adequate theory of the rate of interest.This is referred to as "the neo-Keynesian synthesis." It formulates a well integrated theory which successfully combines all the four factors savings, liquidity preference, investment and the quantity of money. Thus it combines monetary and real factors to give an explanation of the determination of the rate of interest.

Earlier to neo- Keynesian theory, the loanable fund theory also made an attempt to combine these real and monetary factors in explaining the interest rate determinations. But this was unsuccessful task and this task was successfully carried out by the neo-Keynesians.

In explaining the modern theory of interest, Professor Hansen, in his Monetary Theory and Fiscal Policy, gives four determinants of the rate of interest. These are:

1. The investment demand schedule;
2. The consumption function;
3. The liquidity preference schedule; and
4. The quantity of money.

The equilibrium condition of all these four variables together determines the rate of interest. According to Hansen, "an equilibrium condition is reached when the desired volume of cash balances equals the quantity of money.

So, when the marginal efficiency of capital is equal to the rate of interest, and when the volume of investment is equal to the desired volume of saving, then these factors are interrelated."In short, according to the modern theory of interest, when the four variables, viz. saving, investment, liquidity preference and the quantity of money, are integrated with income, then we get a fairly satisfactory explanation of the rate of interest.For this purpose, a synthesis between the loanable funds formulation and the liquidity preference theory is evolved by neo-Keynesian economists (Hicks, Lerner and Hansen). The basic aim of such a synthesis was to combine the real sector and the monetary sector as well as to combine the flow and stock variables of these distributive theories (loanable funds and liquidity preference) together as an explanation of interest rate determination.

Thus, the neo-Keynesian synthesis evolved two schedules, the IS schedule and the LM schedule the former representing the equilibrium between the flow variables in the real sector and the latter showing the equilibrium of the stock variables.When the IS and LM schedules are plotted graphically, their respective curves (the IS curve and the LM curve) give us the equilibrium rate of interest at the point of their intersection. At this equilibrium rate of interest:

(i) Total saving = total investment;

(ii) Total demand for money = total supply of money; and

(iii) The real as well as the monetary sectors are in equilibrium.

Before moving further, let us discuss the IS and LM framework.

The IS Schedule:

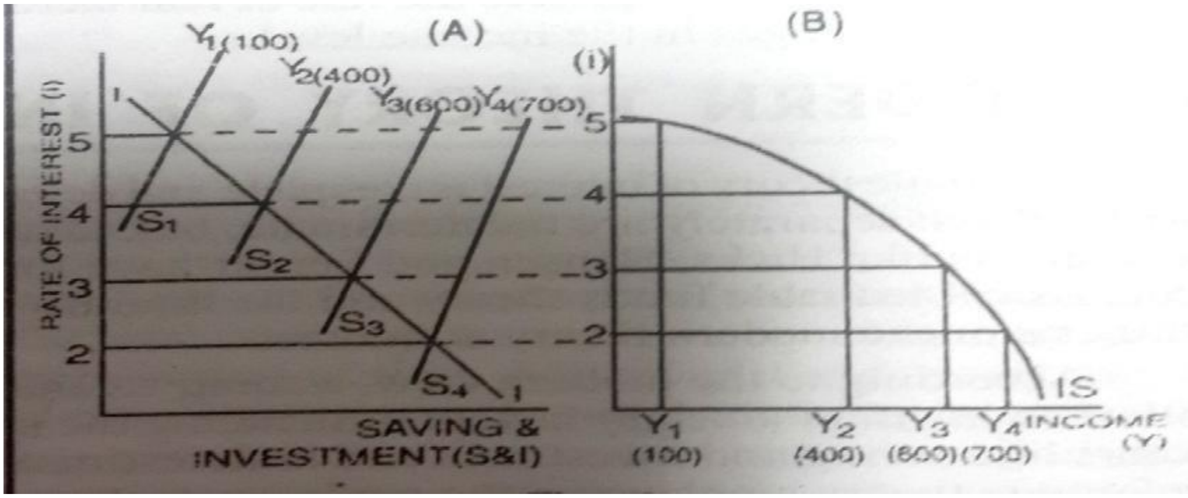
Through the loanable funds formulation, we get a family of loanable fund schedules or saving schedules at various income levels. These together with the investment demand schedule gives us the IS schedule, and when represented diagrammatically we get the IS curve.

The IS curve gives equilibrium in the real sector, showing various combinations of the levels of income (Y) and interest rate (r) at which there is equilibrium between aggregate real saving and real investment. It can be seen that investment is a decreasing function of the rate of interest (i.e., when the rate of interest is low, the investment is also lowand vice versa) and that saving is an increasing function of the level of income (i.e., saving increases with increase in income). Thus the IS curve depicts the relationship between investment and saving.

Derivation of IS Schedule

Investment Schedule		**Saving Schedule**		**IS Schedule**	
Interest Rate (%)	Investment (Rs. Crores)	Income (Rs. Crores)	Saving (Rs. Crores)	Interest Rate (%)	Income (Rs. Crores)
5	20	100	20	5	100
4	30	400	30	4	400
3	40	600	40	3	600
2	50	700	50	2	700

Derivation of IS Curve



The above table and figure explain the derivation of IS curve. At income levelof Y_1(100), the equilibrium saving and investment is found at 5% rate of interest. Similarly, at Y_2(400), the equilibrium level is at 4% and at Y_3(600) equilibrium level is 3% and at Y_4 equilibrium level at 2% rate of interest. Connecting the various equilibrium rates of interest with their corresponding income level, IS curve is obtained as shown in above figure.IS curve is downward-sloping which shows the relation that given the investment function, thefunction from given income is high at low rates of interest, andlow at high rates of interest.

The LM Schedule:

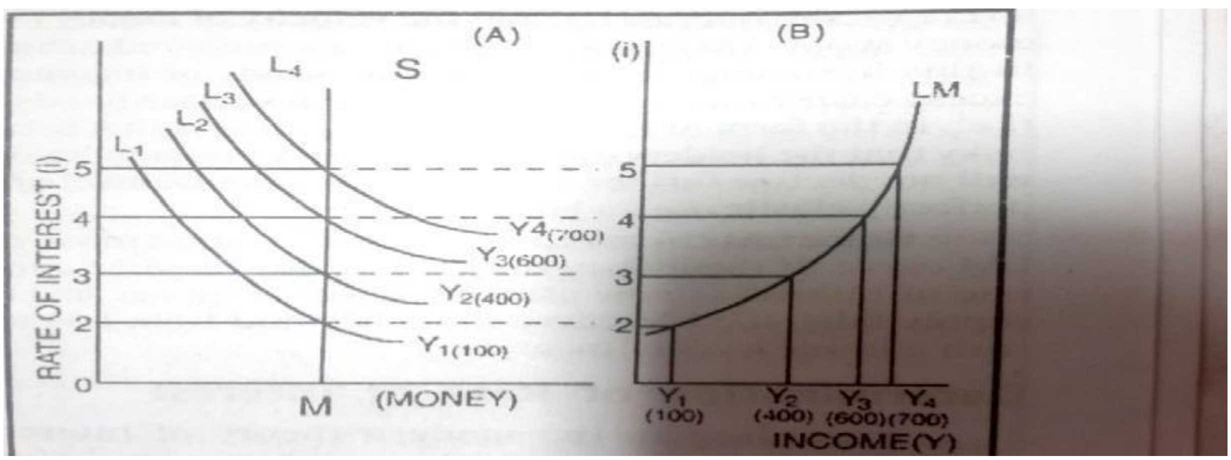
Through the Keynes liquidity preference theory, we get a family of LP schedules at various income levels. These together with the supply of money give us the LM schedule, and when represented diagrammatically we get the LM curve. The supply of money is interest-elastic as it is fixed by the monetary authority. The LM schedule explains whatwill be the various rates of interest at different levels of income(given the quantity of money and the family of liquidity preference schedules). Liquidity Preference is an increasing function of income which implies that given the demand for money; the rate of interest will be low when income is low and high when income is high.

Thus, the LM curve tells the equilibrium between the liquidity preference and supply of money.

Derivation of LM Schedule

Liquidity preference schedule					Supply of money	LM schedule	
L_1 function		L_2 function		Total for money		Interest rate	Income level
Income level (Rs.crores)	Transaction plus precautionary demand for money	Rate of interest	Speculative demand for money				
100	30	2	70	100	100	2	100
400	40	3	60	100	100	3	400
600	50	4	50	100	100	4	600
700	60	5	40	100	100	5	700

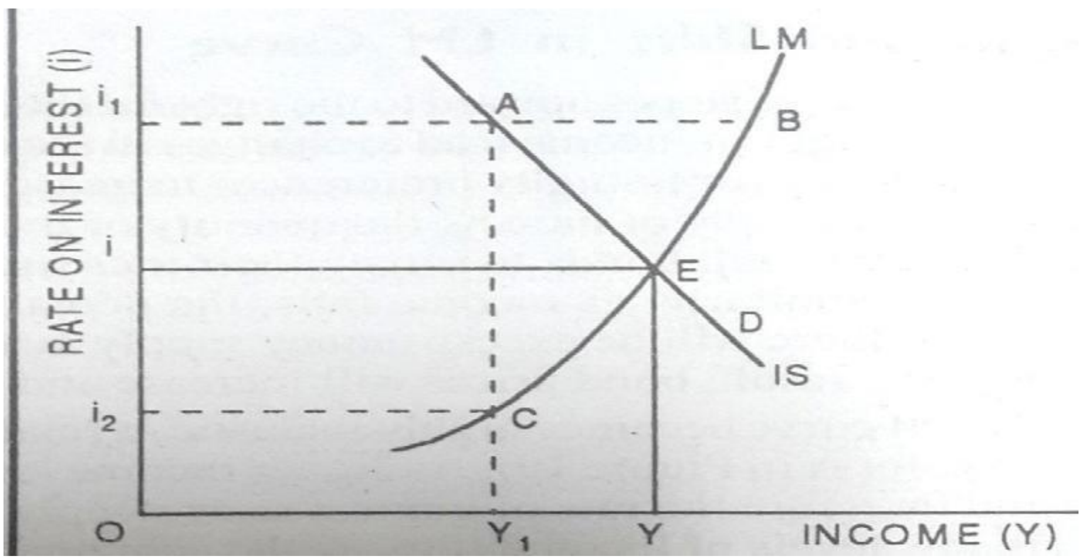
Derivation of LM Curve



The derivation of LM Curve is shown in above table and figure. At income level of Y_1(100), the equilibrium level is found at 5% rate of interest. Similarly, at Y_2(400), the equilibrium level is at 4% and at Y_3(600) equilibrium level is 3% and at Y_4 equilibrium level at 2% rate of interest. Connecting the various equilibrium rates of interest with their corresponding income level, LM curve is obtained as shown in above figure. LM curve is upward-sloping which shows the relation that given the demand for money, thefunction from given income is high at low rates of interest, and low at high rates of interes t.

Determination of the Rate of Interest:

According the modem theory of interest, the point at which the IS and LM curves are intersected, that point is equilibriumrate of interest. The IS curve which denotes equilibrium in the real sector shows the various combinations of the levels of income and interest rate at which there is equilibrium between aggregate real saving and real investment.On the other hand, the LM curve which denotes equilibrium in the monetary sector shows those various combinations of the levels of income and interest rates corresponding to which the supply of and demand for money are in equilibrium. As discussed above, IS curve is downward slopping and LM curve is upward slopping. Income and the rate of interest are, thus, determined together at the point of intersection of these two curves.



In the rate of interest is RM, determined by the intersection of the IS and the LM curves at point R. At this point, income and the rate of interest stand in such relation to each other that: (1) investment and saving are at equilibrium and (2) the demand for money is in equilibrium with the supply of money.

Thus, for a determinate theory of interest, we should view the interaction of the following factors: (1) the investment-demand function, (2) the saving function, (3) the liquidity preference function, and (4) the supply of money.

Hansen, states that the Keynesian analysis, in a broad sense, involves all these.

In this sense, Keynes, unlike the neo-classicists, did formulate a determinate interest theory. But he failed to bring all the elements together in a comprehensive manner to formulate plainly an integrated theory of interest.He, however, did not realise that liquidity preference plus the quantity of money can furnish not the rate of interest but only an LM schedule.

Thus, the credit goes to Professor Hicks for using the Keynesian tools in a proper manner to construct a comprehensive and determinate theory of interest.In short, the modern theory of interest holds that productivity, thr ift, liquidity preference, and the money supply are all important determinants of the rate of interest.

3.6 Factors affecting the level and structure of Interest Rates

Interest rates vary from person to person and from place to place. There are many factors which cause variations in interest rates which are discussed as under.

1. **Differences in Gross Interest**

   Variations in the rate of interest are due to differences in gross interest which includes risk and inconvenience, cost of keeping records and collection of loans etc. Higher the risk and inconvenience and the cost of management of loans, the higher will be the rate of interest and vice versa.

2. **Nature of Security**

   Interest rate varies with the type of security of loan. Loans against security of gold carry low interest rate as compared to loans against the security of immovable property like land or house. The more liquid the asset, the lower is the interest rate and vice versa.

3. **Credit Worthiness of the Borrower**

   Credit worthiness of the borrower also affects the interest rate as person of known integrity and creditability can get loans on easy terms.

4. **Duration of Loan**

   Rate of interest also depends upon the time duration of loan. Long term loan carry higher rate of interest as compared to short term loans. In a long term loan the money gets blocked up for a longer duration and hence less liquid. Naturally the lender wants to be compensated for his sacrifice by a higher rate of interest.

5. **Amount of Loan**

   The rate of interest has negative relation to the amount of loan. Larger the amount of loan, the lesser is the rate of interest and vice versa.

6. **Differences due to distance**

   Distance between the lender and the borrower also causes differences between interest rates. People are willing to lend at a lower rate of interest nearer home than at a long distance.

7. **Differences in Productivity**

   Productivity of capital differs from project to project. People are willing to borrow at a higher rate of interest for productive projects and vice versa.

8. **Market Imperfections**

   Differences in interest rates are also due to market imperfections that may be found in a loan market. Different lending policies are followed by Money lenders, indigenous banks, mutual funds, commercial banks etc and hence charge various interest rates.

3.7 Overview of interest rate structure in India.

Every instrument of the money and capital markets of the country has its own interest rate and each instrument has various maturities.

In the Organized financial system, the differences in the interest rates in India are determined by two forces:

(i) The RBI's policy, and

(ii) The interaction between the demand for and supply of investible funds.

Basically, the interest rate structure in the organized financial sector is determined and governed by the RBI. Under this the activities of the unorganized sector are outside the purview of RBI's control, this leads to lack of orderly arrangement in the interest rate structure in this sector and, hence sometimes, usurious rates are charged.

The Reserve Bank's policy operations can affect the structure of interest rates on the basis of the following:

1. By changing the Treasury Bill Rate.
2. By changing the Bank Rate.
3. By fixing the minimum and maximum lending rates of banks.
4. By fixing the maximum interest on time deposits with the Bank.
5. By affecting call money rates through changes in the reserve requirement ratios.
6. By influencing yields on government securities through open market operations sales and purchase activities.

Structure of Interest Rates in India

(Per cent per annum)

Year (as at end March)	Call/ Notice Money Rates	Deposit Rates*				Lending Rates*
		Savings#	Term Deposits			
			1-3 yrs	3-5 yrs	Above 5 yrs	
1	2	3	4	5	6	7
2000-01	9.15	4.00	8.50-9.50	9.50-10.00	8.50-10.00	11.00-12.00
2001-02	7.16	4.00	7.50-8.50	8.00-8.50	8.00-8.50	11.00-12.00
2002-03	5.89	3.50	4.25-6.00	5.50-6.25	5.50-6.25	10.75-11.50
2003-04	4.62	3.50	4.00-5.25	5.25-5.50	5.25-5.50	10.25-11.00
2004-05	4.65	3.50	5.25-5.75	5.75-6.25	6.25	10.25-11.00
2005-06	5.60	3.50	6.00-6.75	6.25-7.00	6.50-7.00	10.25-12.75
2006-07	7.22	3.50	6.75-8.50	7.75-9.50	7.75-8.50	12.25-14.75
2007-08	6.07	3.50	8.00-8.75	8.00-8.75	8.50-9.00	12.25-15.75
2008-09	7.26	3.50	8.00-8.75	8.00-8.50	7.75-8.50	11.50-16.75
2009-10	3.29	3.50	6.00-7.00	6.50-7.50	7.00-7.75	11.00-15.75
2010-11	5.89	3.50	8.25-9.00	8.25-8.75	8.50-8.75	8.25-9.50
2011-12	8.22	4.00	9.25	9.00-9.25	8.50-9.25	10.00-10.75
2012-13	8.09	4.00	8.75-9.00	8.75-9.00	8.50-9.00	9.70-10.25
2013-14	8.28	4.00	8.75-9.25	8.75-9.10	8.50-9.10	10.00-10.25
2014-15	8.27	4.00	8.75-9.05	8.75-9.05	8.50-9.05	10.00-10.25

Source: Scheduled Commercial Banks (Excluding RRBs) and the Reserve Bank of India.

3.8 Conclusion

In nutshell modern theory of interest is the best theory for determining rate of interest as it combines both the real sector and monetary sector. Thus modern theory of interest is complete and a determinate theory of interest.

3.9 Check Your Progress

1. Which one of the following statements is correct? An increase in money supply in Keynesian framework results in

(a) a higher level of income and a higher rate of interest

(b) a lower level of income and a lower rate of interest

(c) a higher level of income and a lower rate of interest

(d) a lower level of income and a higher rate of interest

2. Which one of the following is the most important determinant of speculative demand for money?

(a) Income (b) Interest rate (c) Profits (d) Prices

3. Which one of the following statements is correct? J.M. Keynes assumed that supply of money as a function of rate of interest is

(a) perfect elastic (b) highly elastic

(c) unitary elastic (d) perfectly inelastic

(Answer: 1c, 2b, 3a)

3.10 Glossary

Real Sector: The sector that is concerned with actually producing goods and services.

Monetary Sector: the sector that is concerned with buying and selling on the financial markets.

3.11 References

- Selgin, George A., The Theory of Free Banking: Money Supply Under Competitive Note Issue, Totowa, New Jersey: Rowman and Littlefield, 1988.
  - Macro Economic Theory and Policy, D.N. Dwivedi (2007), 3rd Edition, McGraw, Hillbook Company Pvt. Ltd., Singapore.

3.12 Suggested Readings

- Macro Economic Theory and Policy, Dr. H.L. Ahuja (2009), S.ChandAnd CompanyPvt. Ltd., New Delhi.
- Macro Economics, M.L.Jhingan (2011), 8th Revised Edition, Konarad PublicationsPvt. Ltd., New Delhi.

3.13 Model Questions

1. What is interest? Distinguish between net interest and gross interest.
2. Explain classical theory of interest and its criticism.
3. Give an overview of structure of interest rate in India

Chapter 4- Introduction to Money Markets

Structure

4.1 Objectives

- To understand the concept of Money market
- To study the instruments of money market in detail
- To analyze the Indian Money Market with its characteristics and drawbacks

4.2 Money Market

Money market refers to a market for short term financial assets that are close substitutes of liquid financial claims. It is a market overnight to short term funds and deals with the instruments having high liquidity and very short term maturities, generally for a period of less than or equal to 365 days. It provides an equilibrating mechanism for demand and supply of short-term funds with the help of central bank (RBI) intervention in order to influence both the quantum and cost of liquidity for bringing efficiency in the money market forces consistent with the overall stance of monetary policy.

Money market is not a single market but a collection of markets for several instruments. It is a wholesale market for short-term debt instruments. Short term obligations such as commercial papers, treasury bills, bankers' acceptances, etc are bought and sold in the money market. Any buying and selling of such instruments is made through the financial intermediaries. For this, one of the major financial intermediaries i.e. commercial banks play vital role for supplying/contradicting money supply in the economy on the directions of Reserve Bank of India.

4.2.1 Definitions of Money Market

Following definitions will help us to understand the concept of money market.

According to **Crowther**, *"The money market is a name given to the various firms and institutions that deal in the various grades of near money."*

According to the **RBI**, *"The money market is the centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."*

According to **Nadler and Shipman**, *"A money market is a mechanical device through which short term funds are loaned and borrowed through which a large part of the financial transactions of a particular country or world are degraded. A money market is distinct from but supplementary to the commercial banking system."*

4.2.2 Characteristics of money market

- It is an inter-bank market which matches the deficit and surplus of banks and other financial intermediaries for the short period.
- The market secures short-term requirements of banks and financial institutions.
- It is a wholesale market of short term debt instruments.

- The Central Bank occupies a strategic position in the money market. Other players are: Discount and Finance House of India (DFHI), mutual funds, banks, non-banking finance companies (NBFCs), state governments, corporate investor, provident funds, Primary dealers, public-sector undertaking (PSUs), Securities Trading Corporation of India (STCI), non-resident Indians and overseas corporate bodies.
- It is a market wherein the demand and supply of money shape the market.

4.2.3 Functions of Money Market

Money market plays very significant functions and is an important part of the economy. Being a market for short term monetary transactions, it has to provide facility for adjusting liquidity to business corporations, the banks, non-banking financial institutions (NBFs) and other financial institutions along with investors.

The major functions of money market are:-

1. **Matches Demand and Supply of individuals for short term need:** Money market is a market which brings lenders and borrowers together for short-term business requirements. It provides place to the individuals/entities whereby, on the one hand borrowers manage to obtain short term debt financing funds and on the other, lenders succeed in getting creditworthy borrowers for investing their money. It helps in bridging the gap between the two. It reallocates financial resources between deficit and surplus entities. Thus, money market keeps a balance between the demand and supply of money for short term transactions.
2. **Promotes economic growth.** Economic growth is directly related to Gross Domestic Product (GDP). An increase in GDP will raise the economic growth of a country and vice- versa. To increase the GDP, it is essential to have more and more industrial and agricultural production

in the economy. For the continuous flow of production, it is necessary that short term needs of funds of all firms are always met. So, whenever their need arises for short term funds, money market makes them available and hence indirectly promotes economic growth.

3. **Provides liquidity.** Liquidity refers to convertibility of monetary assets into money as and when required by the investor. RBI being the main constituent in the money market aims to ensure adequate liquidity in the economy. Money market provides focal point for RBI's intervention for influencing liquidity and general levels of interest rates in the economy. RBI provides framework where all instruments of money market can be resold very easily. Moreover the maturity period of each instrument of money market is less than one year. So when maturity period arises, instrument automatically gets converted into cash.
4. **Helps in implementing Monetary Policy.** Money market provides the basis for efficient implementation of monetary operations. Substantial development had been seen in the Indian money market in terms of depth, variety of instruments and efficiency. This has enabled the Reserve Bank to change its monetary operations from direct quantity based instruments to indirect interest rate based instruments to enhance the efficiency of monetary transmission consistent with international best practices. Money market is the first and the most important stage in the chain of monetary policy transmission. In view of limited control over long-term interest rates, central banks adopt a strategy to exert direct influence on short-term interest rates. Changes in the short-term policy rate provide signals to financial markets, whereby different segments of the financial system respond by adjusting their rates of return on various instruments, depending on their sensitivity and the efficacy of the transmission mechanism. How quickly and effectively the monetary policy actions influence the spectrum of market interest rates depends upon the level of development of various segments of financial markets,

particularly the money market. Thus, Money market provides a mechanism for an effective implementation of the monetary policy.

5. **Helps in Capital Formation:** Process of capital formation involves three distinct but inter-dependent activities including savings, finance and investment.

- Firstly, the current consumption has to be sacrificed in order to accumulate the capital goods. It is so because if society consumes that all it produces and save nothing, future productive capacity of the economy will fall as the present capital equipment wears out. Hence, savings are created by sacrificing some part of current consumption. The other way to have surplus funds without sacrificing current consumption is infusion of foreign capital investment.
- Secondly, these savings are needed to be mobilized through financial intermediaries whereby a pool of finance is created.
- Thirdly, it is provided to those entrepreneurs or business houses that require them for investments.

Money market provides investment avenues for short term period and thus helps in generating savings and investments in the economy. This investment avenues will helps in generalization of more funds and thus helps in capital formation.

4.3 Money market instruments

The instruments traded in money market are:

1. Treasury bills (T- bills)
2. Call/notice money market
3. Commercial paper
4. Certificate of deposits
5. Commercial bills
6. Repo market

4.3.1 Treasury bills

These are short term instruments issued by the Reserve Bank on behalf of the government to tide over short term liquidity shortfalls. It is used by the government to raise short term funds to bridge seasonal or temporary deficit occurred due to excess of expenditure over revenue. They form the most important segment of the money market not only in India but all over the world as well.

T-bills are repaid at par on maturity. T-bills in India have maturities of 3 months, 6 months and 12 months. T-Bills are negotiable securities, highly liquid as they are of shorter tenure, have an assured yield, low transaction cost. T-bills are available for a minimum amount of Rs.25, 000 and in multiples thereof. RBI, banks, mutual funds, primary dealers, provident funds, corporate houses are some of the participants in the T-Bill market.

Features of T-Bills:

1. They are negotiable securities.
2. They have high liquidity as Commercial banks, DFHI, STCI and other institutions provide ready market for these bills.
3. There is zero default risk as these bills are guaranteed by the Government.
4. They have low transaction cost, an assured yield, and are eligible for inclusion in the securities for SLR purposes.
5. These are readily available throughout the week at the rates announced daily.
6. There are 91 day and 364-day T-bills in vogue at present. The 91-day T-bills are auctioned by RBI every Friday and the 364-day T-bills every alternate Wednesday (that is, the Wednesday preceding the reporting Friday).

Types of T-bills:

There are three categories of T-bills. These are:

- **On tap bills:** The bills that could be bought from the Reserve bank at any time at an interest yield of 4.663 percent is called On-tap bills. As they had lost much of their relevance, they were discontinued from April1, 1997,
- **Ad hoc bills:** It was introduced in 1955. The Reserve Bank and the Government of India decided that the government could maintain with the Reserve bank a cash balance of not less than Rs 50 crore on Fridays and Rs 4 crore on other days, free of obligations to pay interest there on, and whenever the balance fell below the minimum the government account would be replenished by the creation of ad hoc bills in favor of the Reserve bank.
- **Auctioned T-bills:** It was introduced in April 1992. The Reserve Bank receives bids in an auction from various participants and issues the bills subject to some cut-off limits. Thus, the yield of this instrument is market determined. These bills can neither be rediscounted with the Reserve Bank, nor be rated.

Sale of T- Bills[i]:

T-Bills are sold by the RBI on behalf of the Government through an auction. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays. The Reserve Bank of India issues a quarterly calendar of T-bill auctions which is available at the Banks' website. (URL:http://www.rbi.org.in). It also announces the exact dates of auction, the amount to be auctioned and payment dates by issuing press releases prior to every auction.

Type of T-bills	**Day of Auction**	**Day of Payment***
91-day	Wednesday	Following Friday
182-day	Wednesday of non-reporting week	Following Friday
364-day	Wednesday of reporting week	Following Friday

* If the day of payment falls on a holiday, the payment is made on the day after

the holiday.

Besides allotting T- bills through auction, the Reserve Bank accepts non-competitive bids from state governments, non-government provident funds, and other central banks. Non competitive bids are accepted to encourage participants who do not have expertise in bidding. Such bids are most efficient way of encouraging retail participation instead of having a large number of retail investors bidding competitively on their own. The Reserve Bank allots bids to the non-competitive bidders at the weighted average price of the competitive bids accepted in the auction.

Types of Auctions:

T-Bills are sold through any of the following auctions: (1) Multiple price auction and (2) Uniform price auction

1. **Multiple Price Auction:** The Reserve bank invites bids by price and participants will have to quote the price of the stock which they desire to purchase. On the basis of received bids, bank then decides the cut off price at which the issue would be made. Securities are allotted to the one who has made bid above the cut off price.

The advantage is that the Reserve bank obtains the maximum price each participant is willing to pay. Thus, competitive bidding is encouraged as each bidder is aware that it will have to pay the price it bid, not just the minimum accepted price.

The disadvantage is that bidders mostly prefer to bid lower prices in such type of auction. The reason behind is that if the trading in these securities starts below the marginal price set at the auction. It may happen that bidders who paid higher prices could face large capital losses, this is known as the "winner's curse". The winner's curse can be a problem in those markets where price volatility is high. The Reserve bank introduced uniform price auction in case of 91 day T-bills in order to eliminate the problem.

2. **Uniform price Auction:** This method is opposite to Multiple Price auction method as in this method, bids are invited by RBI in descending order. Securities are allotted at the price that fully absorbs the issue amount and that price is same to all bidders. In other words, all winning bidders are awarded the auctioned amount at the same price.

The advantage is that such auction tends to minimize uncertainty and encourage broader participation. The disadvantage is that it may be possible that uniform price auctions could reduce the need to prepare for the auction, as allotment at a uniform price reduces the incentive to bid. Moreover, there are dangers of irresponsible bidding or of collusion in a uniform auction.

Most countries follow the multiple price auctions. However, now the trend is shifting towards the uniform price auction. Uniform price auction was introduced on an experimental basis on November 6, 1998, in case of 91 day T-bills. Since 1999-2000, 91 day T-bill auctions are regularly conducted on a uniform price basis. RBI has fixed calendar for auctions of all types of T-Bills. Two or three days prior to an auction, RBI issues a press release indicating the date and terms of auction.

Classification of bids:

The bids submitted can be classified as **competitive** and **non competitive bids.**

Competitive Bids

In a competitive Bid, participants submit their bid to RBI who then decides the cut off price and makes allotment. These can be submitted by any person or institutions like, financial institutions, banks, primary dealers, companies, firms, corporate bodies, trusts in India and institutions.

Non Competitive Bids

In a non- competitive bid, participants are not allowed to bid as they are not experts in bidding. Bids are allotted at weighted average price of the competitive bids.

- **91-Days Treasury Bills**

This is the oldest type of Treasury bill which is issued by the Central Bank on behalf of Government for three months at either a discount or face value, at a competitive auction on a weekly basis in order to meet the short-term shortfall of funds with the government.

At a discount means the instrument is sold to an investor, at below the face value and then redeemed at maturity at the full face value. The difference between the discounted price and the face value determines the yield/ interest earned. The yield on 91-day Treasury bills is the average **discount rate**.

In India, there were two types of 91-Days treasury bills: Ordinary and ad hoc Treasury bills. Ordinary Bills are issue to the public and to the RBI to meet temporary government's short term requirement for the funds.

On the other hand, ad hoc bills are created in favour of RBI. Ad hoc bills were introduced in 1937. RBI and Government of India entered into agreement in 1937 and 1955 that Government shall maintain a cash balance of not less than Rs 50 Crore on Fridays and Rs 4 crore on other days with RBI. When the balance falls below these minimums, the Government account should be replenished by creating ad hoc bills in favour of RBI. But from 1997-98, the systems of ad hoc was discontinued.

- **182-Days Treasury Bills**

These bills were introduced in November 1986 to provide more outlets for temporary surplus funds. These bills are issued by the Central Bank, on behalf of the Government for six months at either a discount or face value, at a competitive auction on a weekly basis. These bills also provide an additional avenue to raise financial resources by the government for its budgetary expenditure.

Initially the auctions were held every month. Later on in July 1988, fortnightly auctions were held. No specific amount was fixed to be raised through the auction of these bills. This amount depended upon the funds available with the market participants and the amount they wish to invest in these bills. These bills were discontinued to be issued and traded from 16 october 1992.

Again in 1999-2000, these bills were reintroduced to enable the development of a market for government securities. These bills were not allowed to be rediscounted with RBI they were offered for sale on an auction basis. The bill was again discontinued in May 2001 but it was reintroduced again in April 2005 with a notified amount of Rs 500 crore.

- **364-Days Treasury Bills**

These bills are issued by the Central Bank, on behalf of the Government for one year at either a discount or face value, at a competitive auction on a weekly basis. The authorities introduced 364- Days treasury bills to replace the 182-Days T-bills in April 1992.

The first auction took place on 28th April 1992 and since then auction is made every fortnight. These bills are not purchased and rediscounted by RBI. The investors such as financial institutions and banks show a good response from it. Such response can be evident from the number of bids and the amount tendered at the time of each auction. These bills offer short term investment opportunity to investors.

- **14-Days Treasury Bills**

These bills are issued by the Central Bank on behalf of Government for 14 days at either a discount or face value, at a competitive auction on a weekly basis. These bills are of two types: one introduced in April 1997 in place of 91- Days T- bills known as Intermediary Treasury bill (ITB) and the second on May 1997 to facilitate the cash management requirements of various segments of the economy.

The Intermediary treasury bills were introduced to help state governments, foreign central banks and other specified bodies to invest their temporary cash surpluses. The salient features of this bill were as follows:

- The bill can be repaid or renewed at par on the expiration of 14 days from the date of issue.
- This bill was introduced as an alternative to 91- day tap bills.
- It is rediscounted at 50 basis points higher than the discount rate.
- These bills were sold for a minimum amount of Rs1, 00,000 or in multiple thereof and were issued only in book form.
- It is non-transferable.
- The discount rate is reset at quarterly intervals such that effective yields of this instrument would be equivalent to the interest rate on WMA (Ways and Means Advances) chargeable to Central Government.

Yield calculation

The yield of a Treasury Bills is calculated as per the following formula:

$$Y = \frac{(100-P)*365*100}{P*D}$$

Wherein Y = discounted yield

P = Price

D = Days to maturity

If a T-bill with a face value of Rs100 is issued at Rs 97, then the yield on 91 day T-bill is

$$Y = \frac{(100-97)*365*100}{97*91}$$

$$= 12.405 \text{ per cent}$$

4.3.2 Call/notice money market

The call money market is a market for very short term funds. The funds are lent for one day or from Saturday to Monday (call/overnight money) or for a period up to 14 days (notice money) in the call/notice market.

The call money market is a non-collateralized interbank dealer market for overnight funds. This market involves credit risk, for there is no collateral. However, the government has not allowed any important bank in India to fail. Hence, the credit risk is negligible. The call money market is a highly liquid market with the liquidity being exceeded only by cash. Call money is required mostly by banks. Commercial banks borrow money from other banks to maintain a minimum cash balance know as the cash reserve requirement. The RBI stipulates this from time to time. CRR refers to the cash that banks have to maintain with the Reserve Bank.

The interest rate paid on call loans is called the call rate. It is a highly volatile rate and varies from day-to-day, hour to hour and sometimes even minute to minute. It is very sensitive to changes in the demand for and supply of call loans.

Till 1973, the call rate was determined by the market forces of demand and supply but on December 1973 when the call rate touched a high of 30 percent due to tight credit policy wherein the bank rate was raised and refinance and rediscount facilities were discontinued. As a result, many banks defaulted and the Indian Banking Association (IBA) started regulating the call rate by fixing a ceiling from time to time.

From 1989 (May 1), call rates were freed from administrative ceiling. Now, the rate is freely determined by the demand and supply forces in the call money market. NSE Mibor (Mumbai Interbank Offer Rate) and Reuters Mibor is the reference rate for the call money market. These rates are determined on a daily basis.

Need of call money

Call money is required mostly by banks. Commercial banks borrow money from other banks to maintain a minimum cash balance known as cash reserve requirement. This inter-bank borrowing has led to the development of the call money market.

This market is governed by the Reserve Bank of India which issues guidelines for the various participants in the call/notice money market. Scheduled Commercial Banks (excluding RRBs), Land Development Banks, Co-operative Banks and Primary Dealers are some entities permitted to participate both as lender and borrower in the call/notice money market.

While, the fortnightly average borrowing outstanding of scheduled commercial banks should not exceed more than 100 per cent of their capital funds. These banks are permitted to borrow to the extent of 125% of their capital funds in the call/notice money market.

At the same time, average fortnightly outstanding lending of SCB (Scheduled Commercial Banks) should not exceed 25 per cent of their capital funds, though SCBs can lend to the extent of 50% of their capital funds on any day, during a fortnight.

The average daily trading in the call money market occurs between 9.30 am to 5.00 pm on Monday to Friday and 9.30 am to 2.30 pm on Saturday and the turnover is around Rs. 12,000-13,000 cr every day. The trades are conducted both on telephone as well as on the NDS Call system. The settlement of money market deals is by electronic funds transfer on the Real Time Gross Settlement (RTGS) system operated by the RBI. The repayment of the borrowed money also takes place through the RTGS system on the due date of repayment.

Participants in the Call Money Market:

Till 1971, the call money market was predominantly an inter-bank market, when UTI and LIC were allowed to operate as lenders. Till March 1978, Brokers were also allowed to participate in the call money market who would affect transactions between lenders and borrowers for a brokerage. In the 1990s, the participation was gradually widened to include STCI (Securities Trading Corporation of India Limited), DFHI (Discount and Finance House of India), GIC (General Insurance Corporation of India), IDBI (Industrial Development Bank of India), NABARD, money market mutual funds, private sector mutual funds and corporates as lenders in this market.

The participants in the call money market who act as both lenders and borrowers are scheduled and non-scheduled commercial banks, foreign banks, state, district and urban cooperative banks and DFHI. RBI permitted primary dealers in 1996-97 to participate in this market as both lenders and borrowers. Those entities that could provide evidence of surplus funds were permitted to lend money from this market through primary dealers. With effect from august 6, 2005, the call money market is now a pure inter-bank money market.

4.3.3 Commercial Paper

The introduction of commercial paper in India was suggested by the working Group on Money Market in 1987 and was introduced by The Reserve bank in January 1990. Been in vogue in the United States since the nineteenth century, they have become popular in money markets all over the world since the 1980s.

A commercial paper is an unsecured short term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by highly rated and leading creditworthy corporate houses to meet their working capital requirements. A commercial paper, depending upon the issuing company, is also known as industrial paper, finance paper, or corporate paper. The period of CP is 15 days to 365 days from the date of issue and is issued at discount.

Initially only leading highly rated corporate houses could issue a commercial paper. The issuer base has now been widened to broad base the market. Satellite dealers, primary dealers, and all-India financial institutions, apart from corporate houses, can also issue commercial papers to access short term funds. To access greater volume of funds to help increase their activities in the secondary market, from September 6, 1996 and June 17, 1998, primary dealers and satellite dealers were also permitted to issue commercial paper.

A commercial paper can be issued to banks, individuals, companies and other registered Indian corporate bodies and unincorporated bodies. A commercial paper can only be issued to a Non-resident Indian only on a non-transferable and non–repatriable basis. Banks are not allowed to underwrite or co-accept the issue of a commercial paper.

A commercial paper is usually privately placed with investors, either through banks or merchant bankers. A specified credit rating of P 2 is to be obtained from credit rating agencies. Credit rating of A2/P2 indicates satisfactory ability of a company to meet its short-term financial liabilities.

A commercial paper is issued in a dematerialized form at a discount or as an unsecured promissory note. The discount is freely determined by market forces. The paper is usually priced between the lending rate of scheduled commercial banks and a representative money market rate.

Corporate houses are allowed to issue CPs up to 100 per cent of their fund based working capital limits. The paper attracts stamp duty. To issue CP, there is no need to take prior approval of the Reserve bank and also underwriting the issue is not mandatory.

Features of commercial paper –

1. They are flexible as well as liquid instruments because they are negotiable by endorsement and delivery. Also, on the requirement of the issuing company, commercial paper can be issued with varying maturities.
2. They are unsecured instruments as they are not backed by any assets of the company which is issuing the commercial paper.
3. They can be sold either directly by the issuing company to the investors or else issuer can sell it to the dealer who in turn will sell it into the market.
4. The companies can get cheaper funds from commercial paper rather than borrowing from the banks and so helps the highly rated companies.

However, the use of commercial paper is limited to only blue chip companies, i.e. those companies which are financially sound. Though commercial paper provides higher returns for the investors they are unsecured and hence investor should invest in commercial paper according to his risk -return profile.

Issues Pertaining to Commercial Paper (CP)

Despite the de-linking of issuance from fund-based working capital limits and complete dematerialisation of CP issuances, the CP market continues to lack the desired level of activity. In terms of extant guidelines, only companies rated P-1 or P-2 by CRISIL or such equivalent rating by other agencies, can issue CP. As the market attains a reasonable level of maturity while the rating criterion may continue, the requirement of rating for issuing CP could be made more flexible so that a more structured market is available to investors depending on their risk appetite.

Guidelines to CP

Eligibility: Corporate houses, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP. A corporate would be eligible to issue CP provided –

- the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore
- company has been sanctioned working capital limit by bank/s or all-India financial institution/s;
- borrowal account of the company is classified as a Standard Asset by the financing bank/s/ institution/s.

Maturity: CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

Rating requirement: All eligible participants shall obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time, for the purpose.

The minimum credit rating shall be A-2/ P2

Limits and amount: The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower.

Denomination: CP can be issued in denominations of Rs.5 lakh or multiples thereof.

Issuing and Paying Agent (IPA): Only a scheduled bank can act as an IPA for issuance of CP.

Investment in CP: Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

Dematerilaised form: CP can be issued either in the form of a promissory note (Schedule I given in the Master Circular-Guidelines for Issue of Commercial Paper dated July 1, 2011 and updated from time –to-time) or in a dematerialised form through any of the depositories approved by and registered with SEBI. Banks, FIs and PDs can hold CP only in dematerialised form.

Issued at a discount: CP will be issued at a discount to face value as may be determined by the issuer.

Trading in the secondary market: CPs are actively traded in the OTC market. Such transactions, however, are to be reported on the FIMMDA (Fixed Income Money Market and Derivatives Association of India) reporting platform within 15 minutes of the trade for dissemination of trade information to market participation thereby ensuring market transparency.

Mode of redemption: Initially the investor in CP is required to pay only the discounted value of the CP by means of a crossed account payee cheque to the account of the issuer through IPA. On maturity of CP,

(a) When the CP is held in physical form, the holder of the CP shall present the instrument for payment to the issuer through the IPA.

(b) When the CP is held in demat form, the holder of the CP will have to get it redeemed through the depository and receive payment from the IPA.

4.3.4 Certificates of Deposit

A certificate of deposit is a document of title to depositors of funds that remain on deposit at the bank for specified period at a specified rate of interest. They are unsecured, negotiable short term instruments in bearer form. They are introduced in June 1989 and only scheduled commercial banks were allowed to issue Certificates of deposit initially. It was only in 1992 that financial institutions were permitted to issue certificates of deposits. The term of a CD generally ranges from one month to five years. Further, the minimum amount of a CD is fixed at Rs.25 Lakh in the denomination of Rs.5 Lakh.

Features of certificate of deposits –

1. CDs are is highly safe for investors as the default risk in them is almost negligible, Thus, they are considered as risk-less and safe securities.
2. Certificate of deposits is highly liquid and marketable and hence investors can buy or sell it whenever they desire to do so.
3. It has an added advantage for investors who are willing to invest in it, as they are transferable from one party to another which cannot be done with term deposits.
4. It is a time deposit that restricts holders from withdrawing funds on demand, however if an investor wants to withdraw the money, this action will often incur a penalty.
5. A certificate of deposits may be payable to the bearer or registered in the name of the investor. Investors can resell bearer CD's more easily than registered CD's and so most certificates of deposits are issued in bearer form.

Certificate of deposits can be one of the alternatives for a investor if he or she does not want to invest in term deposits.

Guidelines to Certificate of Deposit (CD)

Eligibility: CDs can be issued by (i) scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks}; and (ii) select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources within the umbrella limit (prescribed in paragraph 3.2 below) fixed by RBI.

Aggregate Amount: Banks have the freedom to issue CDs depending on their funding requirements. An FI can issue CD within the overall umbrella limit prescribed in the Master Circular on Resource Raising Norms for FIs, issued by DBOD and updated from time-to-time.

Minimum Size of Issue and Denominations: Minimum amount of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh, and in multiples of Rs. 1 lakh thereafter.

Investors: CDs can be issued to individuals, corporations, companies (including banks and PDs (Primary Dealers) trusts, funds, associations, etc. Non-Resident Indians (NRIs) are allowed to subscribe to CDs, but only on non-repatriable basis, a condition, clearly stated on the Certificate of deposit. Such CDs cannot be endorsed to another NRI in the secondary market.

Maturity: The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. But FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue.

Discount / Coupon Rate: CDs may be issued at a discount on face value. Banks / FIs are also allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank / FI is free to determine the discount /coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. The investor should be clearly informedof the same.

Reserve Requirements: Banks have to maintain appropriate reserve requirements, i.e., cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

Transferability: CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs.

Trades in CDs: All OTC trades in CDs shall be reported within 15 minutes of the trade on the FIMMDA reporting platform.

Loans / Buy-backs: Banks / FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity. However, the RBI may relax these restrictions for temporary periods through a separate notification.

Format of CDs: Banks / FIs should issue CDs only in dematerialised form. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. Accordingly, if an investor insists on physical certificate, the bank / FI may inform the Chief General Manager, Financial Markets Department, Reserve Bank of India, Central Office, Fort, about such instances separately.

Security Aspect: Since CDs in physical form are freely transferable by endorsement and delivery, it will be necessary for banks/FIs to see that the certificates are printed on good quality security paper and necessary precautions are taken to guard against tampering with the document. They should be signed by two or more authorised signatories.

Payment of Certificate: Since CDs are transferable, the physical certificates may be presented for payment by the last holder. The question of liability on account of any defect in the chain of endorsements may arise. It is, therefore, desirable that banks take necessary precautions and make payment only by a crossed cheque. Those who deal in these CDs may also be suitably cautioned.

4.3.5 Commercial Bills

According to the Indian Negotiable Instruments Act, 1881, "*bill or exchange is a written instrument containing an unconditional order, signed by the maker, directing to pay a certain amount of money only to a particular person, or to the bearer of the instrument".*

Bills of exchange are negotiable instruments drawn by the seller (drawer) on the buyer (drawee) or the value of the goods delivered to him. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. Thus, a commercial bill enhances the liability to make payment on a fixed date when goods are bought on credit. They are short term, negotiable, and self-liquidating instrument with low risk. In India banks mainly provide the funds for working capital requirement of business firms through cash-credits / overdraft and purchase/discounting of commercial bills.

They bank discount this bill by keeping a certain margin and credit the proceeds. Banks, when in need of money, can also get such bills rediscounted by financial institutions such as UTI, LIC, GIC, ICICI and IRBI. The maturity period of the bills varies from 30 days, 60 days or 90 days, depending on the credit extended in the industry.

Features of Commercial Bills

By offering the bills for rediscounting commercial bills can be traded. Banks provide credit to their customers by discounting commercial bills for a certain sum of money. This credit is repayable on maturity of the bill. Commercial bills ensure improved quality of liquidity, lending, and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has a high degree of liquidity.

The bills market is very limited in India but is highly developed in industrial countries. Commercial bills rediscounted by commercial banks with financial institutions amount to less than Rs 1,000 crore. In India, the bill market did not develop due to (1) the cash credit system of credit delivery where the onus of cash management rest with banks and (2) an absence of an active secondary market.

Types of Commercial Bills:

Commercial bill is an important tool to finance credit sales. It may be a **demand bill or a usance bill.** A demand bill is payable immediately at sight or on presentation to the drawee. A usance bill is payable after a specified time.

These bills can either be **clean bills or documentary bills.** Clean bills are those which are not accompanied by document of title to goods. Documents are enclosed and delivered against acceptance by drawee, after which it becomes clear. In the case of a documentary bills are those which are accompanied by document of title to goods.

Commercial bills can be **inland bills or foreign bills**. Inland bills are those which are made in India and must be payable in India or drawn upon any person resident in India. Foreign bills, on the other hand, are drawn outside India and drawn on a party in India or it may be drawn in India and made payable outside India.

A related classification of bills is **export bills and import bills**. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by exporters abroad.

Hundi is an indigenous variety of bills of exchange for financing the movement of agricultural produce. According to the Indian Central Banking Enquiry Committee, "an indigenous banker is any individual or private firm receiving deposits and dealing in Hundies or lending money. Indigenious bankers used it to raise money or to remit funds or financa inland trade.

RBI introduced an innovation instruments known as '**Derivative Usance Promissory Notes,**' backed by such eligible commercial bills for required amounts and usance period (up to 90 days) with a view to eliminating movement of papers and facilitating multiple rediscounting. Government has exempted stamp duty on derivative usance promissory notes. This has simplified and streamlined bill rediscounting by institutions and made the commercial bill an active instrument in the secondary money market. This instrument, being a negotiable instrument issued by banks, is a sound investment for rediscounting institutions. Moreover rediscounting institutions can further discount the bills any time prior to the date of maturity. The Reserve Bank restricted such rediscounting to a minimum period of 15 days as some banks were using the facility of rediscounting commercial bills and derivative usance promissory notes of as short a period as one day. The eligibility criteria prescribed by the Reserve Bank for rediscounting commercial bills are that the bill should arise out of a genuine commercial transaction showing evidence of sale of goods and the maturity date of the bill should to exceed 90 days from the date of rediscounting.

What is the difference between Commercial Paper and Commercial Bill?

Both Commercial Paper and Commercial Bill are financial instruments used by banks but they both are different in the following way:

- Commercial paper is used by banks to raise finances for a short time period. The buyer gets CP at a discounted rate, while he gets face value on maturity whereas, Commercial bill is an instrument that helps companies get advance payment for the invoices they raise after making sales to their customers.
- Commercial paper is used by banks to meet their short-term obligations, while commercial bills help companies to get money in advance, for sales they make.

4.3.6 Repo market

Repo is a money market instrument, which enables collateralized short term borrowing and lending through sale/purchase operations in debt instruments. Under a repo transaction, a holder of securities sells them to an investor with an agreement to repurchase at a predetermined date and rate. Repo rate is nothing but the annualised interest rate for the funds transferred by the lender to the borrower. Generally, the rate at which it is possible to borrow through a repo is lower than the same offered on unsecured (or clean) interbank loan because repo transaction is a collateralised transaction and the credit worthiness of the issuer of the security is often higher than the seller.

In the money market, this transaction is collateralised lending as the terms of the transaction are structured to compensate for the funds lent in the form of repo rate. Such inflow of cash from the transaction can be used to meet temporary liquidity requirement in the short term money market at comparable cost. The factors affecting the repo rate include, the credit worthiness of the borrower, liquidity of the collateral and comparable rates of other money market instruments.

A repo is also sometimes called a ready forward transaction as it is a means of funding by selling a security held on a spot (ready) basis and repurchasing the same on a forward basis.

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence, whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction. When the reverse repo transaction matures, the counterparty returns the security to the entity concerned and receives its cash along with a profit spread. One factor which encourages an organisation to enter into reverse repo is that it earns some extra income on its otherwise idle cash.

Pricing

In a repo transaction where there are two legs of transactions viz. selling of the security and repurchasing of the same, in the first leg of the transaction for a nearer date, sale price is usually based on the prevailing market price for outright deals. In the second leg, which is for a future date, the price will be structured based on the funds flow of interest and tax elements of funds exchanged.

This is on account of two factors:

Firstly, as the ownership of securities passes on from seller to buyer for the repo period, legally the coupon interest accrued for the period has to be passed on to the buyer. Thus, at the sale leg, while the buyer of security is required to pay the accrued coupon interest for the broken period, at the repurchase leg, the initial seller is required to pay the accrued interest for the broken period to the initial buyer.

Secondly, Transaction-wise, both the legs are booked as spot sale/purchase transactions. Thus, after adjusting for accrued coupon interest, sale and repurchase prices are fixed so as to yield the required repo rate. The excess of the coupon at the first leg of repo would represent the coupon interest for the repo period. Thus, the price adjustment depends directly upon the relationship between the net coupon and the repo amount worked out on the basis of the repo interest agreed upon the total funds transferred.

Eligible instruments

Different instruments can be considered as collateral security for undertaking the ready forward deals and they include Government dated securities, Treasury Bills, corporate bonds, money market securities and equity.

Types of Repos

Broadly, there are four types of repos available in the international market when classified with regard to maturity of underlying securities, pricing, term of repo etc. They comprise buy-sell back repo, classic repo bond borrowing and lending and tripartite repos.

1. **Buy-sell back repo**: Under a buy-sell repo transaction the lender actually takes possession of the collateral . Here a security is sold outright and bought back simultaneously for settlement on a later date. In a buy-sell repo the ownership is passed on to the buyer and hence he retains any coupon interest due on the bonds. The forward price of the bond is set in advance at a level which is different from the spot clean price by actually adjusting the difference between repo interest and coupon earned on the security. The spot buyer/borrower of securities in effect earns the yield on the underlying security plus or minus the difference between this and the repo interest rate.
2. **Classic repo:** Classic repo is an initial sale of securities with a simultaneous agreement to repurchase them at a later date. In the case of this type of repo the start and end prices of the securities are the same and a separate payment of "interest" is made. Classic repo makes it explicit that the securities are only collateral for the loan of the cash. Here the coupon income will be accrued to the seller of the security.
3. **Bond lending/borrowing repo:** In a bond lending/borrowing transaction, the customer lends bonds for an open ended or fixed period in return for a

fee. The fee charged would depend on the type of underlying instrument, size and term of the loan and the credit rating of the counterparty. The transaction would be taken care of by an agreement on securities lending and cash or other securities of equal value could be provided as collateral in the transaction.

4. **Tripartite repo:** Under a Tripartite repo, a common custodian /clearing agency arranges for custody, clearing and settlement of repos transactions. They operate under a standard global master purchase agreement and provides for DVP system (delivery versus Payment), substitution of securities, automatic marking to market, reporting and daily administration by single agency which takes care of the risk on itself and automatic roll overs (automatic renewal) while does not insist on disclosing the identities by counterparties. The system starts with signing of agreements by all parties and the agreements include Global Master Repurchase and Tripartitle Repo Service Agreements. This type of arrangement minimizes credit risk and can be utilized when dealing with clients with low credit rating.

Repo period

Repo period could be overnight term, open or flexible. Overnight repos last only one day. If the period is fixed and agreed in advance, it is a term repo where either party may call for the repo to be terminated at any time although requiring one or two days' notice. Though there is no restriction on the maximum period for which repos can be undertaken. Generally term repos are for an average period of one week.

In an open repo there is no such fixed maturity period and the interest rate would change from day to day depending on the money market conditions. In such cases the lender agrees to provide money for an indefinite period and the agreement can be terminated on any day.

Under flexible repos, the lender places funds, but they are withdrawn by the borrower as per his requirements over an agreed period.

Risks

As far as risks are concerned although repos are collateralised transactions they are still exposed to counterparty risk and the issuer risk associated with the collateral. As far as the counterparty risk is concerned, the investor should be able to liquidate the securities received as collateral, thus largely offsetting any loss. Against this the seller /lender of bonds will hold cash or other securities as protection against non-return of the lent securities. In both the cases it is to be ensured that the realisable value equals or exceeds the exposure. There is also the concentration risk resulting from illiquid issues which are used as collateral in the transaction.

Dealing and Settlement

A suitable dealing and settlement system is an integral part of a repo market. There are a number of alternative approaches followed by countries ranging from the development of an in-house solution through to the purchase of an existing solution. The key features of the system incorporated are always the delivery versus payment mechanism, confirmation and matching of trades with automated settlement, an extensive registry/sub registry system with full reporting capabilities on holders, turnover, closing of books and record dates, securities reconciliation etc.

Advantages of Repos

There are a variety of advantages repos can provide to the financial market in general, and debt market, in particular as under:

- An active repo market would lead to an increase in turnover in the money market, thereby improving liquidity and depth of the market;
- Repos would increase the volumes in the debt market as it is a tool for funding transactions. It enables dealers to deal in higher volumes. Thus, repos provide an inexpensive and most efficient way of improving liquidity in the secondary markets for underlying instruments.
- Debt market also gets a boost as repos help traders to take a position and go short or long on security. For instance, in a bullish scenario, one

can acquire securities and in a bearish environment, one can dispose them of, thus managing cash flows taking advantage of flexibility of repos.

- For institutions and corporate entities, repos provide a source of inexpensive finance and offers investment opportunities of borrowed money at market rates, thus, earning a good spread;
- Tripartite repos will offer opportunities for suitable financial institutions to intermediate between the lender and the borrower.
- Central banks can use repo as an integral part of their open market operations with the objective of injecting/withdrawing liquidity into and from the market and also to reduce volatility in short term in particular in call money rates. Bank reserves and call rates are used in such instances as the operating instruments with a view to ultimately easing /tightening the monetary conditions.

4.4 The Indian Money Market:

The Indian money market is not an integrated unit due to the existence of organised and unorganized sector. The organised sector is fairly integrated. Both nationalized and private sector commercial banks constitute the core of the organised sector. The foreign banks, cooperative banks, the Reserve bank of India (India's central bank), finance companies and mutual funds are some institutions which operate in the organised sector. The unorganized sector comprises of indigenous bankers, moneylenders and unregulated non-bank financial intermediaries such as chit funds, nidhis etc.

4.4.1 Indian Money Market – characteristics

Here are some of the features of Indian Money Market:

1. **Dichotomic Structure**: It is a significant aspect of the Indian money market. In both the organized money market as well as unorganised money markets, it has a simultaneous existence. The organized money market consists of all scheduled commercial banks, RBI and other recognized

financial institutions while unorganized money market includes domestic money lenders, trader, indigenous bankers, etc. The organized money market is in full control of the RBI but the unorganized money market remains outside the RBI control. Thus, both the organized and unorganized money market exists simultaneously.

2. **Seasonality**: The demand for money in Indian money market is of a seasonal nature. The demand for money is generated from the agricultural operations, as India is an agriculture predominant economy (though its dominance has reduced over the years). More agricultural activities take place during the busy season i.e. between October and April, leading to a higher demand for money.
3. **Multiplicity of Interest Rates**: In Indian money market, we have many levels of interest rates. They differ from period to period, from bank to bank and even from borrower to borrower. Again in both organized and unorganized segment the interest rates differ. Thus, there is an existence of multiplicity of rates of interest in the Indian money market.
4. **Lack of Organized Bill Market**: The organized bill market is not prevalent in the Indian money market. Though the RBI tried to introduce the Bill Market Scheme (1952) and New Bill Market Scheme in 1970, yet it has a long way to go to reach at maturity stage. Hence, there is no properly organized bill market in India.
5. **Absence of Integration**: Integration is a very important feature of the Indian money market. Indian money market is divided among several segments or sections which are hardly connected with each other. There is a lack of coordination among these different components of the money market.
6. **High Volatility in Call Money Market**: The call money market is a market for very short term money. Here money is demanded at the call rate. Basically, the demand for call money comes from the commercial banks and institutions such as the LIC, GIC, etc which suffer huge fluctuations and make this market highly volatile.

4.4.2 Strength of Indian Money Market

The major strength of Indian money market are given below:-

1. **Helps in maintaining monetary equilibrium:** Monetary equilibrium means maintaining balance between the demand and supply of money for short term monetary transactions. Money market instruments provide the short term finance as and when required. Thus helps in maintaining monetary equilibrium.
2. **Promote economic growth:** Through the instruments of Money market, one can get funds available for various business activities pushing towards surplus capital formation. Indian money market efficiently provides the money to the needy business entrepreneurs as well as other players of industry which promotes the economic growth.
3. **Provide help to Trade and Industry:** Money market provides adequate funds to trade and industry. Beside this, it also gives the facility of discounting bills of exchange for trade and industry. With the availability of finance, it becomes easier for trade and industry to attain more profit.
4. **Helps in implementing Monetary Policy**: Monetary policy can be effectively implemented only through the instruments of Money market. As money market is governed by RBI, thus according to the changes in the economy, RBI brings changes in the Monetary Policy through money market instruments.
5. **Generates Capital Formation:** Money market provides investment avenues for short term period. Thus it inoculates the person to invest more in the money market instruments. As money market is highly liquid, so a person can get his/ her instrument converted easily. This helps in generating more capital formation in the economy.
6. **Provides non-inflationary sources of finance to government:** Government can also raise finance through investment in money market. It is possible by issuing treasury bills in order to raise short term loans. Raising finance through Treasury bill is non- inflationary as this does not

leads to increases in the prices. Thus money market provides non-inflationary source of finance to government.

4.4.3 Weaknesses of Indian Money Market

Among the developing countries, Indian money market is considered as the advanced money market, but still it suffers from many weaknesses. These weaknesses affect the efficiency of Indian Money market. Some of the important weaknesses of Indian money market are :-

1. **Absence of Integration :** The Indian money market is broadly classified into the Organized and Unorganized Sectors. The former includes the legal financial institutions backed by the RBI. The unorganized sector comprised of various institutions which are not backed by RBI such as indigenous bankers, money lenders, traders, etc. There is lack of proper integration between these two sectors.
2. **Multiple rate of interest:** In the Indian money market, there exist too many rates of interests, especially in the banks. These rates are different for lending, borrowing, government activities, etc. Thus so many rates of interests create confusion among the investors.
3. **Insufficient Funds:** With the seasonal changes, the Indian economy faces problem of frequent shortage of financial resources. Lower income means lower savings by people and hence lack of banking habits among people. It implies that demand for money is more than the supply of money and hence shortage of funds arises.
4. **Shortage of Investment Instruments**: In the Indian money market, there are various investment instruments such as Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc. are used. But the size of the population and market of these instruments are inadequate.
5. **Shortage of Commercial Bill :** In India, the use of the commercial bills is very limited as many banks keep large funds for liquidity

purpose. Similarly people preferred to do transactions in the form of cash and hence the scope for commercial bills is limited.

6. **Lack of Organized Banking System:** In India the banking system suffers from major weaknesses such as the NPA, huge losses, and poor efficiency even though we have a big network of commercial banks. The absence of the organized banking system is again a another major problem for Indian money market.
7. **Less number of Players**: In India, the players of money market are very less in number. Players are those entities who can act as mediators.

4.5 Conclusion:

The aspects like inflation, high interest rates, high cost of short-term finances, adverse foreign exchange rates, the state of SLR, CRR, Repo rate, reverse repo rate and expansion/contraction in money supply indicate about the poor health of an economy in the short-run. Any arrangements to bring it out from such situation would become an integral part of policy framework. Such arrangements in the form of money market instruments, if traded efficiently, transparently and priced objectively, might prove catalyst to any developing economy.

4.6 Check Your Progress

1. Which of the following is not a characteristic of a money market instrument?

A. liquidity B. long maturity

C. liquidity premium D. Both b and c

2. Treasury Inflation-Protected Securities (TIPS)

A. pay a fixed interest rate for life.

B. pay a variable interest rate that is indexed to inflation.

C. provide a constant stream of income in real (inflation-adjusted) dollars.

D. None

3. Which one of the following is not a money market instrument?

A. a Treasury bill B. a negotiable certificate of deposit

C. commercial paper D. a Treasury bond

4. Commercial paper is a short-term security issued by__________to raise funds.

A. the Federal Reserve Bank B. commercial banks

C. large, well-known companies D. the New York Stock Exchange

Answers: 1D 2C 3D 4C

4.7 Glossary

MIBOR: It is the interest rate at which banks can borrow funds, in marketable size, from other banks in the Indian interbank market. The Mumbai Interbank Offered Rate (MIBOR) is calculated everyday by the National Stock Exchange of India (NSEIL) as a weighted average of lending rates of a group of banks, on funds lent to first-class borrowers.

Real Time Gross Settlement (RTGS): Real time gross settlement systems (RTGS) are funds transfer systems where transfer of money or securities takes place from one bank to another on a "real time" and on "gross" basis. Settlement in "real time" means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. "Gross settlement" means the transaction is settled on one to one basis without bunching or netting with any other transaction. Once processed, payments are final and irrevocable.

4.8 References

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4.9 Suggested Readings

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4.10 Model Questions

1. Define money market. What are the objectives and characteristics of the money market?
2. Write short notes on:
   a) Treasury Bills
   b) Commercial Paper
   c) Certificate of Deposits
   d) Call money market
   e) Repo market
3. Explain in brief Indian Money Market.
4. Discuss briefly the various types of instruments that are dealt in money market.

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[i] Source: RBI Website

Chapter 5- Banking

1.1 Introduction

Now a day's banking sector acts as the backbone of modern business. Development of any country mainly depends upon the banking industry. The term bank has been used since so long but there is no clear conception about its beginning. Origin of word banking is from word Banchi or Greek word Banck which means heap or a mound. The first Public bank was bank of Venice. It was established in 1157.

It refers to an institution which deals in money. The institution accepts deposits and gives loans to those who are in need. Besides dealing in money, bank performs various functions of general utility, agency functions, services etc.

1.1.1 Definition of a Bank

Following has been the definitions which explain about the bank:

- **Indian Banking Companies Act -**

"Banking Company is one which transacts the business of banking which means accepting for the purpose of lending or investment of deposits money from the public repayable on demand or otherwise and withdraw able by cheque, draft, order or Otherwise".

- Professor G. Crowther:

"A bank is a firm which collects money from those who have it spare. It lends to those who require it."

- Professor Parking:

"A bank is a firm that takes deposits from households and firms and makes loans to other household and firms.

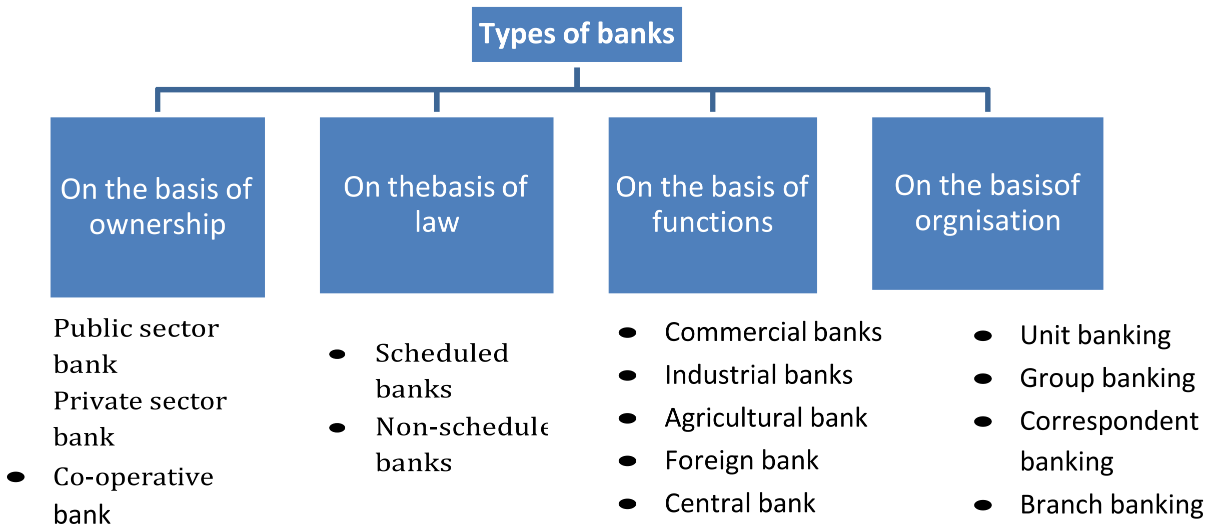
1.1.2 Characteristics and features of bank

From the above definitions, the following characteristics have been listed for a bank:

1. **Deals in money:** Bank is institution which deals in other people's money. It accepts deposits from people and institutions and lends to the needy ones.
2. **Individual firm/company:** Bank may be a firm or a company. A banking company is a company which deals in the business of banking.
3. **Acceptance of deposits**: The bank accepts deposits from the public in form of deposits which are usually repayable on demand or after expiry of a fixed period. It gives safety to the deposits of its customers.
4. **Giving advances:** The Bank lends to the needy ones in the form of term loans at a cost most commonly known as rate of interest.
5. **Facilitates in payment and withdrawal**: The Bank provides easy deposit and withdrawal facility to its customers in the form of cheques and drafts.
6. **Agency and utility services:** The Banks provide various facilities to customers apart from accepting and lending money like provision of lockers, accepting standing instructions of receipt and payment etc.
7. **Profit and service organisation:** The Bank is a profit making organisation having service oriented approach. A service oriented approach is a approach which focuses on its delivery of services to its customers.

8. **Banking business:** As discussed above, it the businesses of banking for which banks are known for. These institutions should not be subsidiary to any other business.
9. **Name identity:** A Bank should always add the word 'BANK' to its name in order to enable to know that it is a bank.

1.2 Types of banks:



Classification on the basis of ownership:

(i) **Public sector banks**: Public sector banks are those banks which are *owned by government*. Main objective of these banks are *social welfare.*

(ii) **Private sector banks**: These are the banks which are owned and run by *private sector*. Various banks in the country belong to this category like HDFC bank, ICICI bank, etc.

(iii) **Co-operative banks:** These are the banks which are *jointly run by group of individuals*. Each individual having equal share in bank.

Profits are equally distributed among shareholders. Mutual help of the shareholder is the core objective.

Classification according to law:

I. **Scheduled banks**: These are those banks which are mentioned in the *second schedule* of the Reserve Bank of India Act 1934. These are like Joint Stock Company or cooperative organisation.

II. **Non-scheduled banks**: These are those banks which are *not mentioned under the second schedule* of the reserve bank of india act 1934.

III. **Classification according to functions**:

I. **Commercial banks**: These are the most important constituents of the banking system governed by banking companies act 1949. These banks are basically for the *earning profit*. Commercial banks are the institutions that make short term loans to business and in the process create money.

II. **Foreign banks**: These are those banks which are *incorporated in foreign country*. They have their branches in India. These banks deal in foreign exchange. These banks convert the currency of one country into the other for example Standard charted bank, Hong Kong bank, Bank of America.

III. **Industrial banks**: these are those banks which offer long term and medium term *loan to the industries* and also work for their development. These banks help industries to purchase capital assets. In India many industrial banks are there like Industrial Development Bank of India, Industrial Finance Corporation and others.

IV. **Agricultural banks**: These are those banks which *give credit to agricultural sector* of the economy. Short term loans are given to farmers in order to purchase seeds, fertilizers, etc. Long term loans are given for the improvement in the farming facilities. Agricultural co-operative banks deal with the short term credits. To fulfil agricultural needs at the national level, National bank for agriculture and rural development has been established.

V. **Central bank:** Central bank is the *apex bank* in the Banking system in our country. Reserve Bank of India is the central bank of our country. It issues currency notes and acts as banker's bank. It controls credit and regulates credit system of banks. Main objectives of this bank are to *provide economic stability in the country*. Central banks issues all types of currencies, controls all other banks in country and functions as a bank of government.

Classification of commercial banks on the basis of their organisation

I. **Unit banking**: Under unit banking system banking operations are carried from the *single banking office* rather than through network of branches .Each banking company is the separate banking company, separately licensed having its own capital, board of directors and Shareholders.

In this banking system a particular bank functions in a limited area. Bank has *no branch office*.

II. **Branch banking:** This type of banking system is the one in which bank establishes a *head office in some big city* and *operates all over the country*. Some of them have their branches in foreign country .This system is too much prevalent in India.

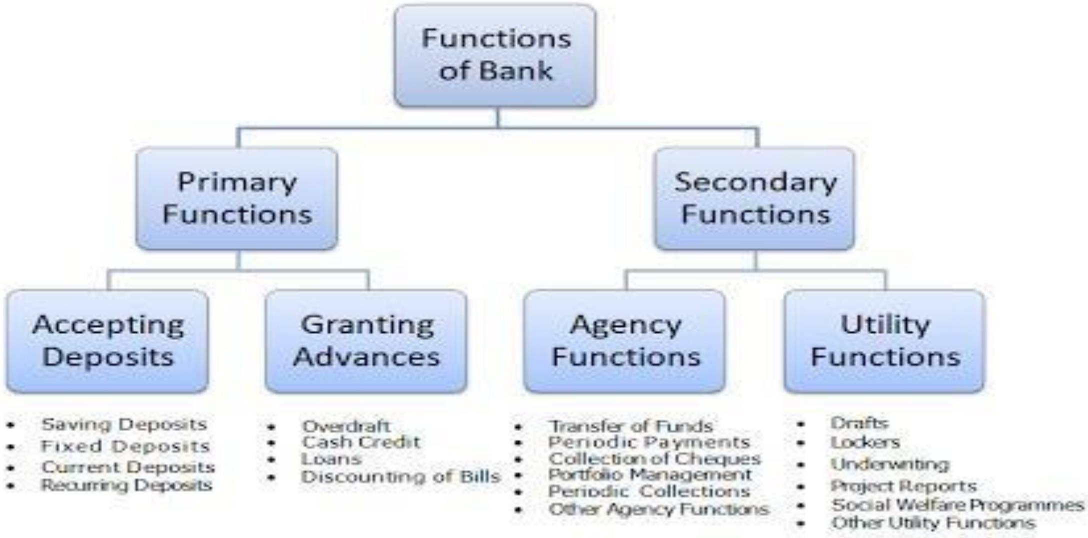
III. **Group Banking**: It is the banking system in which two or more banks operate *under the control of holding company* .These banks are known as subsidiaries of the corporation or holding. These banks may be unit banks or branch banks. Group banking system is most popular in the United States of America.

IV. **Chain Banking**: Chain banking is the banking system where the *same individual or group of individual controls two or more banks*. In this system an undivided or group of individual's buy the bulk of shares of two or more banks and thus control them.

V. **Correspondent banking:** it is an arrangement that exists among banks throughout the country based on practice of smaller banks carrying deposits with larger banks in exchange with performance of various services. Services include cheque clearing, sale and purchase of securities, making advances for big loans. These large banks called correspondent banking.

1.3 Functions of banks:

Commercial banks functions can be divided into following parts :



1.3.1Primary functions:

1. **Accepting Deposits**: A bank accepts deposits from the public as to deposit their cash balances in either of the following accounts as per their needs

    I. **Savings deposit account**: This account is meant for encouraging small savings. In this type of account restrictions are put on number of transactions. Bank pays interest on this account although interest rate is less than the rate on fixed deposits.

    II. **Fixed deposits**: cash is deposited for a fixed time period. For the amount deposited the depositor gets receipt which is known as fixed deposit receipt. This receipt comprises the name of the depositor, amount of deposit, time period for deposit, interest rate on deposit. This receipt is non-transferable. If any depositor demands his fixed deposit amount back before the maturity he is provided with money on discount. This kind of deposit attract high rate of interest. Longer the duration higher will be the rate of interest.

    III. **Current deposit/demand deposits accounts**: Number of transactions is not limited i.e. the depositor can deposit and withdraw the money any number of times. Generally no rate of interest is allowed on the deposits. The amount from this accounts is withdrawn with the help of cheques.

IV. **Recurring deposit account:** under this type of account a specified amount is deposited every month for a specific period of time say 6 ,12,24,36 or 60 months. This amount cannot be withdrawn before the expiry of this period except under exceptional circumstances. Interest on this type of account is credited to the account only. Usually interest rate on this type of account is higher than the other accounts.

V. **Home safe saving account:** under this small portable safe is provided by bank to the depositor at home. Key of the safe is kept by bank. Depositor puts his savings in this account and after certain time depositor hand over the money to bank and that amount will be credited to depositors account.

2. Advancing of loans: another primary function of the commercial bank is to advance loans. A part of deposits is kept as reserves and rest of the part is lended further. Banks advance loans for some productive purposes on approved security. The amount of loan is generally less than the value of the security. Banks advance following types of loans:

I. **Cash credit:** under this scheme debtor is allowed to withdraw certain amount of money on a given security. The debtor withdraws the amount within this limits , as per requirement and also repays it. Interest is charged by the bank on the amount actually withdrawn.

II. **Overdraft:** This facility is only provided to the current account holders. Under this client is allowed to sanction to withdraw more money than the lying in the said account. It is called overdraft. This facility is available only for meeting short term requirements.

III. **Loans and advances**: bank enters the loan amount in the account books of the debtor. The interest is charged on the whole of the amount from the day loan is sanctioned.

IV. **Discounting of the bills of exchange**: This is the most prevalent and important method of advancing loans to the business man for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

3. **Credit creation**: One of the main functions of banks these days is credit creation. Banks create credit by granting more loans than their primary deposits.

1.3.2 SECONDARY FUNCTIONS:

Besides these functions bank performs many secondary functions like agency functions, utility functions and developmental functions.

1. **Agency functions** :these are those functions in which bank act as an agent

I. **Purchase and sale of securities**: Banks keep securities on behalf of customers and deal in buying and selling of shares on their behalf.

II. **Letter of references:** bank issues letter of references telling the economic position of their customer to domestic and foreign trader's on the other hand economic position of the domestic and foreign traders to their customers.

III. **Remitting of money**: bank also remit money on behalf of their customer to other places or accounts.

IV. **Trustee and executor**: bank also acts as trustee and executor of the property of their customers on their advice.

V. **Collection and payments**: Bank perform this duty on behalf of his customer like payment of taxes, collection of refund, premium payment etc.

2. General utility functions:

Bank also provides certain services of general utility to the society.

I. **Locker facility**: Bank provides locker facility to their customers for keeping their valuables safe like gold , silver , cash and important documents, etc.

II. **Traveller's cheque**: bank issues travellers cheque to their customers in order to save them from the risk of carrying the cash.

III. Helps in transportation of goods:

Big business houses after consigning their goods to their retailers send the railway receipt to the bank. Retailers get the receipt from the bank on payment of value of consignment to it. In this way bank helps to transport goods from production centre to consumption centre.

3. Developmental functions: Bank also performs functions related to economic development and social welfare of the country.

I. It is the important function of bank to collect idle savings of people and invest in some productive activity.

II. Banks also takes part in capital market.

III. Banks gives loan to weaker section of society that too at lower interest rate.

IV. Banks have opened their branches in rural area in order to inculcate saving habits in them.

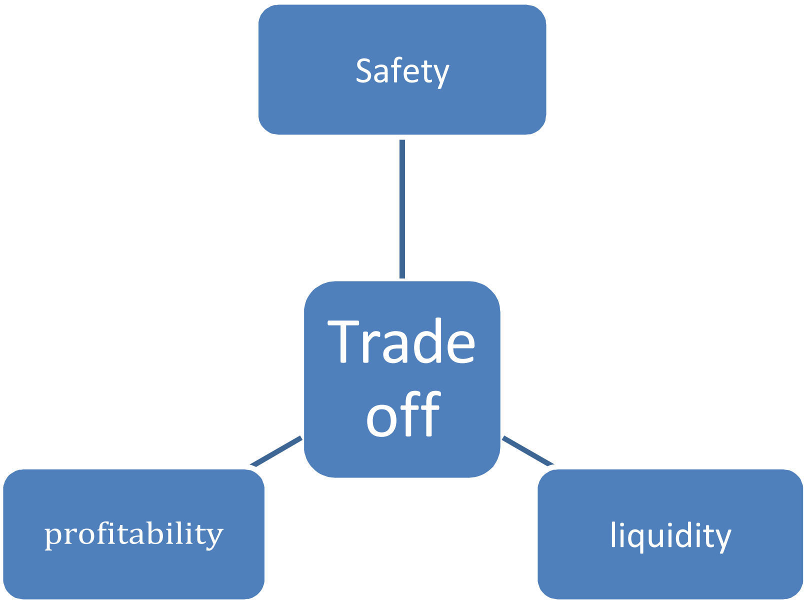
V. Bank provide educational loan to the needy students.

VI. Banks also performs functions like merchant banking, housing finance, factory leasing etc.

In short a bank performs various functions which are of great significance to the economic growth of country.

1.4 Safety – Liquidity – Profitability Trade Off

A bank is required to maintain a balance between liquidity, profitability and safety while conducting its day to day operations. Investments in current assets are inevitable to ensure various services to the ultimate customers. A proper management of the same could result in the desired impact on either profitability or liquidity or safety.



Liquidity:

Liquidity is a precondition to ensure that banks are able to meet itsshort-term obligations. The 'liquidity position' in a bank is measured based on the 'current ratio' and the 'quick ratio'. The current ratio establishes the relationship between current assets and current liabilities. Normally, a high current ratio is considered to be an indicator of the firm's ability to promptly meet its short term liabilities. The quick ratio establishes a relationship between quick or liquid assets and current liabilities. An asset is liquid if it can be converted into cash immediately or reasonably soon without a loss of value.

Banks are dealers in debts. Deposits with them are debts of others. Commercial banks are contractually under obligation to pay certain amount of money on very short notice so it becomes obligatory for the banks to maintain sufficient cash and liquid assets in order to meet claims for payments. The capacity of banks to make payments available on demand is called liquidity.

Prof Sayers has described liquidity as ‘the word that the banker uses to describe the ability to satisfy demands for cash in exchange of deposits.’

However, under the changed banking practices it is not always possible to satisfy liquidity requirement. Once the bank goes beyond the bills discounting business or financing against the goods in trade, decision-making becomes difficult. The lending beyond this is not self-liquidating in nature and so it becomes difficult for banks to tackle with such situations.

Safety:

Safety of funds is the most important principle of a commercial bank. The loan must be safe. It requires that it should be granted to those who will be able to repay it on time. Safety requirements should usually be supported by deposit of approved securities as an assurance against the unforeseen payments. In certain times bank is under pressure to lend aggressively and at the same time to ensure its returns. This is the reason banks calls for the collaterals. The safety needs should be ensured through many measures like good documentation, inspections etc. greater importance should be given to the continuous follow up not of security alone but of borrowers operations as well.

Profitability:

Profitability is a measure of the amount by which banks revenue exceeds its expenses. Profitability ratios are used to evaluate the management's ability to create earnings from revenue-generating bases within the bank.

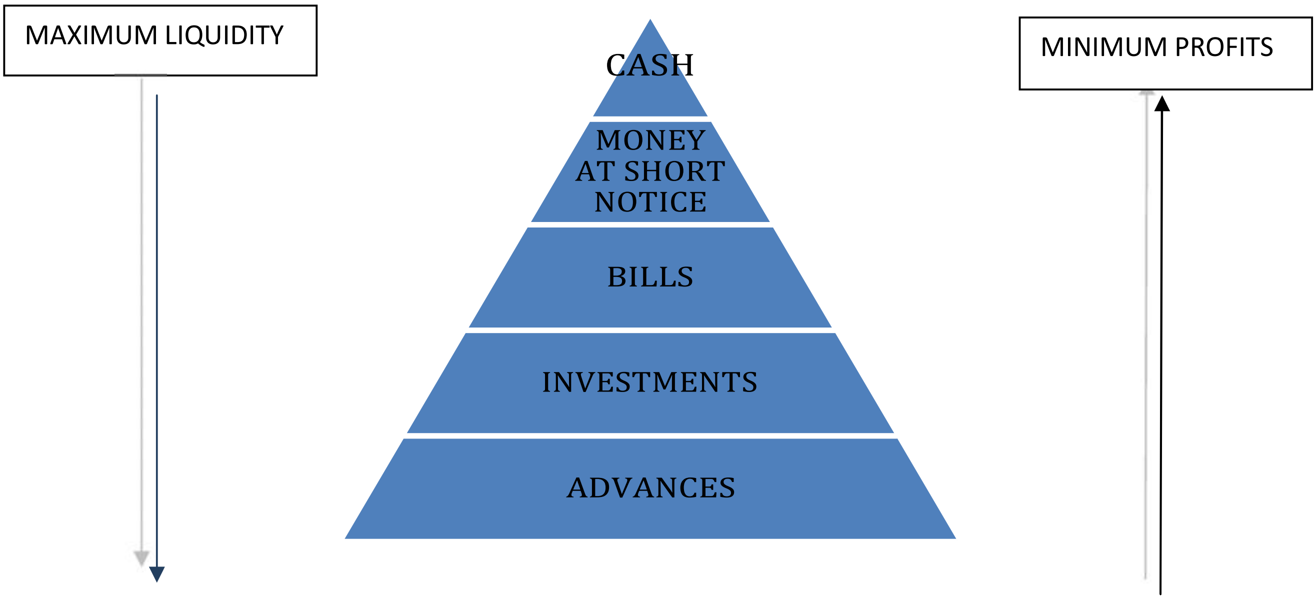
There is no point that bank granting facilities without any profit motive. Bank must earn sufficient income to meet the costs and then yield the results for the depositors. Profits of a bank are dependent on the following determinants:

1. Likely receipts from an asset during the period.
2. Variable cost in owing the asset.
3. Cost of acquiring an asset.

Apparently profitability is a sub – ordinate consideration to safety and liquidity. However, it is appreciated that in that long run higher income can be ensured only by maintaining a sound liquidity and safety position. Liquidity and safety cannot be sacrificed in quest of higher profits. Bank can earn income only if it is survives and bank cannot survive without liquidity and safety.

Trade off:

It is a technique of reducing or forgoing one or more desirable outcomes in exchange for increasing or obtaining other desirable outcomes in order to maximize the total return or effectiveness under given circumstances.



Liquidity, profitability and safety are the three principles of lending, each one of them is important for the bank so as to earn well in long run. Liquidity and safety are of primary consideration and profitability is on secondary consideration. Secondary consideration cannot be achieved at the cost of primary consideration , so banks requires to maintain the balance between all which is known as trade off so as to maintain its liquidity ,safety and earn higher profits in long run.

Situation:

- If bank goes for liquidity it has to sacrifice on its profits. That is where liquidly is high profits are low. There is an inverse relation between liquidity and income bank can earn income only by forgoing liquidity. For liquidity bank needs cash but cash it's not everything.

- If banks goes for safety it has to put restrictions on lending or increase its margin requirement which will further affect on the loan taking capacity of borrowers which will lead to decline on profits.
- If bank choose for profitability will go for high yield investment but high yield investment will likely to carry risk so higher the risk higher will be the profits. So if bank wants to employ an asset yielding high returns will have to endanger its safety.

So profits alone cannot do everything unless the liquidity and safety of funds will not be there that is secondary consideration cannot be achieved without achieving primary considerations of liquidity and safety so trade off of safety , profitability and liquidity should be there.

1.5 Conclusion

A crucial element of Indian financial system which channelizes the savings from investors to industry for capital formation is the bank. Apart from discharging its duty towards the financial system, it makes an endeavour to bring trade-off between safety, liquidity and profitability. In the absence of this trade-off, no bank can attain maximum utilisation of its financial resources.

1.6 Check your progress:

- Any bank which is incorporated under the RBI Act 1934 is called:
    a) Commercial Bank
    b) Foreign bank
    c) Scheduled bank
    d) Non-scheduled bank
- Trade-off refers to a situation where:

a) Liquidity is preferred over safety and profitability
b) Safety is preferred over profitability and liquidity
c) Profitability is preferred over liquidity and safety
d) A balanced measure where all aspects i.e. profitability, liquidity and safety are within the limits of the bank.

1.7 Glossary

- **Agency:** It refers to an agreement in which one party acts for the other in return to a certain charge.
- **Discounting of bills:** It refers to providing liquidity to business on the basis of a bill of exchange which signifies a trade and promise to pay after a certain period of time.

1.8 References

- **Lewis, M.K and K.T.Davis (1987)**: Domestic and International Banking, Cambridge, M.A., M.I.T. Press.
- **Muraleedharan, D (2009)**: Modern Banking- Theory and Practice, Prentice Hall of India Pvt. Ltd.

1.9 Suggested Readings

- **"Advanced study in Money and Banking",** Perminder Khanna (2005), published by Atlantic publishers and distributors, New Delhi.
- **"Banking sector liberalization in india** : by Dr. Christian Roland (2008), By Springer Company

1.10 Model Questions

a) Explain the various types of banks.
b) What do you mean by an Industrial bank?
c) Differentiate between primary and secondary functions of a bank
d) Is it possible for a bank to achieve trade-off between the three main elements of banking business i.e. profitability, liquidity and safety?

Chapter 6- Central Banking

Structure

6.1 Objectives

- ❖ To understand the role of RBI in financial system.
- ❖ To understand the monetary policy issued by RBI to control money supply

6.2 Introduction

The central bank of any country is the apex institution of its monetary system as well as financial system because monetary system is the major constituent of the country's financial system. As the apex body, the central bank **organizes runs, supervises, regulates and develops the monetary system and thus the financial system of the country**. Formulating and implementing the monetary policy are the main responsibilities of the central bank.

Central banks, in general, are very old institutions. For instance, The Bank of England was set up in 1694, and the Bank of France is more than 200 years old. As for the Federal Reserve Bank it was set up in 1913. Coming to RBI it was set up in 1935. It though may appear young due to its late inception when compared to developed world, but as .....Governor Dr Bimal Jalan, said though it may appear like a 'toddler or at most a young adult', it is one of the oldest central banks among the developing world.

The central bank of India was established on April 1, 1935, under the Reserve Bank of India Act. It was entrusted with the responsibility to create financial stability in India and is charged with regulating the country's currency and credit systems. RBI uses monetary policy as major tool to discharge its fundamental responsibilities stated above.

6.3 Characteristics of Central Bank

1) **Monetary Authority:**

RBI formulates implements and monitors the monetary policy. The objective of formulating monetary policy is to maintain price stability and ensuring adequate flow of credit to productive sectors as well as adequate money supply in the economy.

2) **Regulator and supervisor of the financial system:**

RBI prescribes broad parameters of banking operations within which the country's banking and financial system functions. The objective of formulating common rules and regulation for the overall banking industry is to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3) **Manager of Foreign Exchange**

Adequate foreign exchange reserve and efficient foreign exchange rate establish sound creditability status in the globalized world. RBI is responsible for managing foreign exchange reserves and its conversion rates. This management of reserves is regulated under the Foreign Exchange Management Act, 1999. The objective is to facilitate external trade, payment and promote orderly development and maintenance of foreign exchange market in India.

4) **Issuer of currency:**

RBI is having the sole responsibility of issuing currency. Besides Issues only, it also exchanges or destroys currency and coins not fit for circulation. The objective is to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5) **Developmental role**

RBI performs a wide range of promotional functions to support national objectives. For this Reserve Bank has helped in the setting up of the various institutions such as Industrial Financial Corporation of India (IFCI) and the State Financial Corporations (SFC); the Unit Trust of India (UTI) in 1964, the Industrial Development Bank of India (IDBI) also in 1964, the Agricultural Refinance Corporation of India in 1963, NABARD in 1982 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up by the Reserve Bank directly or indirectly to promote saving habit among individuals and mobilize these savings to provide industrial finance as well as agricultural finance. The basic objective is to equal development of all sectors of an economy.

6.4. Techniques Credit Control

The Central Bank controls the credit through monetary policy. Credit is expanded or contracted as per the need by the Reserve Bank. It is called credit control. For this purpose the R.B.I. uses the different methods of monetary policy. After independence, the RBI has used the controlled expansion policy so that the economic expansion and stabilization could be achieved.

The R.B.I. uses different methods to control the credit. These methods can be divided into two parts:

R.B.I.'s Methods of Credit Control

Quantitative Credit Control | **Qualitative Credit Control**

Quantitative Methods	Qualitative Methods
1. Bank Rate Policy 2. Open Market Operations 3. Variable in the Reverse Ratio	1. Fixing marginal requirements 2. Consumer Credit regulation 3. Publicity 4. Credit rationing 5. Moral Suasion 6. Control through directives 7. Direct Action

The Quantitative Instruments are also known as the General Tools of monetary policy. These tools are related to the Quantity or Volume of the money. They are designed to regulate or control the total volume of bank credit in the economy while Qualitative instruments regulate provide credit to selected borrowers for selected purpose, depending upon the use to which the control try to regulate the quality of credit - the direction towards the credit flows.

(A) Quantitative Instruments or General Tools

1. Bank Rate Policy (BRP)

The Bank Rate Policy (BRP) is a very important tool for controlling the volume or the quantity of the credit in a country. The bank rate refers to rate at which the central bank (i.e. RBI) is prepares to discount discounts bills. It is the standard rate prescribed by RBI at which the bank is prepared to buy or rediscount bills of exchange or other commercial paper.

Change in the bank rate will necessarily bring out a resultant change in the cost of credit available to commercial banks. If the RBI increases the bank rate then cost of credit will increase and thus the volume of commercial banks borrowing has been reduced from the RBI.

On the other hand, if the RBI reduces the bank rate, cost of credit will be easy and cheaper. This will increase the credit creation in the economy. Thus bringing the change in bank rate will affect the availability of credit in the economy.

2. Open Market Operation (OMO)

The open market operation refers to the purchase and/or sale of short term and long term of Government securities by the Central Bank in the open market. If the RBI sells securities in an open market, institutions or individuals will buy these securities which reduce the cash reserves with the banking system and credit created by it. Contrary to this when the RBI buys the securities from commercial banks in the open market. The cheques issued by the central bank to the sellers are deposited with the central banks. It increases the cash reserves with the banking system which will further increase the credit creation capacity of commercial banks.

3. Variation in the Reserve Ratios (VRR)

The Commercial Banks have to keep a certain percentage of their total deposits in the form of Cash Reserves. Some parts of these cash reserves have to be kept in the form of cash with themselves, known as Statutory Liquidity Ratio (SLR). Apart of these, some part of cash reserves has to be kept with the RBI for the purpose of maintaining liquidity and controlling credit in an economy, known as Cash Reserve Ratio (CRR).

Any change in any of the above will affect the lending capacity of commercial banks.RBI increases these reserves during the inflation to reduce the credit creation in the economy. But during the period of recession or depression it lowers these reserves by making more cash reserves available to commercial banks for credit expansion.

(B) Qualitative Instruments or Selective Tools

The Qualitative Instruments are also known as the Selective Tools of monetary policy. These tools are not directed towards the quality of credit or the use of the credit. These methods are meant to give the central bank as ability to affect particular segments of the economy on selective basis. They are used for discriminating between different uses of credit. The Selective Tools of credit control comprises of following instruments.

1. Fixing Margin Requirements

The margin requirement refers to the difference between the market value of the security and its maximum loan. An increase in margin requirement will decrease the amount of loan and thus reduces the money supply in the economy. On the contrary decrease in margin requirement will increase the amount of loan and thus raises the money supply in the economy.

2. Consumer Credit Regulation

Under this method, consumer credit supply is regulated through hire-purchase and installment sale of consumer goods. Under this method the down payment, installment amount, loan duration, etc is fixed in advance. This can help in checking the credit use and then inflation in a country.

3. Publicity

This is yet another method of selective credit control. Through it, Central Bank (RBI) publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public and banks can use it for attaining goals of monetary policy.

4. Credit Rationing

Under this method the central Bank fixes a limit for the credit facilities available to commercial Banks. The available credit is rationed among the applicants according to the purpose of credit. This method controls even bill rediscounting. For certain purpose, upper limit of credit can be fixed and banks are told to stick to this limit. This can help in lowering banks credit exposure to unwanted sectors.

5. Moral Suasion

Moral suasion is a general term for describing a variety of informal or non legal methods used by the central bank to persuade commercial banks to behave in particular manner. It is a simply a pressure exerted by the RBI on the Indian banking system without any strict action for compliance of the rules. Under moral suasion, central banks can issue directives, guidelines and suggestions for commercial banks regarding reducing credit supply for speculative purposes.

6. Control through Directives

Under this method, the central bank issue frequent directives to commercial banks. These directives guide commercial banks in framing their lending policy. Through a directive the central bank can influence credit structures, supply of credit to certain limit for a specific purpose e.g. issuance of directives to commercial banks for not lending loans to speculative sector such as securities, etc beyond a certain limit.

7. Direct Action

Under this method, the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. Secondly, RBI may refuse credit supply to those banks whose borrowings are in excess to their capital. Central bank can penalize a bank by changing some rates. At last, it can even put a ban on a particular bank if it does not follow its directives and work against the objectives of the monetary policy.

These are various selective instruments of the monetary policy. However the success of these tools is limited by the availability of alternative sources of credit in economy, working of the Non-Banking Financial Institutions (NBFIs), profit motive of commercial banks and undemocratic nature of these tools. But a right mix of both the general and selective tools of monetary policy can give the desired results.

6.5 Monetary Policy

Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit.

The goal: achieving specific economic objectives, such as low and stable inflation and promoting growth.

6.5.1 Definition of Monetary Policy

Many economists have given various definitions of monetary policy. Some prominent definitions are as follows.

According to **Prof. Harry Johnson**,"A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

According to **A.G. Hart**, “A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

As per **Shapiro**, "The monetary policy of a nation involves the overall set of laws and practices that control the quantity and quality of money in an economy."
From these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

6.5.2 Objectives of Monetary Policy

The objectives of a monetary policy are as follows:

- **Rapid Economic Growth** :

Amongst the most important objectives of a monetary policy is rapid economic growth. The monetary policy by controlling real interest rate and its resultant impact on the investment can influence economic growth. Also, the investment level in the economy can be encouraged if the RBI opts for a cheap or easy credit policy by reducing interest rates. This increased investment can speed up economic growth. If the monetary policy succeeds in maintaining income and price stability then faster economic growth is possible.

- **Price Stability** :

Inflation and deflation marks all economies – the situation is called Price Instability and is harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable, as helps in reducing the wealth and income inequalities. The monetary policy should be an 'easy money policy' when the economy suffers from recession, but when there is inflationary situation there should be a 'dear money policy'.

- **Exchange Rate Stability** :

Price of a home currency expressed in terms of any foreign currency is called exchange rate. The international community might lose confidence in our economy, if this exchange rate is very volatile. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI tries to maintain the exchange rate stability by altering the foreign exchange reserves and tries to influence the demand for foreign exchange.

- **Balance of Payments (BOP) Equilibrium** :

India, along with many other countries, suffers from the Disequilibrium in the BOP. The Reserve Bank of India tries to maintain equilibrium in the balance of payments through its monetary policy. The BOP has two aspects i.e. the 'BOP Surplus' that reflects an excess money supply in the domestic economy and the 'BOP Deficit', that stands for stringency of money. BOP equilibrium can be achieved, if the monetary policy succeeds in maintaining monetary equilibrium.

- **Full Employment :**

It was after the Keynes's publication of the "General Theory" in 1936 that the concept of full employment was much discussed. It refers to absence of involuntary unemployment. To say, 'Full Employment' stands for a situation in which everybody who wants a job, get a job. However, it does not state that there is no unemployment and that full employment is actually full. Monetary policy can be used to achieve full employment. If the monetary policy is expansionary then credit supply can be encouraged and this in turn could assist in creating more jobs in different sector of the economy.

- **Neutrality of Money** :

Money has always been looked at as a passive factor by economists such as Wicksted and Robertson. They feel that money should play only a role of medium of exchange and not more than that and hence the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus, to neutralize the effect of money expansion, monetary policy has to regulate the supply of money. However, this objective of a monetary policy is always criticized on the ground that it would be difficult to attain price stability, if money supply is kept constant then.

- **Equal Income Distribution** :

The role of the fiscal policy is to maintain economic equality, felt many contemporary economists. However, in the recent years economists have given the opinion that the monetary policy can also help and play a supplementary role in attainting economic equality. Special provisions for the neglect supply such as agriculture, village industries and small-scale industries can be provided by Monetary policy, along with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus to reduce economic inequalities among different sections of society in the recent period, monetary policy can be of great help.

6.6 Targets and Indicators of Monetary Policy (https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=35087)

On the basis of an assessment of the current and evolving macroeconomic situation, RBI has decided to:

- reduce the policy repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 7.25 per cent to 6.75 per cent with immediate effect;
- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of net demand and time liability (NDTL);
- continue to provide liquidity under overnight repos at 0.25 per cent of bank-wise NDTL at the LAF repo rate and liquidity under 14-day term repos as well as longer term repos of up to 0.75 per cent of NDTL of the banking system through auctions; and
- continue with daily variable rate repos and reverse repos to smooth liquidity. Consequently, the reverse repo rate under the LAF stands adjusted to 5.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate to 7.75 per cent.

6.7 Conclusion

The central bank of any country is entrusted with twin jobs of regulating the financial environment in short-run and acting as a banker/agent to any government. The success of any political government largely depends upon *the way central bank reacts in the given economy. Its reactions are often seen in the form of monetary policy measures linked towards curbing inflation, moderate money supply, economy suited interest rates and banking ratios.*

6.8 Glossary

- **Scheduled banks: Scheduled Banks** in India are those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (6) (a) of the Act.
- **Balance of Payments (BOP):** Balance of payments (BOP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers.
- **Wholesale Price Index (WPI):** The Wholesale Price Index or WPI is "the price of a representative basket of wholesale goods". Some countries use the changes in this index to measure inflation in their economies. The purpose of the WPI is to monitor price movements that reflect supply and demand in industry, manufacturing and construction. This helps in analyzing both macroeconomic and microeconomic conditions. Inflation is based on Wholesale Price Index.
- **Industrial Financial Corporation of India (IFCI):** The Industrial Finance Corporation of India (IFCI) on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term finance needs of the industrial sector. The newly established DFI was provided access to low-cost funds through the central bank's Statutory Liquidity Ratio or SLR which in turn enabled it to provide loans and advances to corporate borrowers at concessional rates.

- **NABARD:** It was established on 12 July 1982 by a special act by the parliament and its main focus was to uplift rural India by increasing the credit flow for elevation of agriculture & rural non farm sector and completed its 25 years on 12 July 2007.[4] It has been accredited with "matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India"

6.9 Suggested Readings:

- M. R. Baye and D. W. Jansen, Money, Banking and Financial Markets, AITBS, 1996.
- Rakesh Mohan, Growth with Financial Stability- Central Banking in an Emerging Market, Oxford University Press, 2011
- N. Jadhav, Monetary Policy, Financial Stability and Central Banking in India, Macmillan, 2006.
- Reserve Bank of India : Report of Currency & Finance

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6.10 Model Questions

1. Explain the role of RBI in the Management of Financial Sector.
2. What do you mean by monetary policy? Explain its various objectives.
3. What are the various methods of RBI to control the credit in India?
4. How does financial system and monetary policy are related to each other?
5. Explain the reforms in financial sector.
6. Write a brief note on globalization of Indian financial system.

Chapter-7

Reserve Bank of India

Structure

7.1 Objectives

- To understand the function of commercial banks and their role in economic development of the country.
- To study the banking reforms in India
- To study the prudential norms for income recognition, provision for bad and doubtful debts, capital adequacy and concentration of credit/investments.

7.2 Introduction

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

7.2.1 Preamble of RBI

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

7.3 Role and Functions of Reserve Bank of India

All the important functions of central bank, the Reserve Bank of India, are entrusted to it by The Reserve Bank of India Act of 1934

1. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. Reserve Bank, as agent of the Government, distributes rupee notes and coins of small denomination all over the country and issues them via a separate department called Issue Department.

Issue Department keeps its assets and liabilities separate from those of the Banking Department. The assets of the Issue Department, originally, were to consist of not less than two-fifths of gold bullion, gold coins, or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in Government of India rupee securities, rupee coins, eligible bills of exchange and promissory notes payable in India. These provisions were modified due to the exigencies of the Second World War. The Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold since 1957. The system as it exists today is known as the minimum reserve system.

2. Banker to Government

Reserve Bank of India acts as Government banker and adviser. Except Jammu and Kashmir, Reserve Bank acts as agent of Central Government and of all State Governments in India. The Reserve Bank has the obligation to transact Government business like to receive and to make payments on behalf of the Government, to keep the cash balances as deposits free of interest, and to carry out their exchange remittances and other banking operations. The Reserve Bank of India also helps the Government (both the Union and the States) to float new loans and to manage public debt. Advances to the Governments for 90 days can also be made by the bank. States and local authorities also take loans and advances from RBI. Besides, RBI acts as adviser to the Government on all banking and monetary matters.

3. Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. Every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilites and 2 per cent of its time liabilities in India, according to the provisions of Banking Companies Act 1949. However, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities, by an amendment of 1962. The minimum cash requirements can be changed by the Reserve Bank of India on timely basis.

The scheduled banks can get financial accommodation in times of need or stringency by rediscounting bills of exchange or can borrow from the Reserve Bank of India on the basis of eligible securities or. Also, the Reserve Bank becomes not only the banker's bank but also the lender of the last resort, as commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis.

4. Controller of Credit

RBI has the power to influence the volume of credit created by banks in India and so is called the controller of credit. It influences the credit through open market operations or by changing the Bank rate. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Selective controls of credit are increasingly being used by the Reserve Bank, since 1956.

The Reserve Bank of India has many powers to control the Indian money market. For instance, to do banking business within India, every bank has to get a license from the Reserve Bank of India. This license can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled.

To open a new branch every bank will have to get the permission of the Reserve Bank. Each scheduled bank must send a detailed weekly return to the Reserve Bank showing of its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The accounts of any commercial bank can also be inspected by The Reserve Bank.

As supreme banking authority in the country, the Reserve Bank of India has the following powers:

(a) Cash reserves of all the scheduled banks are held by RBI.

(b) System of inspection, licensing and calling for information is also controlled in the banking system.

(c) It also controls the credit operations of banks through qualitative and quantitative controls.

5. Custodian of Foreign Reserves

It is the responsibility of Reserve Bank to maintain and manage forex reserves. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. In 1946, after India became a member of the International Monetary Fund, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

RBI has also to provide custody to India's reserve of international currencies. Further, the RBI has the responsibility of administering the exchange controls of the country.

6. Supervisory functions

The Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over co-operative and commercial banks, branch expansion, relating to licensing and establishments, liquidity of their assets, management and methods of working, reconstruction amalgamation and liquidation. Periodical inspections of the banks can be held by RBI and the Bank has the power to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards realization of certain desired social objectives and more rapid development of the economy. All these supervisory functions helped in improving the standard of banking in India and also in improving the methods of their operation.

7. Promotional functions

The range of the Reserve Bank's functions has steadily widened after economic growth assumed new urgency post Independence. For starters, it now performs a variety of developmental and promotional functions, which, earlier were regarded as outside the scope of central banking. The Reserve Bank was asked to extend banking facilities to rural and semi-urban areas, promote banking habit, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Industrial Development Bank of India in 1964, the Unit Trust of India also in 1964, the

Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up indirectly or directly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance.

Though the Reserve Bank of India set up the Agricultural Credit Department in 1935 to provide agricultural credit, it is only after 1951 the Bank's role became important in this field.

While, Co-operative credit movement was developed by the Bank to encourage saving, to route its short term credit to agriculture and to eliminate moneylenders from the villages, Agricultural Refinance and Development Corporation was set up by RBI to provide long-term finance to farmers.

8. Controller of money supply

One of the objectives of RBI is to control money supply in the economy. This objective can be achieved through formulating monetary policy by RBI. There are the quantitative and qualitative methods of monetary policy to control the money supply in the economy.

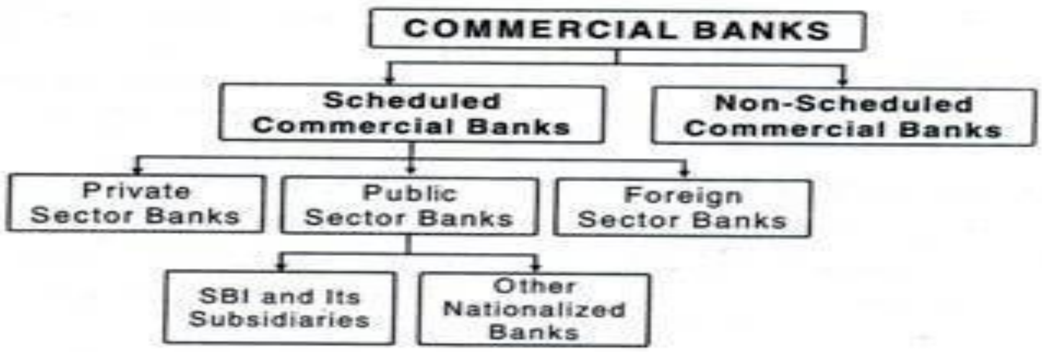
7.4 Meaning of Commercial Banks

A bank is an institution which deals with money. It is a profit seeking business firms which deals in money or rather claims to money. It accepts deposits from the public and on the basis of these deposits make the funds available to people who need them. Commercial Banks play an important role in the financial sector as it creates credit in the economy. They are the creators of credit. More credit generation will leads to more investment in the economy and hence growth in an economy took place. Thus, the growth of the economy of any country basically depends on a sound and solvent banking system.

The Banking Companies Act of 1949, defines banking company as "accepting for the purpose of lending or investment of deposit money from the public, repayable on demand or otherwise and withdrawable by cheque, drafts, order or otherwise".

7.5 Structure of Commercial Banks in India:

The commercial banks can be broadly classified under two heads:



1. Scheduled Banks:

Scheduled Banks are those banks which have been included in the Second Schedule of Reserve Bank of India Act, 1934.

In India, scheduled commercial banks are of three types:

(i) **Public Sector Banks**:

These banks are those banks which are owned and controlled by the government. The main aim of these banks is not to earn profit rather to provide service to the society. Some examples of public sector banks are State Bank of India, Bank of India, Punjab National Bank, Canada Bank and Corporation Bank. Public sector banks are of two types:

(a) SBI and its subsidiaries;

(b) Other nationalized banks.

(ii) **Private Sector Banks:**

These banks are those banks which are owned and controlled by private businessmen. Their main aim is to earn profits and they had least concern towards providing services to the society. Some examples are ICICI Bank, HDFC Bank, IDBI Bank.

(iii) **Foreign Banks**:

These banks are those banks which are owned and controlled by foreign promoters. When the process of economic liberalization had started in India, their number has grown rapidly since 1991. Some examples are Bank of America, American Express Bank, Standard Chartered Bank.

2. Non-Scheduled Banks:

Non-Scheduled banks are those banks which are not included in the Second Schedule of Reserve Bank of India Act, 1934.

7.6 Functions of Commercial Banks

Various functions of commercial banks are as follows:

I. **Primary / Banking Functions :-**

Commercial banks have two important functions, i.e. accepting deposits and advancing loans. People consider it safer to deposit their savings in bank to avoid the danger of theft.

1) **Deposits :-**

One of the main functions of commercial bank is to accept deposits from the public. People earn interest by getting their money deposited in the banks. They can deposit their cash in the banks in various forms.

a) **Current Account Deposits :-**

Current Accounts are usually operated by businessmen who have a number of routine transactions with the bank, both deposits and withdrawls. There is no restriction on number and amount of deposits and withdrwals. No interest is paid on current deposits rather banks charge interest for providing this facility.

b) **Saving Account Deposits :-**

Saving Accounts are usually opened by salaried people and other people having less income. There is no restriction on number and amount of deposits but there is restriction on withdrawls in such accounts. It earns Interest which induces saving habit among people. thus the saving deposits are an important source of funds for banks.

c) **Fixed Account Deposits :-**

These are also known as time deposits. Under this account, money is deposited for a certain fixed period of time varying from 15 days to several years. These deposits carry a high rate of interest as compared to saving deposits. There is penalty in the form of lower rate of interest if money is withdrawn before expiry date. People can also use fixed deposit as a security in taking loans from banks.

d) **Recurring Account Deposits :-**

In Recurring deposit, a specified amount of money is regularly deposited by account holder, at a regular interval, usually a month. This deposit encourages people to form the habit of small savings. At the end of maturity period, the account holder gets a substantial amount. Interest on this type of deposit is almost equal to fixed deposits. Thus by giving variety of deposits, banks encourages people towards savings in the economy.

2) **Loans And Advances :-**

Banks not only accept deposits but also advance money to its credit worthy customers for maximizing profits. Loans and Advances are granted in following forms:-

i) **Overdraft :-**

Commercial banks grant overdraft facility to current account holders which allowed them to draw more than what is deposited in their account. Against collateral security, the borrower is granted to a fixed additional amount. Interest is charged for actual amount withdrawn by borrower.

ii) **Cash Credit :-**

Cash credit is given to the borrower by the bank to meet regular working capital needs, against the security of goods or any other personal security. Interest is charged for actual amount withdrawn by borrower.

iii) **Discounting Of Bills :-**

Sometimes the holder of the bill is not in a position to wait till the maturity of the bill and requires cash urgently then he has option to sells the bill of exchange to bank after making some marginal deductions. Bank provide discounting facility on the instruments which can be government securities or any other approved financial instruments.

iv) **Money At Call :-**

Such loans are for a very short period, generally not exceeding 7 days. Such advances are repayable immediately at a short notice hence they are called as Money at Call or Call money. These loans are generally given to other banks or financial institutions.

v) **Direct Loans :-**

Loans are given to customers against the security of moveable properties for a period from 1 to 10 years. Interest has to be paid on entire loan amount sanctioned.

II. **Secondary / Non-banking Functions:-**

Other than basic functions of accepting deposits and advancing loans, banks offered other forms of services to public. Such services are termed as non-banking or secondary functions:-

1. **Agency Services:-**

Sometimes banks perform certain functions on behalf of their customers and hence act as agents to their customers. Such type of services are called as agency services and some of these important agency functions are :-

a) **Collection :-**

Commercial banks collect cheques, drafts, bills, promissory notes, dividends, subscriptions, rents and any other receipts on behalf of their customers by charging a nominal amount.

b) **Payment :-**

Banks also makes payments like paying insurance premium, rent, taxes, electricity and telephone bills etc on behalf of their customers by charging services commission.

c) **Income – Tax Consultant :-**

Commercial banks also acts as income-tax consultants and prepare the income tax returns of their clients.

d) **Sale And Purchase Of Financial Assets :-**

Banks undertake sale and purchase of securities, shares and any other financial assets as per the instructions of the customers. In return, bank charges nominal charges.

e) **Trustee, Executor And Attorney :-**

Banks also becomes the custodian and manager of customer funds by executing deceased customer's will. As an Attorney the banks sign the documents on behalf of customer.

2. **Utility Services :-**

Modern Commercial banks also performs certain general utility services for the community, such as :-

a) **Letter Of Credit :-**

Banks issue letter of credit to their customers who deal in the foreign trade. Banks also provide guarantee to foreign traders for the soundness of their customers.

b) **Traveller's cheques :-**

Banks issue traveller's cheques to their customers so that they can travel easily and safely without the fear of theft or loss of money.

c) **Guarantor :-**

Banks offer a guarantee of payment on behalf of importer to facilitate imports with deferred payments.

d) **Underwriting :-**

Bank underwrites the securities issued by Joint Stock Companies or by government which enable them to raise funds. Basically, banks give the guarantee to purchase certain proportion of shares, if not sold in the market.

e) **Locker Facility :-**

Bank provides lockers facility to their customers so that they can deposit their valuables like Jewellery, Securities, Shares and other documents.

f) **Referee :-**

Banks may act as referee with respect to collect information regarding the financial standing, business reputation and respectability of customers.

III. Subsidiary Activities:-

Many commercial banks also undertakes subsidiary activities such as :-

1) **Housing Finance:-**

Housing finance is provided against the security of immoveable property like land and buildings. Many banks such as SBI, Bank of India etc. have set up their own housing finance subsidiaries.

2) **Mutual Funds :-**

A Mutual fund is a financial intermediary which pools the savings of investors for collective investment in diversified portfolio securities Many banks like SBI, Indian Bank etc. have set up their own mutual fund subsidiaries.

3) **Merchant Banking:-**

Bank also provides the services of merchant banker like Marketing and Underwriting of new issues, project promotion, corporate advisory services, investment advisory services etc.

4) **Venture Capital Fund:-**

Venture capital fund provides start-up share capital to risky, young and small private business, who wants to start their new business especially in technology oriented and knowledge intensive business. Many commercial banks like SBI, Canara Bank etc. have set up their own venture Capital Fund Subsidiaries.

5) **Factoring:-**

Factoring is an arrangement between a firm and financial institution where by the factor purchases the clients accounts recieveable. Banks like SBI and Canara Bank have established subsidiaries to provide factoring services. Thus various services are provided by commercial Banks.

7.7 Role of Commercial Bank in Economic Development

In India, there was acute shortage of capital and people lack initiative and enterprise. Means of transport were undeveloped and as such Industry was in bad condition. Thus there is a need of an institution which removes all the above deficiencies and this lead to the emergence of Banks. “A bank is an

Institution, which touches and should touch the lives of millions, has necessarily to be inspired by a larger social purpose and has to sub serve national priorities and objectives." A well-developed banking system provides a basic foundation for the economic development of the country. The role of a commercial bank in a developing country is discussed as under.

1. Mobilizing Saving for Capital Formation:

Capital formation is the most important function of commercial banks. The commercial banks help in mobilizing savings through network of branch banking in the different areas. People in developing countries have low incomes and through the variety of deposit schemes, banks induce them to save. They collect deposits from the public and by mobilizing savings; the banks channelize these deposits into productive investments. Thus they help in the capital formation of a developing country.

2. Financing Industry:

The commercial banks finance the industrial sector by providing them short-term, medium-term and long-term loans. In India, the commercial banks provide short-term and medium-term financing of small scale industries, and also provide hire- purchase finance. Besides, these, they also underwrite the shares and debentures of large scale industries. Thus banks provide two types of finance to industries- a) one is by giving them short term or medium term loan and b) second is providing underwriting facility to them.

3. Financing Trade:

The commercial banks provide finance for internal and external trade. Internal finance includes providing loans to retailers and wholesalers to purchase goods in which they deal. Banks also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. External finance including providing finance to both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

4. *Financing Agriculture:*

The commercial banks provide loans to traders who deal in agricultural commodities. With the aim to provide agricultural finance, commercial banks open a network of branches in rural areas. They provide finance directly to agriculturists for the marketing of their produce, for the use of machines in their farms, for providing irrigation facilities, etc. They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, and horticulture.

For the small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas, Government provides financial assistance through the regional rural banks in India, which are operated under a commercial bank. Thus the commercial banks cater need of the credit requirements of all types of rural people.

5. *Financing Consumer Activities:*

People in underdeveloped countries are poor and are having low incomes and because of it they do not have sufficient finance to purchase durable consumer goods. The commercial banks provide loans to such consumers for the purchase of durable items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries.

6. *Financing Employment Generating Activities:*

The commercial banks also provide finance for employment generating activities in developing countries by providing educational loans to the young person's studying in engineering, medical and other vocational institutes of higher learning. They provide loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business which further generates more employment opportunities for other. Hence, the banks not only help in human capital formation but also provide help in increasing entrepreneurial activities in developing countries.

7. Help in Monetary Policy:

By fully implementing the monetary policy of the central bank, the commercial banks help the economic development of a country. In fact, the success of monetary policy depends upon the commercial banks in keeping with requirements of a developing economy.

7.8 Banking sector reforms

Since nationalisation of banks in 1969, the Public sector had been dominating the banking sector. There was financial repression, role of technology was limited, no risk management etc which leads to low profitability and poor asset quality and hence the country was caught in deep economic crises. To save the country from the deep crisis, the Government decided to introduce comprehensive economic reforms and hence Banking sector reforms were introduced. In august 1991, the Government appointed a committee on financial system under the chairmanship of M. Narasimhan.

Narasimham Committee Report I - 1991

The Narsimham Committee was set up in order to study the problems of the Indian financial system and to suggest some recommendations for improvement in the efficiency and productivity of the financial institution.

Following are the major recommendations given by the committee:-

1. **Reduction in the SLR and CRR**: First of all, committee recommended to reduce the higher proportion of the Statutory Liquidity Ratio 'SLR' and the Cash Reserve Ratio 'CRR' which were very high at that time. The SLR then was 38.5% and CRR was 15%. This high amount of SLR and CRR implied that the bank resources had been locked up for government uses. It was major obstacle in the productivity of the bank and so the committee recommended to reduce SLR from 38.5% to 25% and CRR from 15% to 3 to 5%.
2. **Phasing out Directed Credit Programme** : In India, credit programmes were directly adopted by the government since nationalization. The committee

recommended phasing out of this programme with a view that banks must be compelled to earmark the financial resources for the needy and poor sectors at confessional rates of interest. But this leads to the reduction in the profitability of banks and thus the committee recommended stopping such programmes.

3. **Interest Rate Determination**: It was felt by committee that the interest rates in India are regulated and controlled by the authorities. But it recommended determining interest rate on the grounds of market forces such as the demand for and the supply of fund. Hence the committee recommended removing government controls on interest rate.
4. **Reorganization of the Structural of the Banking sector**: The committee recommended that the actual numbers of public sector banks need to be reduced. It felt that three to four big banks including SBI should be developed as international banks and Eight to Ten Banks having nationwide presence which should concentrate on the national and universal banking services. Local banks should concentrate only on region specific banking. Regarding the RRBs (Regional Rural Banks), it recommended that they should focus on agriculture and rural financing. They recommended that the government should assure that any nationalization and private and foreign banks should be allowed liberal entry in India.
5. **Establishment of the ARF Tribunal**: The proportion of bad debts and Non-performing asset (NPA) of the public sector Banks and Development Financial Institute was a very important issue in those days. The committee recommended the establishment of an Asset Reconstruction Fund (ARF) which will take over the proportion of the bad and doubtful debts from the banks and financial institutes. It would help banks in reducing their bad debts.
6. **Removal of Dual control**: Those days both Reserve Bank of India (RBI) and the Banking Division of the Ministry of Finance (Government of India) controlled the banks. The committee recommended stopping this system and

hence recommending that the RBI should be the only main agency to regulate or control the banking in India.

7. **Banking Autonomy**: The committee recommended that the public sector banks should be free and autonomous. This will improve their competitiveness and efficiency. If banks will enjoy autonomy then they can reform the work culture and easily adopt changing banking technology up gradation.

Narasimham Committee Report II - 1998

In 1998 the government appointed yet another committee under the chairmanship of Mr. Narsimham. It is better known as the Banking Sector Committee. The purpose of this committee was to review the banking reform progress and design a programme for further strengthening the financial system of India. The committee focused on various areas such as capital adequacy, bank mergers, bank legislation, etc. It submitted its report to the Government in April 1998 with the following recommendations.

1. **Strengthening Banks in India** : The committee recommended to adopt the stronger banking system in the context of the Current Account Convertibility 'CAC'. This will help Indian banks in handling problems regarding domestic liquidity and exchange rate management in the light of CAC.
2. **Narrow Banking**: Those days many public sector banks were facing the problem of increasing Non-performing assets (NPAs). Some of them had even had NPAs as high as 20 percent of their assets. Thus for successful rehabilitation of these banks committtee recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in short term and risk free assets.
3. **Capital Adequacy Ratio** : In order to improve the internal strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity .

4. **Bank ownership**: As in the earlier committee, it was recommended the freedom for banks in its working and bank autonomy. But in the present committee, it felt that the government control over the banks in the form of management and ownership and bank autonomy does not go side by side and thus it recommended a review of functions of boards and enabled them to adopt professional corporate strategy.
5. **Review of banking laws** : The committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalization Act, etc. This upgradation was necessary in regard to the present needs of the banking sector in India.

Along with these major recommendations, the committee has also recommended faster computerization, technology upgradation, training of staff, depoliticizing of banks, professionalism in banking, reviewing bank recruitment, etc.

7.9 Latest Developments in Banking Sector in India

- Reserve Bank of India (RBI) has reduced the policy repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 7.25 per cent to 6.75 per cent with immediate effect. This was announced in the recently released fourth bi-monthly policy of RBI since January 2015.
- 4th bi-monthly policy of RBI says that Policy repo rate under the LAF:
- Reduced the liquidity adjustment facility (LAF) by 50 basis points from 7.25 per cent to 6.75 per cent.
- Cash reserve ratio (CRR) of scheduled banks has kept unchanged at 4 per cent of net demand and time liabilities (NDTL).
- Continuation of liquidity under overnight repos at 0.25 per cent of bank-wise NDTL at the LAF repo rate.

- Continuation of liquidity under 14-day term repos as well as longer term repos of up to 0.75 per cent of NDTL of the banking system through auctions.
- Continuation with overnight/term variable rate repos and reverse repos to smooth liquidity.

7.10 Prudential Norms for Income Recognition[1]

(1) The income recognition shall be based on recognized accounting principles.

(2) Income including interest/discount or any other charges on NPA shall be recognized only when it is actually realized. Any such income recognized before the asset became non-performing and remaining unrealized shall be reversed.

(3) In respect of hire purchase assets, where installments are overdue for more than 12 months, income shall be recognized only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non-performing and remaining unrealized, shall be reversed.

(4) In respect of lease assets, where lease rentals are overdue for more than 12 months, the income shall be recognized only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before the asset became non-performing and remaining unrealized shall be reversed.

7.11 Prudential Norms for Provisioning on Loans & Advances[2]

In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribed categories. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security andthe erosion over time in the value of security charged to the bank, the banks

[1] www.rbi.org.in
[2] https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8154#16

should make provision against loss assets, doubtful assets and sub-standard assets as below :

(i) Loss Assets

(a) The entire assets should be written off after obtaining necessary approval from the competent authority and as per the provisions of the Co-operative Societies Act / Rules. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

(b) In respect of an asset identified as a loss asset, full provision at 100 per cent should be made if the expected salvage value of the security is negligible.

(ii) Doubtful Assets

(a) Provision should be for 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse should be made and the realisable value is estimated on a realistic basis.

(b) In regard to the **secured portion**, provision may be made on the following basis, at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful:

Tier I and Tier II Banks

Period for which the advance has remained in 'doubtful' category	**Provision Requirement**
Up to one year	20 per cent
One to three years	30 per cent
Advances classified as 'doubtful for more than three years' on or after April 1, 2010	100 percent

(iii) Sub-standard Assets

A general provision of 10 per cent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

(iv) Provision on Standard Assets

From the year ended March 31, 2000, the banks should make a general provision of a minimum of 0.25 per cent on standard assets.

7.12 Prudential Norms for Capital Adequacy[3]

(1) Every systemically important non-deposit taking non-banking financial company shall maintain, with effect from April 1, 2007, a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than ten per cent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items. 19 Such ratio shall not be less than 12% by March 31, 2010 and 15% by March 31, 2011.

(2) The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

(3) 20NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier l capital of 12 percent by April 01, 2014.

7.13 Prudential Norms for Concentration of credit/ investments[4]

On and from April 1, 2007 no systemically important non-deposit taking non-banking financial company shall,

(i) Lend to

(a) any single borrower exceeding fifteen per cent of its owned fund; and

(b) any single group of borrowers exceeding twenty five per cent of its owned fund;

(ii) Invest in

(a) the shares of another company exceeding fifteen per cent of its owned fund; and

(b) the shares of a single group of companies exceeding twenty five per cent of its owned fund;

(iii) Lend and invest (loans/investments taken together) exceeding

(a) twenty five per cent of its owned fund to a single party; and

(b) forty per cent of its owned fund to a single group of parties.

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[3] https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8154#16

[4] https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8154#16

Provided further that any systemically important non-deposit taking non-banking financial company

Cannot invest in shares of another company in respect of investment in the equity capital of an insurance company upto the extent specifically permitted, in writing, by the Reserve Bank of India.

- Exceed the above ceilings on credit / investment concentration to a single party or a single group of parties by 5 per cent of its owned fund, with the approval of its Board.
- Cannot accessing public funds, either directly or indirectly, or not issuing guarantees may make an application to the Bank for an appropriate dispensation consistent with the spirit of the exposure limits.

7.14 Conclusion

Commercial Banks play an important role in the economic development of the country. They play the key role in mobilizing savings and hence generate capital formation in the country. With the changing scenario, banking reforms had been made to improve the internal strength of the Indian banking system. These reforms were necessary in regard to the present needs of the banking sector in India.

7.15 Check Your Progress

1. Who is the fiscal agent and advisor to government in monetary and financial matters in India?

   a) SBI b) IDBI c) ICICI d) RBI

2. The Commercial Banks in India are governed by

(A) Reserve Bank of India Act, 1934

(B) Indian Companies' Act, 1956

(C) Indian Banking Regulation Act, 1949

(D) Securities and Exchange Board of India Act, 1992

3. The most important reason for an investor to prefer a Bank deposit is

(A) The credit worthiness of the Bank.

(B) The Bank does not invest in the securities.

(C) The Bank offers a guarantee.

(D) All of the above.

4. Find out the odd one out of the following :

(A) State Bank of India (B) Reserve Bank of India

(C) Union Bank of India (D) Central Bank of India

(Answers: 1D, 2A, 3A and 4B)

7.16 Glossary

Tier I Capital: The elements of Tier I capital include:

- Paid-up capital (ordinary shares), statutory reserves, and other disclosed free reserves, if any;
- Perpetual Non-cumulative Preference Shares (PNCPS) eligible for inclusion as Tier I capital - subject to laws in force from time to time;
- Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier I capital; and
- Capital reserves representing surplus arising out of sale proceeds of assets.

Tier II Capital: The elements of Tier II capital include undisclosed reserves, revaluation reserves, general provisions and loss reserves, hybrid capital instruments, subordinated debt and investment reserve account.

7.17 References

- Steiner and Shapiro: Modern Banking.
- Sayers, R.S: Modern Banking

7.18 Suggested Readings

- M. R. Baye and D. W. Jansen, Money, Banking and Financial Markets, AITBS, 1996.

- Rakesh Mohan, Growth with Financial Stability- Central Banking in an Emerging Market, Oxford University Press, 2011

7.19 Model Questions

1. What is Commercial Banking and what are its functions?
2. Discuss the role of Commercial Bank in the economic development of a country.
3. Discuss the prudential norms for the following:
   a) Provision for bad and doubtful debts
   b) Capital adequacy
4. Discuss the banking reforms that took place in India.

Chapter8- Innovations in Banking

8.1 Objectives:

- To understand the concept of internet banking , mobile banking , universal banking , narrow banking, wholesale , retail banking.
- To understand offshore banking and non-performing assets

8.2 Internet banking is an electronic payment system that enables customers of banks to conduct transactions on a website operated by them, such as a retail bank, virtual bank, credit union etc. Internet banking is also referred as **online banking**, **e-banking**, **virtual banking** and by other terms. To access a financial institution's internet banking facility, a customer with Internet access would need to register with the institution for the banking services, and need to set up a password and other credentialsfor customer verification. The credentials for online banking are normally not the same as for telephone banking. Financial institutions now routinely allocate customers numbers to customers, whether or not customers have an intention to access their online banking facility. Customers' numbers are normally not the same as account numbers, because a number of customer accounts can be linked to the one customer number. The customer number linked to any account that the customer controls, such as cheque, savings, loan, credit card etc.

To access online banking, a customer visits the banks secure website, and enters the online banking using the customer number and password previously setup. Online banking services generally include viewing and downloading balances and statements, and include the ability to make payments, transfers and other transactions, as well as interacting with the bank in many other ways.

Advantages of internet banking:

- It is helps in doing cost less transactions
- Transaction speed is too high
- Helps in doing transactions speedily
- It has vast coverage
- 24* 7 banking services

Online banking transactions:

- **Transactional** (e.g., performing a financial transaction such as account to account transfer, paying a bill , apply for a loan, new account, etc.):
  - Payments to third parties, including bill payments.
  - Funds transfer between a customer's own account and savings accounts.
  - Investments purchase or sale transactions.
  - Loan applications and transactions such as repayments of enrolments.

- **Non-transactional** (e.g., online statements, cheque links, browsing, chat):
  - Viewing weekly transactions.
  - Downloading historical bank statements in PDF/other formats.

- Viewing images of paying cheques.
- Financial Institution Administration.
- Management of multiple users having varying levels of authority.
- Balance enquiry

Disadvantages of internet banking:

- **No customer relationship:**
  In traditional banking system, bank staff and customers were in direct contact with each other. It provides with the opportunity to develop personal relations with the customers but which is difficult to establish in internet banking.
- **Lack of offer of special services: I**n traditional banking system, customer is having good relations with the bank due to which banks sometimes offers them a special scheme on special bonuses. Bank manager even sometimes changes the terms and conditions for the loyal customer which is not possible in internet banking.
- **Threat of Security:** There is always a risk in internet banking of getting your personal information leaked. In internet banking we also have a risk of getting our accounts hijacked by them person and manipulation of accounts.

8.3 E-banking:

Electronic banking, known as electronic funds transfer (EFT), is simply the use of electronic means to transfer money directly from a account to another, instead by cheque or cash. The following functions can be performed through e-banking:

a. Have your salary deposited directly into your bank
b. Withdraw money from your account from an ATM machine with a personal identification number (PIN), at your convenience.
c. Instruct your bank to automatically pay certain monthly bills from your account, like your auto loan or your mortgage payment.

d. Have the bank transfer funds each month from your account to your mutual fund account.
e. Have your government social security benefits or your tax refund deposited directly into your account.
f. Buy groceries, gasoline and other purchases at the point-of sale, using an electronic card instead of paying cash.

Various forms of E-banking:

Internet banking: Internet Banking allows you to handle many banking transactions via your personal computer. For example you may use your computer to view your account balance, request transfers between accounts, and pay bills electronically. The system is capable of distinguishing between those customer service requests which are capable of automated realization and those requests which require handling by a customer service representative. The system is connected with the host system of the bank so that the remote customer can access other programmed services of the bank.

Automated Teller Machines (ATM): An electronic machine in a public place, connected to a data system and activated by a bank customer to obtain cash withdrawals and other banking services. It is also called automatic teller machine, cash machine. An automated teller machine or automatic teller machine (ATM) is an electronic computerized device that allows the customers to directly use a secure method to access their bank accounts, order or make cash withdrawals and check their account balances. Many ATMs also allow people to deposit cash or cheques, transfer money between their bank accounts, recharge their mobile phones' pre-paid accounts.

Tele-banking: Undertaking a most of banking related services from the convenience of customers place anywhere across the world and any time of date and night has now been made possible by introducing Telebanking services. By dialling the Telebanking number through a landline or a mobile anywhere all over the world, the customer can access his account and by following the user-friendly menu, all banking transactions can be performed through Interactive Voice Response (IVR) system. With sufficient numbers of hunting lines made available. The system is multi-lingual and has following facilities offered:

- Automatic balance voice out for the default account.
- Balance inquiry and transaction inquiry.
- Inquiry of term deposit account
- Statement of account by e-mail or ordinary mail.
- Cheque book request
- Stop payment which is on-line and instantaneous
- Transfer of funds with CBS which is automatic and instantaneous
- Utility Bill Payments
- Renewal of term deposit which is automatic and instantaneous

Smart Card: A smart card contains an embedded 8-bit microprocessor (kind of computer chip). The microprocessor is under a contact pad on one side of card.. The microprocessor is there on the smart card for security. The host computer and card reader actually "talk" to microprocessor. The microprocessor enforces access to the data on the card. The chips in these cards are capable of many kinds of transactions. For example, a person could make purchases from his/her credit account, debit account or from some other account. The enhanced memory and processing capacity of the smart card is many times that of traditional magnetic-stripe cards and can accommodate various different applications on single card. Smart cards can also used with a smart card reader attachment to a personal computer to authenticate a user. Smart cards are very popular in Europe. In Europe, the health insurance and banking industries use smart cards extensively.

Debit Card: Debit cards are also known as checks cards. Debit cards look like credit cards or ATM (automated teller machine) cards, but operate like cash or personal check. Debit cards are different from the credit cards. Credit card is a way to "pay later," while a debit card is a way to "pay now." When you use a debit card, your money is quickly deducted from your checking or savings account. Debit cards are accepted at many locations, including grocery stores, retail stores, gasoline stations, and restaurants.

You can use your card anywhere .They offer an alternative to carrying a cheque book or cash.

E-Cheque:

• An e-Cheque is the electronic version of paper cheque.

• The Legal Framework on the E-Cheque is the same as that of the paper cheques.

• It can now be used in place of paper cheques to do all remote transactions.

• An E-cheque work the same way a cheque does, the cheque writer "writes" the e-Cheque using one of many types of electronic devices and "gives" the e-Cheque to the payee electronically. The payee "deposits" the Electronic Cheque receives credit, and payee’s bank "clears" the e-Cheque to the paying bank.

Benefits of E-banking:

For Banks:

- **Cost effective**- In the long run a bank can save on money by not paying for cashiers or for managing branches. It's cheaper to make transactions over the Internet.
- **Customer Base**- the Internet allows banks to reach a whole new market- and a well off one too, because there are no geographic boundaries with the Internet. The Internet also provides a level playing field for small banks who want to add to their customer base.
- **Efficiency**- Banks can become more efficient than they already are by providing internet access for their customers. The Internet provides the bank with an almost paper less system.
- **Customer Service and Satisfaction**- Banking on the Internet not only allows the customer to have a full range of services available to them but also allows availing some services not offered at any of the

branches. A person can print any information, forms, and applications with the help of Internet and be able to search information efficiently rather than waiting in line and asking a teller.

For Customers:

- **Bill Pay**: Bill Pay is a service offered with the help of Internet banking that allows the customer to set up bill payments in seconds. Customer can select the person or company to whom he wants to make a payment and Bill Pay will withdraw the money from his account and send the payee a paper check or an electronic payment
- **Other Important Facilities**: E- banking gives customer the control over every aspect of managing his bank accounts. Besides the Customers can, Buy and Sell Securities, Check Stock Market Information, Currency Rates, Check Balances, See which cheques are cleared, Transfer Money, View Transaction History and avoid going to an actual bank. The best benefit is that Internet banking is free.

Concerns with E-banking:

As with new technology new problems are faced.

- **Customer support** - banks will have to create a whole new customer relations department to help customers. Banks have to take care that the customers receive assistance quickly as and when they need help. Any major problems can destroy the banks reputation easily. By showing the customer that the Internet is reliable you are able to get the customer to trust online banking more and more.
- **Laws** - While Internet banking does not have national or state boundaries, the law does. Companies have to take care that they are abiding the laws.

- **Security:** Customer is always worried about their protection and security or accuracy. There are always questions whether or not something took place.
- **Other challenges**: lack of knowledge from customers end, changes by the banks, etc.

8.4 Mobile Banking:

Mobile Banking: Internet banking helped give the customers anytime access to their banks. Customers can check their account details, get bank statements, perform various transactions like transfer of money to other accounts and pay their various obligations. Main problem with the internet banking is that we need a computer and a good internet connection but it is not possible to make it available everywhere so mobile banking addresses this limitation of internet banking. Main reason mobile baking scores over internet banking is it enables 'Anywhere Anytime Banking'. Customers can do so by while they are traveling, waiting for thebus , while they are in restaurants, etc.

8.4.1 Features of mobile banking:

A mobile banking service in order to become successful in the market as a mode of payment the following conditions have to be met:

a) **Simplicity and Usability**: The mobile application are user friendly with little learning curve to the customer. The customers arebeing able to personalize the application to suit his or her convenience.

b) **Universality**: Mobile payments service provide for transactions between one customer to another customer (C2C), or from a business to a customer (B2C) or between businesses (B2B). The coverage includes domestic, regional and global environments. Payments must be possible in terms of both low value micro-payments and high value macro payments.

c) **Security, Privacy and Trust**: A customer can trust a mobile payment application provider that his or her information may not be misused. Secondly, when these transactions become recorded their privacy should not be lost in the sense that the credit histories and spending patterns of the customer should not be openly available for public. Mobile payments have to be as anonymous as cash transactions. Third, system should be resistant to attacks from hackers. This may be provided using public key infrastructure security, biometrics and passwords integrated into the mobile payment solution architectures.

d) **Cost**: The mobile payments is not be costlier than existing payment mechanism A m-payment solution competes with other modes of payment in terms of cost and its convenience.

e) **Speed:** The speed at which m-payments are executed is helpful to customers and merchants.

f) **Cross border payments**: It helps in making transactions globally.

8.4.2 Mobile banking services:

Following are the services provided by mobile banking.

Account information:

- Mini statements
- Alerts on account activities
- Access to loan statements
- Access to card statements
- Pension plan management
- Mutual fund statements
- Pension funds

Payments and Transfers:

- Domestic and international fund transfer
- Micro payments handling
- Mobile recharging
- Commercial banking processing

- Bill payment processing

Investments:

- Portfolio management services
- Real time stock quotes
- Personalised alerts and notification on security prices

Support services:

- Cheque book and card requests
- Status of requests for credit, insurance coverage’s.

8.4.3 Mobile banking business models:

A wide spectrum of branchless banking models is evolving. These models differs primarily on the question that who will establish relationship.(account opening , lending etc.) with the end customers , the bank or non-banking communication company.

Models of mobile banking are:

- **Bank focused model:** it emerges when a traditional bank uses non-traditional low cost delivery channels to provide services to existing customers. Example providing limited mobile banking services to its customers.
- **Bank led model**: It offers a distinct alternative to conventional branch based banking in that customer conducts whole range of banking transactions on the mobile banking instead of going to the bank branches. The bank led model may be implemented by either using correspondent arrangements or by creating a joint venture bank and telecom company .Customer account relationship rests with the bank.
- **Non-bank led model:** The non-bank model is where bank does not come into picture and non-bank performs all the functions.

8.4.4 Advantages of mobile banking:

- It helps in reducing the cost of providing services to customers of banks.
- Effective way of delivering services to customers.
- Immediate information of account debit credit.

- Bank could remind customers of the outstanding bill payments dates.
- Helps in making investments though mobile phone only.

8.5 Wholesale Banking and retail banking:

8.5.1 Wholesale banking is the practice of borrowing funds and providing funds between very large institutions. When you think of a bank, you likely think of your local teller with whom you can fulfil your savings and credit needs. This kind of bank is a retail bank; it offers small-scale, one-on-one services to individuals or businesses. For institutions with larger financial needs, wholesale banks offer same services, generally at a lower base price than that charged for retail transactions.

Purpose of Wholesale Banking

For a company's carrying high number of financial transactions daily, with large sums of money in each transaction, the cost of retail banks would not serve needs very well. For example, you may pay 10 percent of your balance to maintain your checking account at a retail level. A large company with Rs.1 crore in a checking account will not want to spend this same amount. This same company may have Rs. 50 lakh in money market accounts and Rs.10 lakh in mutual funds, all administered through the same bank. In exchange for placing such a large amount of money with the bank, the bank offers this company a large discount on its services. For example, the fee may be reduced to only 1 percent. The company saves, and the bank still makes a handsome profit.

Wholesale Banking Example

For example, a regional grocery store having with 15 branches with a name called Babi's Groceries. It needs a separate checking account for each of 15 locations. Babi's also needs a credit card to access this account for three managers at each location, in total 45 cards. It likes to keep money in reserve in a savings account totalling no less than Rs.50 lakh. Finally, it needs to process credit cards, which means it will need a merchant account. Instead of walking into local Bank and opening a checking account like any person do, it needs a corporate facility that can accommodate all of its financial accounts. Ideally, It would like a discount for the large amount of business it hands this bank. It decides to work with someABC Wholesale Bank. ABC offers competitive fees as long as it maintains at least three accounts and holds more than Rs.50 lakh in the bank at all times. Babi's agrees, and Babi's and Sally's begin a wholesale banking relationship.

Drawbacks of Wholesale Banking

The main drawback of wholesale banking is the risk; it poses to all parties involved. Whenever a business has large amount of cash in one location, it relies wholly on the safety of that location to ensure the stability of its funds. If anything were to happen to the banking institution, such as goes insolvency, the organization holding funds could stand to lose funds in an instant. To insure against this, many large institutions insure their funds and further diversify their money. Wholesale banks, on their part, should attempt to ensure their solvency through good business practices

8.5.2 Retail Banking:

Retail banking is the provision of services by a bank to individual consumers, rather than to companies,other banks with bank branches at various locations. Theterm "retail" refers to the almost storefront-shopping nature of commercial banking services. It is also known as consumer banking, personal banking. Services offered by retail banking are savings and transactional accounts, personal loan,debit cards, and credit cards. The term is generally used to distinguish these banking services from investment banking, commercial banking or wholesale banking. It may also be used to refer to a division or department of a bank dealing with retail customers.

Retail banking allows commercial banks to provide banking products and services in one place at virtually any of branch locations. The retail banking aspect turns commercial banks into a kind of "store" (or retailer) where clients are able to purchase various banking products.

Products offered by retail banking are:

- Debit cards
- Credit cards
- Travellers cheque
- ATM card

- Mortgages
- Personal loans
- Certificate of deposit
- Saving accounts

8.5 Universal and narrow banking:

8.6.1 Universal banking

A system of banking in which banks are allowed to provide a variety of services to their customers at one roof is called universal banking. In universal banking, banks are not limited to just loans, checking and savings accounts, and other similar activities, but also allowed to offer investment services as well.

In simple words, Universal Banking means Financial Institutions (FIs) and Banks are allowed to undertake all kinds of activity of banking, financing and related businesses.

As per the World Bank, the definition of the Universal Bank is as follows:

"In Universal banking, the large banks operate extensive network of branches, provide many different services, hold several claims on firms (including equity and debt) and participate directly in the Corporate Governance of firms that rely on the banks for funding or as insurance underwriters."

So we can say that Universal bank is a Financial Supermarket which provides all financial products under one roof. Apart from the savings, these banks provide project financing, project counselling, insurance services, forex operations etc.

The concept of Universal Banking conceptualized in India after the RH Khan Committee recommended it as a different concept. The Khan Working Group held the view that DFIs (Development Finance Institutions) should be allowed to become banks at the earliest.

Advantages:

1. Economies of Scale would result in greater economic efficiency in the form of lower cost, higher output and better products.
2. Increased diversions and increased profitability
3. Better Resource Utilization.
4. Brand name leverage
5. Existing clientele leverage
6. Value added services
7. 'one-stop shopping' saves a lot of transaction costs

Hurdles:

1. Different regulatory framework for Financial Institutions and Banks
2. No expertise in both the fields as both needs domain expertise.
3. Long gestation of Infrastructure Financing

RBI Guidelines on Universal Banking[1]:

Some of the guidelines are as follows:

1. Once the FI becomes a universal Bank, it would be compliant with the CRR and SLR requirements of the RBI.
2. The activity which is permissible for the FI but not permissible for Bank, would have to be stopped.
3. Any immovable property acquired by the FI would have to be disposed of in 7 years time.
4. The composition of the Board of Directors would be required to be changed so that it is compliant with the Section 10 (A) of the Banking Regulation Act which requires at least 51% of the total number of directors to have special knowledge and experience.
5. If there is any floating charge on any of its assets, it would have to be ratified by the RBI since a banking company is not allowed to create a floating charge on the undertaking or any property of the company unless duly certified by RBI as required under the Section 14 (A) of B R Act.

[1] www.rbi.org.in

6. If there is any subsidiary that is engaged in an activity which is not permissible under the B R Act, then the subsidiary will have to be delinked.
7. Banks cannot hold shares in the companies in excess of 30% of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves as per the B R act, so , the FI after becomes a Universal Bank shall divert the excess of the equity.
8. Section 20 of the B. R. Act prohibits grant of loans and advances by a bank on security of its own shares or grant of loans or advances on behalf of any of its directors or to any firm in which its director/manager or employee or guarantor is interested. The compliance with these provisions would be mandatory after conversion of an FI to a universal bank.
9. The FI would require obtaining a license from RBI to carry business of banking in India and has to comply with the applicable conditions.
10. The FI would need to comply with the existing branch licensing policy of RBI which requires allotting at least 25 per cent of their total number of branches in semi-urban and rural areas.
11. At the close of business on the last Friday of every quarter, the FI after becomes a Universal Bank, would make sure that its total assets held in India are not less than 75 per cent of its total demand and time liabilities in India, as required of a bank under Section 25 of the B R Act.
12. Publishing annual financial reports as per requirements.

8.6.2 Narrow banking:

Narrow banking is also known as safe banking. As in narrow banking, banks places its funds under the risk free assets and the maturity of liabilities match the assets so as their will be no mismatch between asset and liability. Loans would be made by other financial intermediaries. Narrow banking means narrow in sense of engagements of funds not in context with narrowing down its activities. So it is simply mobilising large part of funds in risk-free assets like government securities.

Narrow Banking helps the Banks to reduce the Non-Performing Assets (NPA) as the engagement brings them some returns also.Banks will be able to eliminate their high NPA levels only by investing in safer securities though not at higher interest rates but earning sufficient net margins. It will help to bring weak banks to normalcy.

Features of narrow banking are:

- No lending of deposits of public
- High liquidity is maintained
- Asset security is extremely high
- Depositors are paid less interest rate
- Regulatory framework with higher level of scrutiny and operational and investing restrictions.

8.7 Offshore banking asset classification:

Offshore bank is the bank located outside the country of residence of the depositor, typically in a low tax area which provides legal and financial benefits.

Offshore banking been associated with underground economy and organised crime via tax evasion however offshore banking does not prevent assets from being evades tax on the interest. Offshore banks may decide not to report income to other tax authorities and do not have obligation to do so as they are protected by bank secrecy.

Advantages of offshore banking:

- They sometimes provide access to politically and economically stable jurisdictions. This is a benefit for people who are in jurisdictions where political instability is there.
- Offshore banks operate with low cost base and provide with high interest rates.
- Interest is generally paid by without tax being deducted. This is a benefit to people who do not pay tax on their worldwide income.
- Offshore banking may link to other structures like offshore companies, trusts and foundations which may have certain tax advantages.

Banking services offered by offshore banking:

- Savings accounts
- Fund management
- Debit credit cards
- Trustee services
- Electronic fund transfer
- Investment management
- Foreign exchange
- Corporate administration

8.8 Non-performing assets[2]:

An asset becomes non-performing when it ceases to generate income for the bank. Earlier an asset was considered as non-performing asset (NPA) based on the concept of **'Past Due'**. A 'non performing asset' (NPA) was defined as credit in respect of which interest and / or instalment of principal has remained 'past due' for a specific period of time. The specific period was reduced in a phased manner as under:

Year ended March, 31	**Specific period**
1993	4 quarters
1994	3 quarters
1995	2 quarters

An amount is considered as past due, when it remains outstanding for 30 days beyond the due date. However, with effect from March 31, 2001 the 'past due' concept has been dispensed with and the period is reckoned from the due date of payment.

With a view to moving towards international best practices and to ensure greater transparency, '90 days' **overdue** norms for identification of NPAs have been made applicable from the year ended March 31, 2004. As such, with effect from March 31, 2004, a non-performing asset shall be a loan or an advance where:

[2] www.rbi.org.in

(i) Interest and / or instalment of principal remain overdue for a period of more than 90 days in respect of a Term Loan.

(ii) The account remains '**Out of order'**for a period of more than 90 days, in respect of an Overdraft / Cash Credit (OD/CC).

(iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

(iv) In the case of direct agricultural advances as listed in Annex 1, the overdue norm specified at para 2.1.5 would be applicable. In respect of agricultural loans, other than those specified in Annex 1, identification of NPAs would be done on the same basis as non-agricultural advances.

(v) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

** Any amount due to the bank under any credit facility, if not paid by the due date fixed by the bank becomes **overdue**.*

"An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit / drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit / drawing power, but there are no credits continuously for 90 days or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'".

Asset Classification of non-performing assets:

- **Classification**

Banks should classify their assets into the following broad groups, viz. -

(i) Standard Assets

(ii) Sub-standard Assets

(iii) Doubtful Assets

(iv) Loss Assets

- **Definitions**

Standard Assets

Standard Asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.

Sub-standard Assets

(i) With effect from March 31, 2005 an asset would be classified as sub-standard if it remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrowers / guarantors or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such assets will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(ii) An asset where the terms of the loan agreement regarding interest and principal have been re-negotiated or rescheduled after commencement of production, should be classified as sub-standard and should remain in such category for at least 12 months of satisfactory performance under the re-negotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of this condition.

Doubtful Assets

With effect from March 31, 2005, an asset is required to be classified as doubtful, if it has remained NPA for more than 12 months. For Tier I banks, the 12-month period of classification of a substandard asset in doubtful category is effective from April 1, 2009. As in the case of sub-standard assets, rescheduling does not entitle the bank to upgrade the quality of an advance automatically. A loan classified as doubtful has all the weaknesses inherent as that classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or by the Co-operation Department or by the Reserve Bank of India inspection but the amount has not been written off, wholly or partly. In other words, such an asset is considered un-collectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

8.9 Conclusion:

With the change in technology banking sector has undergone changes in their products and services. New banking system has been emerged like wholesale banking, retail banking, universal banking, and narrow banking.

8.10 Check your progress:

- ………is simply the use of electronic means to transfer funds directly from one account to another rather than by cheque or cash
  1. M- banking
  2. O-banking
  3. E- banking
  4. I- banking

  Answer- 3
- Mobile banking services does not include
  1. Automatic balance voice out
  2. Cash deposits
  3. Direct cash withdrawal
  4. Utility bill payments

  Answer- 2
- What is the full form of SWIFT:
  1. .society for worldwide internet financial corporations
  2. Secret wide interbank financial tele communications
  3. None of the above

Answer-3

8.11 Glossary:

- INTERNET BANKING: Internet Banking allows you to handle many banking transactions via your personal computer. For example you may use your computer to view your account balance, request transfers between accounts, and pay bills electronically.
- Electronic banking, known as electronic funds transfer (EFT), is simply the use of electronic means to transfer money directly from a account to another, instead by cheque or cash.

8.12 References:

- Steiner and Shapiro: "Money and Banking : An introduction to the Financial System" , published by Holt, Rinehart and Winston Inc, New York

8.13 Suggested readings:

Baye, M.R and D. W. Jansen (2000): Money, Banking and Financial Markets, published by AITBS,.

8.14 Model questions:

1. What do you mean by universal banking? How it is different from narrow banking.
2. Define NPA? What are the provisions of asset classification by reserve bank of India?

Chapter 9- International Trade

Structure

9.1 Objectives

- To understand the concept of international Trade
- To study the implications of international trade for developing countries
- To study the foreign trade policies after post reform period.

9.2 Introduction

Society has the ever increasing needs which require the uninterrupted supply of goods but never ending human wants. The society can satisfy such needs and wants only with the help of trade. Trade refers to buying and selling of goods and services for money. In other words, it involves transfer or exchange of goods and services for money. Thus, trade is a social activity which is essential for satisfaction of human wants. With the beginning of human life, trade has taken birth and shall continue as long as human life exists on the earth. Trade is conducted not only for the sake of earning profit but also to provide service to the consumers.

9.3 Different Types of Trade

Trade can be divided into two types which are as follows:

9.3.1. Internal Trade or Home Trade

Internal trade is conducted within the political and geographical boundaries of a country. Hence trade carried on among traders of Delhi, Mumbai, etc. is an example of internal trade.

9.3.2. External Trade or International Trade

External trade also called as foreign trade. It implies buying and selling of goods or services between two or more countries. For instance, If Mr. A who is a trader from Delhi, sells his goods to Mr. B another trader from China then this is an example of foreign trade or International trade.

International Trade can be further sub-divided into following three groups:

Export Trade: When a trader from home country sells his goods to a trader located in another country, it is called export trade. For e.g. a trader from India sells his goods to a trader located in New York.

Import Trade: When a trader in home country bought goods from a trader located in another country, it is called import trade. For e.g. a trader from India bought goods from a trader located in New York.

Entrepot Trade: When goods are imported from one country and then after doing some processing re-exported again, it is called entrepot trade. In other words, it can be also called as re-export of processed imported goods. For e.g. a trader from India bought some raw material or spare parts from a trader from Canada, then convert it into finished goods and then re-export to a trader from New York.

For all practical purposes, trade or exchange of goods and services between two or more countries is called “international” or “foreign” trade.

International trade takes place on account of many reasons such as:

1. Countries’ resources are not sufficient to satisfy wants of all people resides in their country. Hence, there tends to be interdependence of one country to another country. .
2. Factor endowments differ in different countries.
3. Technological advancement of different countries differs. Thus, some countries are having better technological production in one type of goods and some others have better technological production in another type of goods.
4. Labour and entrepreneurial skills in different countries differ.
5. Immobile Factors of production between countries.

In short, international trade is the result of territorial division of labour and specialization in the countries of the world.

9.4 Salient Features of International Trade:

The following are the distinguishing features of international trade:

(1) Immobility of Factors:

There is high degree of immobility of factors like labour and capital between countries. There are Immigration laws, citizenship, qualifications, etc. which restricts the international mobility of labour. Similarly, there are government restrictions on International capital flows. Due to the difference in labour cost and capital cost, there is influence on price and cost of commodity. There are different prices in different countries for the same commodity. For instance, the price of tea in India must, in the long run, be equal to its cost of production in India. But in the U.K., the price of Indian tea may be permanently higher than its cost of production in India. In this way, international trade differs from home trade.

(2) Heterogeneous Markets:

In the international economy, world markets have differences in climate, language, preferences, habit, customs, weights and measures, etc. Due to such difference, there is difference in the behaviour of international buyers.

(3) Different National Groups:

International trade is a phenomenon that occurs between differently cohered groups. The socio-economic environment differs greatly among different nations.

(4) Different National Policies and Government Intervention:

There is difference in economic and political policies from one country to another. Policies pertaining to trade, commerce, export and import, taxation, etc., are also different from country to country though they are more or less uniform within the country. Thus, government through the tariff policy, import quota system, subsidies and other controls interfere with the objective of normal trade between one country and another.

(5) Different Currencies:

Another notable feature of international trade is that it includes the use of different types of currencies. So, each country has its own policy with regard to exchange rates and foreign exchange.

9.5 Importance of Foreign Trade

Following points explain the need and importance of foreign trade to a nation.

1. Division of labour and specialisation

Foreign trade brings division of labour and specialisation at the world level. Some countries are having abundant natural resources and hence they export raw materials and import finished goods from countries which are abundant in skilled manpower. This provides benefits to all the countries and thereby leading to division of labour and specialisation.

2. Optimum allocation and utilisation of resources

Due to specialization, unproductive products can be eliminated and wastage of resources avoided. In other words, resources are used only for the production of productive goods. Thus there is optimum allocation and utilization of resources at the international level due to foreign trade.

3. Brings reputation and helps earn goodwill

A country which deals in exports earns goodwill in the international market. For e.g. Japan export quality electronic goods and hence earns goodwill in the international market.

4. Availability of multiple choices

Since, it is difficult for all countries to manufacture all types of goods. Foreign trades make available new varieties to consumers all over the world and provide a better choice to the consumers.

5. Ensures quality and standard goods

Foreign trade is highly competitive as compared to internal trade. This is so because every firm has to compete not only with the firms of their country but also with the firms of other countries. With a view to maintain and increase the demand for their goods, the exporting countries have to maintain the quality of goods. Thus foreign trade ensures that only the quality and standardised goods are produced.

6. Improves the standard of living of the people

Imports can improve the standard of living of the people as people can have a choice of better and new varieties of goods and services. Better qualities of goods raise the standard of living of the people.

7. Generate employment opportunities

By increasing the mobility of labor and resources, foreign trade helps in generating employment opportunities. It creates direct employment in import sector and indirect employment in other sector of the economy such as Service Sector industry (insurance, banking, transport, and communication), etc.

8. Facilitate economic development

Imports play an important role in economic development of a nation. This is because with the import of capital goods and technology, a country can generate growth in all sectors of the economy, i.e. agriculture, industry and service sector.

9. Assistance during natural calamities

When a country affected by natural calamities such as earthquakes, floods, famines, etc., then they have to face the problem of shortage of essential goods. Foreign trade helps the country to import food grains and medicines from other countries to help the affected people.

10. Maintains balance of payment position

Maintenance of balance of payment position is an essential for every country. Since, every country has to import, which leads to outflow of foreign exchange, and export which leads to the inflow of foreign exchange. Balance of payment is the recording of inflow and outflow of foreign exchange transactions.

11. Promotes World Peace

Foreign trade brings countries closer. It facilitates transfer of technology and other assistance from developed countries to developing countries. It brings different countries closer due to economic relations arising out of trade agreements. Thus, foreign trade creates a friendly atmosphere for avoiding wars and conflicts. It promotes world peace as such countries try to maintain friendly relations among themselves.

9.6 Implications of International Trade for developing countries

In the previous section, we discuss the importance of international trade in general. But actually the impact of international trade varies from country to country. Some of the negative and positive effects of international trade for developing countries are discussed below:

9.6.1 Negative effects of international trade for developing country business

- **Increasing income inequalities**

  The growth of international trade is increasing income inequalities among countries. Industrialized nations are generating income from international trade and hence income inequalities is exacerbating between and within industrialized and less industrialized nations.

- **Increasing domination by translational corporations**

  Globalization of business is increasingly dominated by transnational corporations which aim to maximize profits without being considering the development needs of individual countries or the local populations.

- **Barrier from protectionist policies**

  Industrialized countries are having their own Protectionist policies which prevent many producers in the Third World from entering export markets. Hence, only industrialized nations are taking advantage of international trade.

- **Increases the banking and currency crisis risk**

  With the globalization of trade, both the volume and volatility of capital flows increases. This leads to increases in the risks of banking and currency crises, especially in countries having weak financial institutions

- **Danger to environmental standards**

  With the pace of increasing Competition among developing countries to attract foreign investment, developing countries entered in to a "race to the bottom" in which countries dangerously lower environmental standards

- **Loss of cultural uniqueness**

  In favor of homogenization, Cultural uniqueness is lost and a "universal culture" is coming forth which draws heavily from American culture

- **Dumping:**

  Dumping is the practice of selling low quality goods by advanced countries at low prices in under developed countries. This tactics resorted to by developed countries may harm the development of underdeveloped countries.

Economists who are against international trade often give example of Latin America where increased openness to international trade had a negative economic effect. Many governments in Latin America (e.g. Peru) liberalized imports far more rapidly than in other regions. In much of Latin America, import liberalization has been credited with increasing the number of people living below the USD $1 a day poverty line and has perpetuated already existing inequalities (Watkins, 2002).

9.6.2 Positive effects of globalization for developing country business

Conversely, economist who are in favor of international trade, explained that international trade create new opportunities, new ideas, and open new markets that an entrepreneur may have not had in their home country. Hence, there are a number of positives associated with globalization:

- **Create greater opportunities for firms**

  In less industrialized countries, firms have less area of market and hence international trade allowed them to tap into more and larger markets around the world.

- **More access to capital flows and human capital**

  With the globalization, now countries have more access to capital flows, technology and human capital. Now they can arrange capital and human capital from the country where it is cheaper.

- **Improves standard of living**

  Since, it is difficult for developing countries to manufacture all types of goods because of the resource constraint. Hence they depend on import to satisfy the needs of people and people can have a choice of better and new varieties of goods and services. Better qualities of goods raise the standard of living of the people.

- **Facilitate economic development**

  In developing nations, all sectors of the economy, i.e. agriculture, industry and service sector are not fully developed. But with the import of capital goods and technology, a country can generate growth in all sectors of the economy, i.e. agriculture, industry and service sector. Thus, Imports also plays role in economic development of the developing countries.

9.7 Foreign Trade Policy

Indian foreign trade policy contains various policy related decisions taken by the government in the sphere of Foreign Trade, i.e., with respect to imports and exports from the country and more especially export promotion measures, policies and procedures related thereto. Trade Policy is prepared and announced by the Central Government (Ministry of Commerce). Foreign Trade Policy also know as India's Export Import Policy, in general, aims at developing export potential, improving export performance, encouraging foreign trade and creating favorable balance of payments position.

History of EXIM Policy of India

In the year 1962, the Government of India appointed a special EXIM Policy Committee to review the government previous export import policies. The committee was later on approved by the Government of India. Mr. V. P. Singh, the then Commerce Minister and announced the EXIM Policy on the 12th of April, 1985. Initially the EXIM Policy was introduced for the period of three years with main objective to boost the export business in India

Objectives of the EXIM Policy: -

Government control import of non-essential items through the EXIM Policy. At the same time, all-out efforts are made to promote exports. Thus, there are two aspects of EXIM Policy;

- the import policy which is concerned with regulation and management of imports and
- The export policy which is concerned with exports not only promotion but also regulation.

The main objective of the Government's EXIM Policy is to promote exports to the maximum extent. Exports should be promoted in such a manner that the economy of the country is not affected by unregulated exportable items specially needed within the country. Export control is, therefore, exercised in respect of a limited number of items whose supply position demands that their exports should be regulated in the larger interests of the country. In other words, the main objective of the EXIM Policy is:

- To accelerate the economy from low level of economic activities to high level of economic activities by making it a globally oriented vibrant economy and to derive maximum benefits from expanding global market opportunities.
- To stimulate sustained economic growth by providing access to essential raw materials, intermediates, components,' consumables and capital goods required for augmenting production.
- To enhance the techno local strength and efficiency of Indian agriculture, industry and services, thereby, improving their competitiveness.
- To generate new employment.
- Opportunities and encourage the attainment of internationally accepted standards of quality.
- To provide quality consumer products at reasonable prices.

9.7.1 EXIM Policy 1992 -1997

In India, economic reforms took place in 1991 with the introduction of LPG (Liberalization, Privatization and Globalization) Policy. In order to liberalize imports and boost exports, the Government of India for the first time introduced the Indian EXIM Policy on April I, 1992. In order to bring stability and continuity, the Export Import Policy was made for the duration of 5 years. However, the Central Government reserves the right in public interest to make any **Export Import Policy** is believed to be an important step towards the economic reforms of India.

9.7.2 EXIM Policy 1997 -2002

With time the EXIM Policy 1992-1997 became old, and a **New Export Import Policy** was need for the smooth functioning of the Indian export import trade. Hence, the Government of India introduced a new EXIM Policy for the year 1997-2002. This policy has further simplified the procedures and educed the interface between exporters and the **Director General of Foreign Trade (DGFT)** by reducing the number of documents required for export by half. Import has been further liberalized and better efforts have been made to promote Indian exports in international trade.

Objectives of the EXIM Policy 1997 -2002

The principal objectives of the Export Import Policy 1997 -2002 are as under:

- To accelerate the economy from low level of economic activities to high level of economic activities by making it a globally oriented vibrant economy and to derive maximum benefits from expanding global market opportunities.
- To motivate sustained economic growth by providing access to essential raw materials, intermediates, components,' consumables and capital goods required for augmenting production. To improve the technological strength and efficiency of Indian agriculture, industry and services, thereby, improving their competitiveness.
- To create new employment. Opportunities and encourage the attainment of internationally accepted standards of quality.
- To give quality consumer products at practical prices.

Highlights of the EXIM Policy 1997-2002

1. **Period of the EXIM Policy**

This policy is valid for five years instead of three years as in the case of earlier policies. It is effective from 1st April 1997 to 31st March 2002.

2. **Liberalization**

A very important feature of the policy is liberalization. It has substantially eliminated licensing, quantitative restrictions and other regulatory and discretionary controls. All goods, except those coming under negative list, may be freely imported or exported.

3. Imports Liberalization

Out of 542 items from the restricted list, 150 items have been transferred to Special Import License (SIL) list and remaining 392 items have been transferred to Open General Licence (OGL) List.

4. Export Promotion Capital Goods (EPCG) Scheme

The duty on imported capital goods under **EPCG Scheme** has been reduced from 15% to 10%. Under the zero duty EPCG Scheme, the threshold limit has been reduced from Rs. 20 crore to Rs. 5 crore for agricultural and allied Sectors

5. Advance License Scheme

Under Advance License Scheme, the period for export obligation has been extended from 12 months to 18 months. A further extension for six months can be given on payment of 1 % of the value of unfulfilled exports.

6. Duty Entitlement Pass Book (DEPB) Scheme

Under the **DEPB Scheme** an exporter may apply for credit, as a specified percentage of FOB value of exports, made in freely convertible currency. Such credit can be can be utilized for import of raw materials, intermediates, components, parts, packaging materials, etc. for export purpose.

Impact of EXIM Policy 1997 –2002

(a) Globalization of Indian Economy:

The EXIM Policy 1997-02 proposed with an aim to prepare a framework for globalizations of Indian economy. This is evident from the very first objective of the policy, which states. "To accelerate the economy from low level of economic activities to- high level of economic activities by making it a globally oriented vibrant economy and to derive maximum benefits from expanding global market opportunities."

(b) Impact on the Indian Industry:

In the EXIM policy 1997-02, a series of reform measures have been introduced in order to give boost to India's industrial growth and generate employment opportunities in non-agricultural sector. These include the reduction of duty from 15% to 10% under EPCG scheme that enables Indian firms to import capital goods and is an important step in improving the quality and productivity of the Indian industry.

(c) Impact on Agriculture:

Many encouraging steps have been taken in the EXIM Policy 1997-2002 in order to give a boost to Indian agricultural sector. These steps includes provision of additional SIL of 1 % for export of agro products, allowing **EOU's** and other units in EPZs in agriculture sectors to 50% of their output in the domestic tariff area (DTA) on payment of duty.

(d) Impact on Foreign Investment.

In order to encourage foreign investment in India, the EXIM Policy 1997-02 has permitted 100% foreign equity participation in the case of 100% EOUs, and units set up in EPZs.

(e) Impact on Quality up gradation:

The SIL entitlement of exporters holding ISO 9000 certification has been increased from 2% to 5% of the FOB value of exports, which has encouraged Indian industries to undertake research and development programmers and upgrade the quality of their products.

(f) Impact on Self-Reliance:-

The EXIM Policy 1997-2002 successfully fulfills one of the India's long terms objective of Self-reliance. The EXIM Policy has achieved this by encouraging domestic sourcing of raw materials, in order to build up a strong domestic production base. New incentives added in the EXIM Policy have also added benefits to the exporters.

9.7.3 EXIM Policy 2002 – 2007

The EXIM Policy 2002 - 2007 deals with both the export and import of merchandise and services. It is worth mentioning here that the EXIM Policy: 1997 - 2002 had accorded a status of exporter to the business firm exporting services with effect from1.4.1999. Such business firms are known as Service Providers.

Objectives of the EXIM Policy: 2002 - 2007

The main objectives of the Export Import Policy 2002-2007 are as follows:

1. To encourage economic growth of India by providing supply of essential raw materials, intermediates, components, consumables and capital goods required for augmenting production and providing services.
2. To improve the technological strength and efficiency of Indian agriculture, industry and services, thereby improving their competitive strength while generating new employment opportunities and encourage the attainment of internationally accepted standards of quality; and
3. To provide consumers with good quality products and services at internationally competitive prices while at the same time creating a level playing field for the domestic producers.

9.7.4 Main Elements of EXIM Policy 2004-2009

The new EXIM Policy 2004-2009 has the following main elements:

- Special Focus Initiatives
- Promotional Measures
- Duty Exemption / Remission Schemes
- Export Promotion Capital Goods Scheme
- Export Oriented Units (EOUs),Electronics Hardware Technology Parks (EHTPS), Software Technology Parks (STPs) and Bio-Technology Parks (BTPs)
- Special Economic Zones
- Free Trade & Warehousing Zones
- Deemed Exports

Special Focus Initiative of EXIM Policy 2004-2009

With a view to doubling our percentage share of global trade within 5 years and expanding employment opportunities, especially in semi urban and rural areas, certain **special focus initiatives** have been identified for agriculture, handlooms, handicraft, gems & jewellery, leather and Marine sectors. Government of India shall make concerted efforts to promote exports in these sectors by specific sectoral strategies that shall be notified from time to time.

Promotional Measures of EXIM Policy 2004-2009

The Government of India has set up several institutions whose main functions are to help an exporter in his work. It would be advisable for an exporter to acquaint him with these institutions and the nature of help that they can provide so that he can initially contact them and have a clear picture of what help he can expect of the organized sources in his export effort. Some of these institution are as follows.

- Export Promotion Councils
- Commodity Boards
- Marine Products Export Development Authority
- Agricultural & Processed Food Products Export Development Authority
- Indian Institute of Foreign Trade
- India Trade Promotion Organization (ITPO)
- National Centre for Trade Information (NCTI)
- Export Credit Guarantee Corporation (ECGC)
- Export-Import Bank
- Export Inspection Council
- Indian Council of Arbitration
- Federation of Indian Export Organizations
- Department of Commercial Intelligence and Statistics
- Directorate General of Shipping
- Freight Investigation Bureau

Duty Exemption / Remission Schemes of EXIM Policy 2004-2009

The Duty Exemption Scheme enables import of inputs required for export production. It includes the following exemptions-

Duty Drawback: - The Duty Drawback Scheme is administered by the Directorate of Drawback, Ministry of Finance. Under Duty Drawback scheme, an exporter is entitled to claim. Indian Customs Duty paid on the imported goods and Central Excise Duty paid on indigenous raw materials or components.

Excise Duty Refund: - Excise Duty is a tax imposed by the Central Government on goods manufactured in India. Excise duty is collected at source, i.e., before removal of goods from the factory premises. Export goods are totally exempted from central excise duty.

Octroi Exemption: - Octroi is a duty paid on manufactured goods, when they enter the municipal limits of a city or a town. However, export goods are exempted from Octroi.

The **Duty Remission Scheme** enables post export replenishment/ remission of duty on inputs used in the export product.

DEPB: Duty Entitlement Pass Book in short **DEPB Rate** is basically an export incentive scheme. The objective of **DEPB Scheme** is to neutralize the incidence of basic custom duty on the import content of the exported products.

DFRC: Under the Duty Free Replenishment Certificate (DFRC) schemes, import incentives are given to the exporter for the import of inputs used in the manufacture of goods without payment of basic customs duty.

Export Oriented Units (EOUs), Electronics Hardware Technology Parks (EHTPs), Software TechnologyParks(STPs) And Bio-Technology Parks (BTPs) of EXIM Policy 2004-2009

The Export Import Policies relating to Export Oriented Units

(EOUs) Electronics Hardware Technology Parks(EHTPs), Software Technology P arks (STPs) and Bio-technology parks (BTPs) Scheme is given in Chapter 6 of the Foreign Trade Policy. Software Technology Park(STP)/Electronics Hardware Technology Park (EHTP) complexes can be set up by the Central Government, State Government, Public or Private Sector Undertakings.

Export Promotion Capital Goods Scheme (EPCG) of EXIM Policy 2004-2009

Introduced in the EXIM policy of 1992-97, Export Promotion Capital Goods Scheme (EPCG) enable exporters to import machinery and other capital goods for export production at concessional or no customs duties at all. This facility is subject to export obligation, i.e., the exporter is required to guarantee exports of certain minimum value, which is in multiple of total value of capital goods imported.

Special Economic Zone (SEZ) under the EXIM Policy 2004-2009

A Special Economic Zone in short SEZ is a geographically distributed area or zones where the economic laws are more liberal as compared to other parts of the country. SEZs are proposed to be specially delineated duty free enclaves for the purpose of trade, operations, duty and tariffs. SEZs are self-contained and integrated having their own infrastructure and support services. The area under 'SEZ' covers a broad range of zone types, including Export Processing Zones (EPZ), Free Zones (FZ), Industrial Estates (IE), Free Trade Zones (FTZ), Free Ports, Urban Enterprise Zones and others.

In Indian, at present there are eight functional Special Economic Zones located at Santa Cruz (Maharashtra), Cochin (Kerala), Kandla and Surat (Gujarat), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh), Falta (West Bengal) and Noida (Uttar Pradesh) in India. Further a Special Economic Zone at Indore (Madhya Pradesh) is also ready for operation.

Free Trade & Warehousing Zones of EXIM Policy 2004-2009

Free Trade & Warehousing Zones (FTWZ) shall be a special category of Special Economic Zones with a focus on trading and warehousing. The concept of FTWZ is new and has been recently introduced in the five-year foreign trade policy 2004-09. Its main objective is to provide infrastructure for growth of the economy and foreign trade. Free Trade & Warehousing Zones (FTWZ) plays an important role in achieving global standard warehousing facilities as free trade zones. Free Trade & Warehousing Zones is a widely accepted model with a history of providing Substantial encouragement to foreign trade and warehousing activity.

Deemed Exports under the EXIM Policy 2004-2009

Deemed Export is a special type of transaction in the Indian EXIM policy in which the payment is received before the goods are delivered. The payment can be done in Indian Rupees or in Foreign Exchange. As the deemed export is also a source of foreign exchange, so the Government of India has given the benefit duty free import of inputs.

9.7.8 Foreign Trade Policy 2009-14:

In order to maintain fruitful trade practices in the coming five years it is needed that motion strategies and policy measures are set in such a manner that it will catalyze the growth of exports. The policy had the following objectives:

- Achieving an annual export growth of 15% with an annual export target of US$ 200 billion by March 2011.
- The country should be able to come back on the high export growth path of around 25% per annum by 2014.
- Double India's exports of goods and services by 2014

In order to meet these objectives, the Government would follow a mix of policy measures including:

Special Bonus Benefit Scheme

1. It has been decided to introduce a new scheme to provide special assistance to specified sectors for 6 months as special assistance. The support is given to Engineering, Pharmaceutical and Chemical sectors.

2. The scheme would cover 50 products. Some of the major items under Engineering are cast article of alloys steel and stainless steel, hand tools, gas compressors, motorcycles and goods vehicle. The list under chemicals and pharma include carbon black, potassium iodide, niacin amide, erythromycin and its derivatives, ciprofloxacine etc. The list of products at 6-digit/8 digit levels is given in the newly created Table 8 in the appendix 37D of the FPS Scheme.

3. This scheme will be available on exports made on or after 1.10.2011. The scheme would automatically sunset on 31.3.2012.

4. The rate of duty credit is 1% of FOB value of exports.

Special Focus Market Scheme (SFMS)

5. It has been decided to introduce a Special Focus Market Scheme with a view to increase the competitiveness of exports with a geographical targeting. The scheme would provide additional 1 % duty credit when exports are made to these countries. This duty credit is over and above the duty credit granted under FMS i.e. if a item covered under FMS is exported to the countries listed under SFMS, then the total duty credit available would be @ 4%.

6. The markets are categorized into three groups, namely Latin American, African and CIS countries. The countries are listed in new Table 3 of Appendix 37C. The total number of countries included under the scheme is 41. The list includes Cuba and Mexico as new entrants. Therefore, exports to these two

countries would be entitled to duty credit scrip @4% of the FOB value of exports.

7. List of Latin American Countries include Argentina, Colombia, Costa Rica, Cuba, Ecuador, Haiti, Mexico, Nicaragua, Panama Republic, Paraguay, Peru and Uruguay (Total 12 countries).

8. List of African Countries include Angola, Cameroon, Congo D. Republic, Congo P Republic, Cote D'Ivoire, Ethiopia, Gabon, Gambia, Ghana, Liberia, Madagascar, Malawi, Mali, Namibia, Rwanda, Senegal, Sierra Leone, Sudan, Tunisia, Uganda, Zambia and Zimbabwe (Total 22 countries).

9. List of CIS Countries include Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan (Total 7 countries).

Support to Apparel Sector

10. Exports of items under Chapters 61 and 62 have shown a declining trend during 2010-11 compared to year 2009-10. The total exports to USA under Chapters 61 and 62 during 1.4.2010 to 30.09.2010 were Rs. 6129.69 crore. The exports during 1.4.2011 to 30.09.2011 declined to Rs. 3897.29 crore. Similarly the total exports to EU under Chapter 61 and 62 during 1.4.2010 to 30.09.2010 were Rs. 10365.01 crore. The exports during 1.4.2011 to 30.09.2011 declined to Rs. 7869.02 crore. This sector has high potential to achieve higher level of exports and generate great employment opportunities. USA and EU are also our major markets and these two countries are having their own myriad problems at present.

11. The chapters 61 and chapter 62 items were granted duty credit under MLFPS for export to USA till 30.9.2010 and for exports to EU up to 31.3.2011. However, at present the readymade garments are not covered under the FPS/MLFPS. It has been decided to extend MLFPS for exports to USA and EU under chapter 61 and 62.

12. The scheme would cover all the items covered under chapter 61 and 62. The duty credit would be available to exports made during 1.4.2011 to 31.3.2012 @ 2 % of FOB value of exports.

Focus Product Scheme

13. The list of items under FPS has been expanded to include 130 additional items. These items are mainly in the sectors of Chemical/ Pharmaceuticals, Textiles, handicrafts, Engineering and electronics sector**.**

14. These include chemicals like soda ash, other amides and their derivatives, silicon in primary forms, oxygen function amino compound, methyl diethanolamine, and only specified APIs under ITC (HS) Code 29420090.

15. Textile items like polyester textured yarn, fully drawn yarn of polyester, viscose rayon type yarn, polyester chips, woven cotton fabrics denim 85% cotton over 200G/M2, unbleached or bleached cotton fabrics, dyed cotton fabrics knitted or crocheted have been included under the scheme.

16. Important engineering items like other Ferro- chromium, insulated conductors, vending machines, lithographic plates, and biomass gasifiers, fittings for doors and windows made of brass, name sign plates have also been included in the list.

17. Important electronics items included in the list are: static converters, optical disc drives, parts of mobile hand sets, push button phones, telephone answering machines, standard wires cables of copper, optical fibre cable, parts of telecom transmission equipment.

18. This Scheme has also been extended to printing on cartons, boxes, cases, bags and other packing containers, erasers and pencil sharpeners.

19. The items covered under FPS are entitled to get duty credit scrip @ 2% of FOB value of exports.

Market Linked Focus Product Scheme

20. The list of items under MLFPS has been extended to cover new items to specified countries. It has been decided to extend MLFPS for exports of Agricultural tractors> 1800cc capacity which would now be eligible for duty credit for exports made to Turkey. Sugar machinery & high-pressure boilers would be eligible for Brazil, Kenya, South Africa, Tanzania and Egypt. The

scheme has also been extended to all existing MLFPS Countries for printing inks, writing ink etc.

21. The items covered under MLFPS are entitled to get duty credit scrip @ 2% of FOB value of exports.

Towns of Export Excellence

22. The towns of Firozabad for glassware, Bhubaneswar for marine products and Agartala for bamboo and cane products have been notified as town of export excellence.

EDI Initiatives and reduction in transaction Cost

23. DGFT has established itself in the e governance field. From on line filing of application to electronic issuance of licenses, it has been a great success story. In furtherance of the EDI initiatives, online message exchange of DFIA Authorization with Customs has started from today. Therefore, now Advance Authorization, EPCG and DFIA are completely EDI enabled.

24. DGFT has also become India's first digital signature enabled department in government of India, which has introduced a higher level of Encrypted 2048 bit Digital Signature. Digital certificate provides a high level of security for online communication such that only intended recipient can read it. It provides authentication, Privacy, non-repudiation and Integrity in the virtual world.

'Niryat Bandhu' - A scheme for International Business Mentoring

25. We are devising a novel 'Niryat Bandhu' scheme for mentoring first generation entrepreneurs. The officer (Niryat Bandhu) would function in the 'Mentoring' arena and would be a 'Handholding' experiment for the Young Turks in International Business enterprises.

26. Under the scheme, officers of DGFT will be investing Time and Knowledge primarily to mentor the interested individuals who want to conduct the business in a legal way. Over time, it would be expected to develop a class of businessmen who carry out the international business in an ethical manner.

Procedural simplification

27. Import of Radioimmunoassay Kits was classified in the 'Restricted' category as per ITC HS - Import Schedule under the ITC HS Code 28444000.

Since the import item is intended for the diagnosis of disease / disorders in Humans and Animals, the import policy regime for this item is being liberalized to 'Free' subject to prior permission of Atomic Energy Regulatory Board.

28. The procedures for Transfer/ sale of imported firearms have been simplified. For sale/transfer of imported 'firearms' prior permission from DGFT is not required after 10 years of import. Further, this condition of '10 years' would not apply if importer attains sixty years of age. Local Police Licensing Authorities or District Magistrates can give permission of sale/ transfer directly. However, such importers will be debarred from acquiring any additional weapon in India during their (importer's) lifetime. Even for 'Shooters' category, sale/transfer of imported weapons would not require approval from DGFT.

29. Exporters have faced lots of problems in clubbing of their Advance Authorizations and in almost all the cases they were to approach DGFT, Hqrs. This procedure was time consuming and onerous. The procedure has now been simplified and the powers have been delegated to the Regional Authorities of DGFT. For the first time in the history of foreign trade formulation, the draft text for amendment of HBP v1 was uploaded on the website of DGFT seeking suggestions on our draft. The amendment has incorporated their valuable suggestions

30. Process of simplifying the Redemption /No Bond Condition of Advance Authorization has been started. Under this additional window available to exporters the Redemption / No Bond condition of Advance Authorization will be done on the basis of a self-declaration. The cases will be subject to post-scrutiny with stricter penal provisions. The existing route of Redemption will also continue for such exporters who do not wish to go for a 'post scrutiny'. The draft procedure has also been placed on the DGFT website on 7.10.2011 inviting comments. Based on the inputs detailed mechanism would be worked out.

31. The application of IEC has become online w.e.f. 1.1.2011. This reduces the interface of exporters with the Regional Authorities of DGFT. An effort is also

on to update the IEC database containing more than 7.6 lakhs IEC. All the IEC holders are being urged to cooperate in this effort and update their details on-line. This exercise would be completed by 31.3.2012.

9.7.9 FOREIGN TRADE POLICY 2015-2020

A. SIMPLIFICATION & MERGER OF REWARD SCHEMES

Export from India Schemes:

1. Merchandise Exports from India Scheme (MEIS)

Earlier there were 5 different schemes (Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agri. Infrastructure Incentive Scrip, VKGUY) for rewarding merchandise exports with different kinds of duty scrips with varying conditions (sector specific or actual user only) attached to their use. Now all these schemes have been merged into a single scheme, namely Merchandise Export from India Scheme (MEIS) and there would be no conditionality attached to the scrips issued under the scheme.

Rewards for export of notified goods to notified markets under 'Merchandise Exports from India Scheme (MEIS) shall be payable as percentage of realized FOB value (in free foreign exchange). The debits towards basic customs duty in the transferable reward duty credit scrips would also be allowed adjustment as duty drawback. At present, only the additional duty of customs / excise duty / service tax is allowed adjustment as CENVAT credit or drawback, as per Department of Revenue rules.

2. Service Exports from India Scheme (SEIS)

Served From India Scheme (SFIS) has been replaced with Service Exports from India Scheme (SEIS). SEIS shall apply to 'Service Providers located in India' instead of 'Indian Service Providers'. Thus SEIS provides for rewards to all Service providers of notified services, who are providing services from India, regardless of the constitution or profile of the service provider.

The rate of reward under SEIS would be based on net foreign exchange earned. The reward issued as duty credit scrip, would no longer be with actual user condition and will no longer be restricted to usage for specified types of goods but be freely transferable and usable for all types of goods and service tax debits on procurement of services / goods. Debits would be eligible for CENVAT credit or drawback.

3. Incentives (MEIS & SEIS) to be available for SEZs

It is now proposed to extend Incentives (MEIS & SEIS) to units located in SEZs also.

4. Duty credit scrips to be freely transferable and usable for payment of custom duty, excise duty and service tax.

All scrips issued under MEIS and SEIS and the goods imported against these scrips would be fully transferable.

Scrips issued under Exports from India Schemes can be used for the following:-

(i) Payment of customs duty for import of inputs / goods including capital goods, except items listed in Appendix 3A.

(ii) Payment of excise duty on domestic procurement of inputs or goods, including capital goods as per DoR notification.

(iii) Payment of service tax on procurement of services as per DoR notification.

Basic Customs Duty paid in cash or through debit under Duty Credit Scrip can be taken back as Duty Drawback as per DoR Rules, if inputs so imported are used for exports.

5. Status Holders

Business leaders who have excelled in international trade and have successfully contributed to country's foreign trade are proposed to be recognized as Status Holders and given special treatment and privileges to facilitate their trade transactions, in order to reduce their transaction costs and time.

The nomenclature of Export House, Star Export House, Trading House, Star Trading House, Premier Trading House certificate has been changed to One, Two, Three, Four, Five Star Export House. The criteria for export performance for recognition of status holder have been changed from Rupees to US dollar earnings. The new criterion is as under:-

Status category	**Export Performance**
	FOB / FOR (as converted) Value (in US $ million) during current and previous two years
One Star Export House	3
Two Star Export House	25
Three Star Export House	100
Four Star Export House	500
Five Star Export House	2000

Approved Exporter Scheme - Self certification by Status Holders

Manufacturers who are also Status Holders will be enabled to self-certify their manufactured goods as originating from India with a view to qualify for preferential treatment under different Preferential Trading Agreements [PTAs], Free Trade Agreements [FTAs], Comprehensive Economic Cooperation Agreements [CECAs] and Comprehensive Economic Partnerships Agreements [CEPAs] which are in operation. They shall be permitted to self-certify the goods as manufactured as per their Industrial Entrepreneur Memorandum (IEM) / Industrial Licence (IL)/ Letter of Intent (LOI).

B. BOOST TO "MAKE IN INDIA"

6. Reduced Export Obligation (EO) for domestic procurement under EPCG scheme:

Specific Export Obligation under EPCG scheme, in case capital goods are procured from indigenous manufacturers, which is currently 90% of the normal export obligation (6 times at the duty saved amount) has been reduced to 75%, in order to promote domestic capital goods manufacturing industry.

7. Higher level of rewards under MEIS for export items with high domestic content and value addition.

It is proposed to give higher level of rewards to products with high domestic content and value addition, as compared to products with high import content and less value addition.

C. TRADE FACILITATION & EASE OF DOING BUSINESS

8. Online filing of documents/ applications and Paperless trade in 24x7 environment:

DGFT already provides facility of Online filing of various applications under FTP by the exporters/importers. However, certain documents like Certificates issued by Chartered Accountants/ Company Secretary / Cost Accountant etc. have to be filed in physical forms only. In order to move further towards paperless processing of reward schemes, it has been decided to develop an online procedure to upload digitally signed documents by Chartered Accountant / Company Secretary / Cost Accountant.

Henceforth, hardcopies of applications and specified documents would not be required to be submitted to RA, saving paper as well as cost and time for the exporters.

As a measure of ease of doing business, landing documents of export consignment as proofs for notified market can be digitally uploaded in the following manner:-

(i) Any exporter may upload the scanned copy of Bill of Entry under his digital signature.

(ii) Status holders falling in the category of Three Star, Four Star or Five Star Export House may upload scanned copies of documents.

9. Online inter-ministerial consultations:

It is proposed to have Online inter-ministerial consultations for approval of export of SCOMET items, Norms fixation, Import Authorisations, Export Authorisation, in a phased manner, with the objective to reduce time for approval. As a result, there would not be any need to submit hard copies of documents for these purposes by the exporters.

10. Simplification of procedures/processes, digitisation and e-governance

Under EPCG scheme, obtaining and submitting a certificate from an independent Chartered Engineer, confirming the use of spares, tools, refractory and catalysts imported for final redemption of EPCG authorizations has been dispensed with.

At present, the EPCG Authorisation holders are required to maintain records for 3 years after redemption of Authorisations. Now the EPCG Authorization Holders shall be required to maintain records for a period of two years only. Government's endeavour is to gradually phase out this requirement as the relevant records such as Shipping Bills, e-BRC are likely to be available in electronic mode which can be archived and retrieved whenever required.

11. Forthcoming e-Governance Initiatives

DGFT is currently working on the following EDI initiatives:

- Message exchange for transmission of export reward scrips from DGFT to Customs.
- Message exchange for transmission of Bills of Entry (import details) from Customs to DGFT.
- Online issuance of Export Obligation Discharge Certificate (EODC).
- Message exchange with Ministry of Corporate Affairs for CIN & DIN.
- Message exchange with CBDT for PAN.

- Facility to pay application fee using debit card / credit card.
- Open API for submission of IEC application.
- Mobile applications for FTP

D. Other new Initiatives

12. New initiatives for EOUs, EHTPs and STPs

EOUs, EHTPs, STPs have been allowed to share infrastructural facilities among themselves. This will enable units to utilize their infrastructural facilities in an optimum way and avoid duplication of efforts and cost to create separate infrastructural facilities in different units.

EOUs have been allowed facility to set up Warehouses near the port of export. This will help in reducing lead time for delivery of goods and will also address the issue of un-predictability of supply orders.

STP units, EHTP units, software EOUs have been allowed the facility to use all duty free equipment/goods for training purposes. This will help these units in developing skills of their employees.

100% EOU units have been allowed facility of supply of spares/ components up to 2% of the value of the manufactured articles to a buyer in domestic market for the purpose of after sale services.

At present, in a period of 5 years EOU units have to achieve Positive Net Foreign Exchange Earning (NEE) cumulatively. Because of adverse market condition or any ground of genuine hardship, then such period of 5 years for NFE completion can be extended by one year.

13. Facilitating & Encouraging Export of dual use items (SCOMET).

Validity of SCOMET export authorisation has been extended from the present 12 months to 24 months. It will help industry to plan their activity in an orderly manner and obviate the need to seek revalidation or relaxation from DGFT.

14 Facilitating & Encouraging Export of Defence Exports

Normal export obligation period under advance authorization is 18 months. Export obligation period for export items falling in the category of defence, military store, aerospace and nuclear energy shall be 24 months from the date of issue of authorization or co-terminus with contracted duration of the export order, whichever is later. This provision will help export of defence items and other high technology items.

A list of military stores requiring NOC of Department of Defence Production has been notified by DGFT recently. A committee has been formed to create ITC (HS) codesfor defence and security items for which industrial licenses are issued by DIPP.

15. e-Commerce Exports

Goods falling in the category of handloom products, books / periodicals, leather footwear, toys and customized fashion garments, having FOB value up to Rs.25000 per consignment (finalized using e-Commerce platform) shall be eligible for benefits under FTP. Such goods can be exported in manual mode through Foreign Post Offices at New Delhi, Mumbai and Chennai.

Export of such goods under Courier Regulations shall be allowed manually on pilot basis through Airports at Delhi, Mumbai and Chennai as per appropriate amendments in regulations to be made by Department of Revenue. Department of Revenue shall fast track the implementation of EDI mode at courier terminals.

16. Duty Exemption

Imports against Advance Authorization shall also be eligible for exemption from Transitional Product Specific Safeguard Duty. In order to encourage manufacturing of capital goods in India, import under EPCG Authorisation Scheme shall not be eligible for exemption from payment of anti-dumping duty, safeguard duty and transitional product specific safeguard duty.

17. Additional Ports allowed for Export and import

Calicut Airport, Kerala and Arakonam ICD, Tamil Nadu have been notified as registered ports for import and export.

18. Duty Free Tariff Preference (DFTP) Scheme

India has already extended duty free tariff preference to 33 Least Developed Countries (LDCs) across the globe. This is being notified under FTP.

19. Quality complaints and Trade Disputes

In an endeavour to resolve quality complaints and trade disputes, between exporters and importers, a Committee on Quality Complaints andTrade Disputes (CQCTD) is being constituted in 22 offices and would have members from EPCs/FIEOs/APEDA/EICs.

20. Vishakhapatnam and Bhimavaram added as Towns of Export Excellence

Government has already recognized 33 towns as export excellence towns. It has been decided to add Vishakhapatnam and Bhimavaram in Andhra Pradesh as towns of export excellence.

9.8 Conclusion

International Trade is an essential requirement in the present times for all economies. No country can satisfied the needs of all people in isolation. It plays an important role in economic development of the country. With the change in economy, Government also brought changes in foreign trade policy, also known as EXIM policy. The basic policy of an EXIM policy is to encourage exports to the maximum extent.

9.9 Check Your Progress

1. EOU & EPZ schemes for export promotion were started in

(a) 1990 (b) 1991 (c) 1992 (d) 1994

2. Which of the following is not true about EPZ's

(a) Foreign equity capital upto 100% is permissible in EPZ's

(b) No import licence is required by the EPZ's for the import of capital goods, raw material & consumable stores

(c) EPZ's are eligible for complete tax holiday upto 2009-2010

(d) EPZ's cannot import second hand capital goods

3. DFRC stand for

(a) Duty Free replenishment certificate

(b) Duty Free reorganisation certificate

(c) Duty Free reexport certificates

(d) All of above

4. Indian institute of foreign trade was set up in

(a) 1963 (b) 1965 (c) 1975 (d) 1968

(Answers: 1b 2d 3a 4a)

9.10 Glossary

DEPB Rates : It stands for Duty Entitlement Passbook DEPB Scheme from DGFT. DEPB Rates Export Incentives by Indian Government, used to saved Customs Duty when Import the Goods.

Special Focus Initiatives: With a view to continously increasing our percentage share of global trade and expanding employment opportunities, especially in semi urban and rural areas, certain special focus initiatives have been identified for Agriculture, Handlooms, Handicraft, Gems & Jewellery, Leather, Marine, Electronics and IT Hardware manufacturing Industries and Sports Goods and Toys sectors. Government of India shall make concerted efforts to promote exports in these sectors by specific sectoral strategies that shall be notified from time to time.

9.11 References

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- M.L. Jhingan, International Economics", Vrinda Publications(p)ltd. , Delhi

9.12 Suggested Reading

- Dr.D. M. Mithani "International Economics" Himalaya Publishing House, Delhi.
- K.C. Rana& K.N. Varma, International Economics" Vishal Publication Company, Jalandcr.

9.13 Model Questions

1. What do you mean by International Trade and what are its features?
2. Discuss the implications of international trade for developing countries.
3. Explain the foreign trade policy of 1997-2002.

Chapter-10

Recent trends in foreign trade

Structure

10.1 Objectives

- To study the composition and trends in India's Foreign trade
- To study the India's Balance of Payment situation during the post reform period.

10.2 Introduction to India's Foreign Trade

Foreign Trade implies buying and selling of goods or services between two or more countries. India was predominantly a primary goods exporting and mainly an industrial goods importing country. In 1950s, India's share in the world trade was 1.78% which was decline to 0.59% in 1990 and continues to remain around 0.60% till 2005. India's share in world exports rises to 0.8% in 2006.

10.3 Composition of India's Foreign Trade:

During the planning period, a number of structural changes had been registered in Indian foreign trade. In exports, the percentage of non traditional goods has continuously increased. The exports of chemical and engineering goods also had shown an increasing growth rate. During past few years, handmade goods (including gems and jewellery) constitute a significant portion in the important export commodities. In case of imports, gold and electronic goods constitute a major share in the import of principal commodities. The composition of India's Exports and Imports are given below:

10.3.1 Composition of India's Exports

Britishers firmly believed that India was a country which was well suited to export raw materials and other primary goods and a good import market place for British manufacturers. So at the time of our independence our exports mainly constituted primary goods (agricultural commodities and light manufactured consumer goods) and imports were of manufacturers. But after the independence period, India's composition of exports completely changed and now exports of India's are broadly classified into following four categories:

Table 10.1 shows composition of India's export from 2009-10 to 2014-15.

Table 10.1 : Exports of Principal Commodities - Rupees

(in $ Billion)

Commodity/Year	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
1	2	3	4	5	6	7
1. Tea	29.44	33.54	40.79	47.19	48.73	41.71
2. Coffee	20.32	30.10	45.35	47.11	47.99	49.73
3. Rice	112.55	115.86	241.09	338.58	470.87	480.28
4. Other cereals	29.73	36.48	54.93	81.81	71.78	52.62
5. Tobacco	43.44	39.85	40.06	50.30	61.34	58.69
6. Spices	59.49	78.87	131.03	151.77	151.46	148.48
7. Cashew	28.02	28.19	43.90	40.67	50.95	55.66
8. Oil Meals	78.32	110.70	117.96	165.20	170.70	81.29

9. Oil seeds	30.84	46.44	82.07	74.51	78.30	106.37
10. Fruits & Vegetables	71.86	65.84	82.81	97.74	136.51	131.75
11. Cereal preparations & miscellaneous processed items	21.19	26.54	38.58	49.92	69.69	76.88
12. Marine Products	99.00	119.17	165.85	188.41	306.27	336.88
13. Meat, dairy & poultry products	74.49	104.60	151.47	206.88	321.66	329.67
14. Iron Ore	283.66	221.98	221.51	89.85	94.81	32.11
15. Mica, Coal & Other Ores, Minerals including processed minerals	118.47	168.94	175.48	207.26	242.81	238.56
16. Leather & leather products	155.51	174.18	224.57	259.96	338.22	368.43
17. Ceramic products & glassware	33.50	39.42	50.35	62.91	78.31	100.52
18. Gems & Jewellery	1358.74	1927.95	2219.51	2342.08	2503.53	2522.08
19. Drugs & Pharmaceuticals	421.33	476.62	630.21	784.88	904.15	943.50
20. Organic & Inorganic Chemicals	297.23	374.18	546.15	624.48	744.77	762.59
21. Engineering Goods	1594.99	2290.84	2871.70	3219.19	3876.87	4470.49
22. Electronic Goods	266.36	384.81	435.08	449.35	475.58	382.63
23. Cotton Yarn/Fabs./made-ups, Handloom Products etc.	252.27	346.72	430.73	525.44	670.99	659.11
24. Man-made Yarn/Fabs./made-ups etc.	170.92	194.78	242.95	246.79	313.95	322.55
25. RMG of all Textiles	508.46	529.20	657.06	704.55	907.18	1029.43
26. Jute Mfg. including Floor	10.33	20.92	22.26	21.24	23.15	21.23

Covering						
27. Carpet	35.87	47.04	44.10	59.48	71.27	83.18
28. Handicrafts excl. hand made carpet	33.83	34.63	47.61	53.77	91.30	84.26
29. Petroleum Products	1328.99	1887.79	2679.15	3308.19	3832.48	3476.10
30. Plastic & Linoleum	142.38	194.37	271.94	304.65	372.71	350.86
31. Other Commodities	743.82	1278.68	1653.37	1539.03	1521.75	1172.60
Total Exports	8455.34	11429.22	14659.59	16343.18	19050.11	18970.26

Note: Data for 2014-15 are provisional and data for 2013-14 are revised. Data since 2009-10 are based on new commodity classification of DGCI & S..
Source: Directorate General of Commercial Intelligence and Statistics.

The composition of India's export can be summarised as follows :-

1. Agricultural and Allied Products

The share of agriculture items in the total exports of India has increased between 2009-10 to 2014-15. The share of agriculture exports was 8.26% in 2009-10 and rose to 10.28% in 2014-15.

The top items of agriculture exports include :-

1. Fish Products,
2. Rice,
3. Oil Cakes,
4. Fruits and Vegetables

The most important export item in 'Agriculture and Allied products' group over the period 2009-10 to 2014-15 has been rice and marine Products. Their share in export rises from $ 99 billion in 2009-10 to $ 336.9 billion in 2014-15.

As far as agricultural exports are concerned, a significant development during the period since 1991 has been the considerable exports of rice in certain year. In fact, exports of rice were as high as $ 480.3 billion in 2014-15.

2. Ores and Minerals

The overall export performance of ores and minerals is not satisfactory. In percentage terms, the export performance of ores and mineral has decreased from 4.8% in 2009-10 to 1.4% in 2014-15. A major share of ores and minerals exports comes from the export of iron ore.

3. Manufactured Goods

The share of manufactured items in the total export earnings of India is on the increase. In 2009-10, the share of manufactured items in the total export earnings was about 61% of the total export earnings.

In 2014-15, the share of manufactured items in the total export earnings of India remained stagnant at 62%.

The top manufactured export items include :-

1. Engineering Goods,
2. Gems and Jewellery,
3. Chemicals and Allied products, and
4. Readymade Garments

The export of engineering goods increased from $ 1594 billions in 2009-10 to $ 4470 billion in 2014-15. In percentage terms the share of engineering goods rose from 18.86% in 2009-10 to 23.57% in 2014-15.

For most of the period since 1991, largest export earnings came from the exports of gems and jewellery. The share of gems and jewellery in India's total export was 15.3% in 2009-10 and 15.1% in 2014-15. However, gems and jewellery industry is a highly import intensive industry requiring large amount of imports of pearls and precious stones.

Exports of chemicals and allied products rose significantly from $ 297.23 billions in 2009-10 to $ 762.6 billions in 2014-15. In percentage terms, readymade garments maintained an almost constant share all through the period since 1991. They contributed 6.01% of export earnings in 2009-10 and 5.42% of export earnings in 20014-15.

4. Mineral Fuel and Lubricants

There has been an improvement in the export of mineral fuels and lubricants both in terms of value and in terms of percentage. In percentage terms, its share has increased from less than 17% in 2009-10 to 20% in 2014-15.

Some other facts regarding structural change in India's export since 1991 are as follows :-

1. There are some of Indian exports which have moved upwards in value addition chain whereby instead of exporting raw materials, the country has switched over to export of processed goods.
2. There were significant compositional shift within the major manufactured product groups such as engineering. goods, chemicals and allied products, etc.

10.3.2 Composition of India's Imports

After independence, the main items of India's imports were machineries, oil, grains, cotton, cutlery, hardware implements, chemicals, etc. They contributed 70% of India's imports. After that, due to the emphasis on industrialisation during the second 5-Year plan necessitated the imports of capital goods.

Now imports of India's are broadly classified into following four categories.

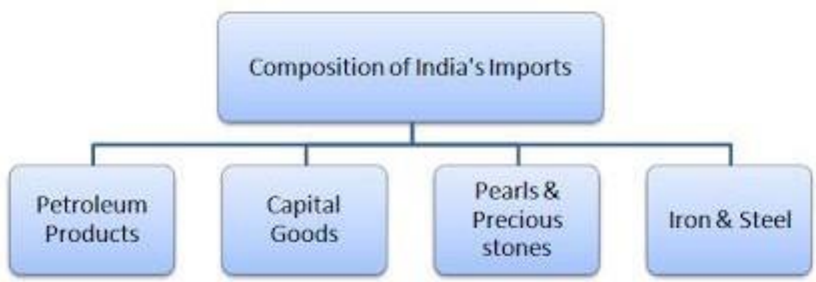

Table below shows composition of India's import from 1990-91 to 2005-06.

Table 10.2 : Imports of Principal Commodities - Rupees						
						(in $ Billion)
Commodity / Year	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
1	**2**	**3**	**4**	**5**	**6**	**7**
1. Cotton Raw & Waste	12.41	6.22	10.59	24.67	23.76	31.01

2. Vegetable Oil	223.17	259.20	389.09	535.62	440.38	648.94
3. Pulses	106.29	75.12	94.48	133.45	110.37	170.63
4. Fruits & vegetables	31.21	39.96	50.53	67.73	83.42	101.80
5. Pulp and Waste paper	22.06	28.31	34.52	40.57	46.48	57.79
6. Textile yarn Fabric, made-up articles	39.76	50.13	68.56	78.43	91.21	103.39
7. Fertilisers, Crude & manufactured	317.55	315.33	533.11	477.22	381.57	452.95
8. Sulphur & Unroasted Iron Pyrts	6.82	10.99	22.86	17.39	11.05	17.50
9. Metaliferrous ores & other minerals	257.73	294.92	388.78	497.50	507.92	568.78
10. Coal, Coke & Briquettes, etc.	425.11	446.70	835.96	925.38	991.31	1089.06
11. Petroleum, Crude & products	4116.49	4822.82	7430.75	8918.71	9978.85	8428.70
12. Wood & Wood products	152.49	168.95	240.78	276.57	309.81	334.13
13. Leather & leather products	21.86	29.01	34.48	40.26	49.84	61.48
14. Organic & Inorganic Chemicals	493.20	613.46	801.15	913.38	1056.63	1134.88
15. Dyeing/tanning/colouring mtrls.	57.42	72.85	101.06	118.12	146.35	149.42
16. Artificial resins, plastic materials, etc.	274.46	357.91	423.40	543.53	632.61	737.21
17. Chemical material & products	141.51	174.21	218.02	264.51	295.12	324.25
18. Newsprint	22.45	37.41	49.38	43.75	53.95	51.28
19. Pearls, precious & Semi-precious stones	755.58	1541.37	1343.74	1231.68	1442.93	1379.68
20. Iron & Steel	549.08	665.16	874.82	963.10	765.87	997.53
21. Non-ferrous metals	213.43	297.95	402.90	491.76	535.85	657.18
22. Machine tools	102.37	134.98	190.60	202.44	184.99	191.88
23. Machinery, electrical & non-electrical	1011.55	1190.50	1586.21	1673.89	1639.08	1712.31
24. Transport equipment	682.66	678.92	897.34	1158.33	1169.14	1125.21
25. Project goods	222.16	279.96	422.21	356.59	274.42	222.12
26. Professional instrument, Optical	106.51	126.56	172.22	204.37	217.66	227.26

goods, etc.						
27. Electronic goods	1054.57	1272.98	1633.27	1790.42	1958.96	2254.49
28. Medcnl. & Pharmaceutical products	170.40	191.49	248.43	297.36	316.61	332.09
29. Gold	1358.83	1847.42	2699.01	2921.53	1662.43	2106.58
30. Silver	45.64	89.53	247.04	107.97	269.74	276.86
31. Other Commodities	642.59	714.36	1009.36	1375.39	1506.03	1394.10
Total Imports	13637.36	16834.67	23454.63	26691.62	27154.34	27340.49
Note : Data for 2014-15 are provisional and data for 2013-14 are revised. Data since 2009-10 are based on new commodity classification of DGCI & S. Source : Directorate General of Commercial Intelligence and Statistics.						

The composition of India's imports can be summarised as follows :-

1. Petroleum Products

Imports of petroleum oil and lubricants rose significantly from $ 4116 billions in 2009-10 to $ 8429 billions in 2014-15. Petroleum products accounted for nearly nearly 31% of the total import bill of India.

2. Capital Goods

The imports of capital goods was $ 3,610 billions in 2009-10. In 2014-15 due to sharp rise in non-electrical machinery imports, the imports of capital goods jumped upto $ 8,458 billions. However due to slowing domestic demand imports of capital goods fell subsequently. The capital goods and related items were 24.1% of the total imports of India in 2009-10, which has come down slightly in 2014-15 to about 22.3%.

3. Pearls and Precious Stones

To meet the requirements of the gems & jewellery industry pearls and precious stones are imported in large quantities. In 1990-91, the share of pearls and precib0s stones was 8.7% which has reduced in percentage terms to 6.4% in2005-06 and further reduced to 5.04% in 2014-15.

4. Iron and Steel

The imports of iron and steel have declined over the years in percentage terms. In 2009-10, the share of iron and steel imports was 4.02%, which has come down to 3.65% in 2014-15. This is because, a good amount of iron ore is now extracted in India which has reduced imports.

5. Fertilizers

Import of fertilizers in 2009-10 stood at $ 317.6 billions. In 2014-15 expenditure on import of fertilizers was $ 453 billions.

The import of fertilizers have declined, which indicates less dependence of India on imported fertilizers. The share in total imports of fertilizers was 2.32% in 2009-10, which came down to 1.6% in 2014-15.

10.4 Trends in India's Foreign Trade

After independence, Indian foreign trade has made cumulative progress both qualitatively and quantitatively. Though the size of foreign trade and its value both have increased during post independence era, this increase in foreign trade cannot be said satisfactory because Indian share in total foreign trade of the world has remained remarkable low. In 1950, Indian's trade to the total world trade was 1.78%, which came down to 0.6% in 1995. According to the World Trade Organisation's forecast, Global trade is set to expand by 3.3 per cent this year and 4 per cent next year on account of cut in protectionist measures and improving market access. As per WTO, India has 19th rank in exports of merchandise and 12th rank in imports.

India's Trade Performance

India's merchandise exports reached a level of US $ 312.61 billion during 2013-14 registering a growth of 4.06 percent as compared to a negative growth of 1.82 percent during the previous year. Despite the recent setback faced by India's export sector due to global slowdown, merchandise exports still recorded a Compound Annual Growth Rate (CAGR) of 15.79 per cent from 2004-05 to 2013-14.

The Trade deficit in 2013-14 was estimated at US $ 81.04.23 billion which was lower than the deficit of US $ 10348.44 billion during 2012-13. But this trade deficit again shows an increase and it rises up to US $ 8370.23 in 2014-15.

Performance of Exports, Imports and Balance of Trade during 1976-77 to 2014-15 is given in the table 10.3:

Table 10.3 : India's Foreign Trade - Rupees

($Billion)

Year	**Exports**			**Imports**			**Trade Balance**		
	Oil	**Non-Oil**	**Total**	**Oil**	**Non-Oil**	**Total**	**Oil**	**Non-Oil**	**Total**
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1976 -77	0.19	51.24	51.43	14.13	36.60	50.74	-13.95	14.64	0.69
1977 -78	0.16	53.92	54.08	15.51	44.69	60.20	-15.35	9.23	-6.12
1978 -79	0.14	57.12	57.26	16.77	51.34	68.11	-16.63	5.78	-10.85
1979 -80	0.19	64.00	64.18	32.67	58.76	91.43	-32.48	5.24	-27.24
1980 -81	0.25	66.86	67.11	52.64	72.86	125.49	-52.39	-6.00	-58.38
1981 -82	2.21	75.85	78.06	51.89	84.18	136.08	-49.68	-8.33	-58.02
1982 -83	12.35	75.68	88.03	56.22	86.71	142.93	-43.87	-11.03	-54.89
1983 -84	15.88	81.83	97.71	48.32	110.00	158.32	-32.44	-28.17	-60.61
1984 -85	18.18	99.26	117.44	54.09	117.25	171.34	-35.91	-18.00	-53.91
1985 -86	6.45	102.50	108.95	49.89	146.68	196.58	-43.45	-44.18	-87.63
1986 -87	4.11	120.41	124.52	28.11	172.85	200.96	-23.99	-52.45	-76.44
1987 -88	6.49	150.25	156.74	40.43	182.01	222.44	-33.94	-31.76	-65.70
1988 -89	5.05	197.27	202.32	43.58	238.78	282.35	-38.53	-41.51	-80.04
1989 -90	6.97	269.62	276.58	62.73	290.56	353.28	-55.76	-20.94	-76.70
1990 -91	9.38	316.20	325.58	108.16	323.77	431.93	-98.78	-7.57	-106.35
1991 -92	10.22	430.20	440.42	131.27	347.24	478.51	-121.05	82.95	-38.09
1992	13.79	523.09	536.88	171.42	462.33	633.75	-	60.76	-96.86

-93							157.63		
1993-94	12.48	685.04	697.51	180.46	550.55	731.01	-167.98	134.49	-33.50
1994-95	13.09	813.65	826.74	186.13	713.58	899.71	-173.04	100.07	-72.97
1995-96	15.18	1048.36	1063.53	251.74	975.05	1226.78	-236.56	73.31	-163.25
1996-97	17.10	1171.07	1188.17	356.29	1032.91	1389.20	-339.18	138.16	-201.03
1997-98	13.11	1287.90	1301.01	303.41	1238.35	1541.76	-290.30	49.55	-240.76
1998-99	3.76	1393.77	1397.53	269.19	1514.13	1783.32	-265.43	-120.36	-385.79
1999-00	1.69	1593.93	1595.61	546.49	1605.88	2152.37	-544.80	-11.95	-556.75
2000-01	85.42	1950.29	2035.71	714.97	1593.76	2308.73	-629.55	356.53	-273.02
2001-02	101.07	1989.11	2090.18	667.70	1784.30	2452.00	-566.63	204.82	-361.82
2002-03	124.69	2426.68	2551.37	853.67	2118.39	2972.06	-728.98	308.29	-420.69
2003-04	163.97	2769.69	2933.67	945.20	2645.88	3591.08	-781.23	123.82	-657.41
2004-05	314.04	3439.35	3753.40	1340.94	3669.71	5010.65	-1026.90	-230.35	-1257.25
2005-06	515.33	4048.85	4564.18	1946.40	4657.69	6604.09	-1431.07	-608.84	-2039.91
2006-07	845.20	4872.59	5717.79	2585.72	5819.35	8405.06	-1740.52	-946.75	-2687.27
2007-08	1141.92	5416.72	6558.64	3206.55	6916.57	10123.12	-2064.63	-1499.85	-3564.48
2008-09	1233.98	7173.57	8407.55	4199.68	9544.68	13744.36	-2965.70	-2371.11	-5336.80
2009-10	1328.99	7126.35	8455.34	4116.49	9520.86	13637.36	-2787.50	-2394.52	-5182.02
2010-11	1887.79	9541.43	11429.22	4822.82	12011.85	16834.67	-2935.03	-2470.42	-5405.45
2011-12	2679.15	11980.45	14659.59	7430.75	16023.88	23454.63	-4751.60	-4043.44	-8795.04
2012	3308.1	13035.0	16343.1	8918.7	17772.9	26691.6	-	-	-

-13	9	0	8	1	1	2	5610.52	4737.92	10348.44
2013-14	3832.48	15217.63	19050.11	9978.85	17175.48	27154.34	-6146.38	-1957.85	-8104.23
2014-15	3476.08	15494.18	18970.26	8428.70	18911.79	27340.49	-4952.62	-3417.62	-8370.23
Note : Data for 2013-14 are revised and for 2014-15 are provisional. Source : Directorate General of Commercial Intelligence and Statistics.									

10.5 Balance of Payments

The balance of payments of a country is a systematic record of all transactions between the residents of a country and the rest of the world carried out in a specific period of time. India's balance of payment worsened in the early 1990's but now the situation is under control. It is because of the reforms of 1991. With the coming up of liberalization, privatization and globalization policy, India BOP position initially shows trade deficit. But now, India has a good foreign exchange reserves mainly because of the capital inflows from foreign financial institutions or the stock exchange.

10.5.1 Main Components of India's Balance of Payments

1. Trade Balance

Trade balance is basically the difference between exports and imports of goods. It was in deficit throughout the period shown in the table 10.3 imports are always more than the exports. Within the imports the Petroleum items constituting a sizeable position continued to increase throughout. Exports did not achieve the required growth rate.

2. Current Account

Current account balance includes visible items (trade balance) and invisibles items. It declined to $ -2,666 million in 2000-01 from $-9680 million in 1990-91 and recorded a surplus in 2003-04 to the extent of $ 14,083 million. In 2005-06, once again there was a deficit of $ 9,186 million. The main reason forthe improvement during 2001-05 was the success of invisible items.

According to the International Monetary Fund (IMF) the current account of the balance of payments includes the following items:

- Merchandise: Exports and imports of goods form the visible account and have a dominant position in the current account of balance of payments.
- Travel: Travel is an invisible item in the balance of payments. Travel may be for reason of business, education, health, international conventions or pleasures, Expenditure by the foreign tourists in our country forms the credit item and the expenditure by our tourists abroad constitutes the debit item in our balance of payments.
- Transportation: International transportation of goods is another invisible transaction. It includes warehousing (while in transit) and other transit expense. Use of domestic transport services but the foreigners is the credit items and the use of foreign transport services by domestic traders is the debit item.
- Insurance: Insurance premium and payments of claims is also an invisible transaction in a country's balance of payments account. Insurance policies sold to foreigner's area credit item and the insurance policies purchased by domestic users form the foreigners are a debit item.
- Investment Income: Another invisible item in the current account of the balance of payment is the investment income which includes interest, rents, dividends and profits. Income received on capital invested abroad is the credit item and income paid on capital borrowed from abroad is the debit item.
- Government Transactions: Government transactions refer to the expenditure incurred by a government for the upkeep of its organisations abroad (e.g., payment of salaries to the ambassadors, high commissioners, etc.) such amounts received by a government from abroad constitute the credit item and made to the foreign government form the debit item.
- Miscellaneous: Miscellaneous invisible items include expenditure incurred on services like advertisement, commissions, film rental, patent fees, royalties, subscriptions to the periodicals, membership fees, etc. Such

payments received by a country from abroad are a credit item and made by a country to foreign countries are a debit item.

- Donations and Gifts: Donations, gifts, etc, received by a country from abroad are the credit item and sent to the foreign countries are the debit item in the balance of payments account. Donations and gifts are 'unilateral transfers' because nothing is given in return for them.

3. Invisible

The impressive role placed by invisibles in covering trade deficit is due to sharp rise invisible receipts. The main contributing factor to rise in invisible receipts are non factor receipts and private transfers. As far as non factor services receipts are concerned the main development has been the rapid increase in the exports of software services. As far as private transfers are concerned their main constituent is workers remittance from abroad. During this period the private transfer receipts also increased from $ 2,069 million in 1990-91 to $ 24,102 million in 2005-06. The current trend of outsourcing a number of jobs by the developed countries to the developing ones is also helping us to get more jobs and earn additional foreign exchange.

4. Capital Account

Capital account has been positive throughout the period. NRI deposits and foreign investment both portfolio and direct have helped to a great extent. The main reasons for huge increase in capital account is due to large capital inflows on account of Foreign direct investment (FDI); Foreign Institutional Investors (FIIs) investment on the stock markets and also by way of Euro equities raised by Indian firms. The Non-resident deposit also forms a part of capital account. The main items of capital account in India are:

- Private Loans. Foreign loans received by the private sector (credit item) and foreign loans repaid by the private sector (debit items)
- Movements in Banking Capital: Inflow of banking capital excluding the central bank (credit item); and outflow of banking capital excluding the central Bank (debit items.)

- Official Capital Transactions
    - Loans: Foreign loans and credits received by the official sector including the drawings from the IMF (credit item); and loans extended to the other countries as well as repurchase of the drawings from the IMF (debit item)
    - Amortisation: Repayment of official loans by other countries (credit items); and repayment of official loans by home country (debit item)
    - Miscellaneous: All other official receipts including those of central bank (credit item); and all other official capital payments including those of central bank (debit item)
    - Reserve and Monetary Gold: Changes in the official foreign exchange holdings, gold reserve of the central bank and SDR holdings of the government, purchase from the IMF and similar other capital transactions ; all such receipts represent credit item and payments represent debit item.

5. Reserves

Reserves have changed during this period depending on a balance between current and capital account. An increase in inflow under capital account has helped us to build up our foreign exchange reserve making the country quiet comfortable on this count. In April 2007 we had $ 203 billion foreign exchange reserves. The year 2005-06 registered the highest trade deficit so far running into $ 51,841 million, because of rising Oil prices; As a result despite impressive positive earnings of as much as $ 42,655 million from invisibles, the current account deficit in this year was $ 9,189 million which is 1.1% of GDP.

10.5.2 Situation of India's Balance of Payments (BoP) after reforms

The India's balance-of-payments (BoP) position improved dramatically in 2013-14, particularly in the last three quarters. This is mainly due to measures taken by the government and the Reserve Bank of India (RBI) and in some part to the overall macroeconomic slowdown that fed into the external sector. Table 10.4 indicates India's BoP position in between 1990-91 to 2005-06.

Table 4: Situation of India's BOP after 1991

India's BOP during 1990-91 to 2013-14 (value in US $ million)

Year	Current account balance	Capital Account balance	Overall Balance
1990-91	-9680	7188	-2492
1991-92	-1178	3777	2599
1992-93	-3526	2936	-590
1993-94	-1159	9694	8535
1994-95	-3369	9156	5787
1995-96	-5912	4690	-1222
1996-97	-4619	11412	6793
1997-98	-5499	10010	4511
1998-99	-4038	8260	4222
1999-00	-4698	11100	6402
2000-01	-2666	8535	5868
2001-02	3400	8357	11757
2002-03	6345	10640	16985
2003-04	14083	17338	31421
2004-05	-2470	28629	26159
2005-06	-9902	24954	15052
2006-07	-9565	46171	36606
2007-08	-15737	107901	92164
2008-09	-27915	7835	-20079
2009-10	-38180	51622	13441
2010-11	-45945	58996	13050
2011-12	-78155	65324	-12832
2012-13	-88163	91989	-3826
2013-14	-32397	47905	-15508

Source: Reserve Bank of India, www.rbi.org

When imports of a country exceed its exports in terms of goods and services, it is said to be into current account deficit. If we look the above table in absolute value, we would identify that current account balance have increased over the years but in trade, one shall prefer to look it from relative value. Identifying the current account balance in 2012-13 with India's Gross

Domestic Product, it was 4.7% while the same percentage reduced to 1.7% in the year 2013-14.

Coming to Capital account balance, it the difference of investments irrespective of public or private flowed in the country and flowed out of the country. One can identify from the above table that from 2009-10 onwards, the flow of investments in the country has exceeded except 2013-14 when it stood to US$ 47905.

10.6 Conclusion

Composition of India's foreign trade has undergone a positive change. It is a remarkable achievement in the history of India have it had transformed itself from a predominantly primary goods exporting country into a non-primary goods exporting country. This trend shows the structural transformation of Indian economy. There also has been improvement in India's balance of payment position in the post reform period inspite of growing trade deficit and current account deficit.

10.7 Check Your Progress

1. Balance of trade means
   (a) Record of foreign exchange inflow and outflow
   (b) Record of value of goods imported and exported
   (c) Record of value of services imported and exported
   (d) Record of value of goods and services imported and exported
2. Efforts for economic development causes
   (a) Equilibrium in balance of payments
   (b) Favourable balance of payments
   (c) Disequilibrium balance of payments
   (d) None of above
3. The balance of payment is currently divided into:

a) Current Account and Capital Account

b) Visible Account and Invisible Account

c) Long-Term Capital Account and short-Term Capital Account

d) None of the Above

(Answers: 1b 2c 3a)

10.8 Glossary

- **Exports:** When a person from home country sells his goods to a person located in another country, it is called export. For e.g. a trader from India sells his goods to a trader located in New York.
- **Imports:** When a person in home country bought goods from a person located in another country, it is called import trade. For e.g. a trader from India bought goods from a trader located in New York

10.9 References

- www.commerce.nic.in
- www.rbi.org.in

10.10 Suggested Readings

- K.C. Rana & K.N. Varma, International Economics" Vishal Publication Company, Jalander.
- M.L. Jhingan, International Economics", Vrinda Publications(p)ltd. , Delhi

10.11 Model Questions

1. Discuss the composition and trend of India's foreign trade.
2. Explain the situation of India's BOP after post reform period.

Chapter-11

Recent Changes in India's export and import policies

Structure

11.1 Objectives

11.2 Recent changes in India's export and import policies

11.3 Organizations and institutions involved in export and import management

11.4 Conclusion

11.5 Check Your Progress

11.6 Glossary

11.7 References

11.8 Suggested Readings

11.9 Model Questions

11.1 Objectives

- To study the recent changes in India's export and import policies.
- To study the Organizations and institutions involved in export and import management

11.2 Recent changes in India's export and import policies[1]

With an objective to make India a significant partner in global trade by 2020, the government came out with a new Foreign Trade Policy (FTP). The new policy aims at boosting India's exports. Commerce Minister Nirmala Sitharaman said that PM Narendra Modi's pet projects, 'Make in India' and 'Digital India' will be integrated with the new Foreign Trade Policy.

The government is pitching India as a friendly destination for manufacturing and exporting goods, and the new policy is being seen as an important step towards realising that goal.

[1] http://articles.economictimes.indiatimes.com/2015-04-01/news/60720349_1_digital-india-india-scheme-foreign-trade-policy

Key features of the new Foreign Trade Policy:

- India to be made a significant participant in world trade by 2020
- Merchandize exports from India (MEIS) to promote specific services for specific Markets Foreign Trade Policy
- FTP would reduce export obligations by 25% and give boost to domestic manufacturing
- FTP benefits from both MEIS & SEIS will be extended to units located in SEZs
- FTP 2015-20 introduces two new schemes, namely "Merchandise Exports from India Scheme (MEIS)" and "Services Exports from India Scheme (SEIS)". The 'Services Exports from India Scheme' (SEIS) is for increasing exports of notified services. These schemes (MEIS and SEIS) replace multiple schemes earlier in place, each with different conditions for eligibility and usage. Incentives (MEIS & SEIS) to be available for SEZs also. e-Commerce of handicrafts, handlooms, books etc., eligible for benefits of MEIS.
- Agricultural and village industry products to be supported across the globe at rates of 3% and 5% under MEIS. Higher level of support to be provided to processed and packaged agricultural and food items under MEIS.
- Industrial products to be supported in major markets at rates ranging from 2% to 3%.
- Served From India Scheme (SFIS) will be replaced with Service Export from India Scheme (SEIS).
- Branding campaigns planned to promote exports in sectors where India has traditional Strength.
- SEIS shall apply to 'Service Providers located in India' instead of 'Indian Service Providers'.
- Business services, hotel and restaurants to get rewards scrips under SEIS at 3% and other specified services at 5%.
- Duty credit scrips to be freely transferable and usable for payment of customs duty, excise duty and service tax.
- Debits against scrips would be eligible for CENVAT credit or drawback also.

- Nomenclature of Export House, Star Export House, Trading House, Premier Trading House certificate changed to 1,2,3,4,5 Star Export House.
- The criteria for export performance for recognition of status holder have been changed from Rupees to US dollar earnings.
- Manufacturers who are also status holders will be enabled to self-certify their manufactured goods as originating from India.
- Reduced Export Obligation (EO) (75%) for domestic procurement under EPCG scheme.
- Online procedure to upload digitally signed document by Chartered Accountant/Company Secretary/Cost Accountant to be developed.
- Inter-ministerial consultations to be held online for issue of various licences.
- No need to repeatedly submit physical copies of documents available on Exporter Importer Profile.
- Validity period of SCOMET export authorisation extended from present 12 months to 24 months.

11.3 Organizations and institutions involved in export and import management

11.3.1 Ministry of Commerce

The mandate of the Department of Commerce is regulation, development and promotion of India's international trade and commerce through formulation of appropriate international trade & commercial policy and implementation of the various provisions thereof. The basic role of the Department is to facilitate the creation of an enabling environment and infrastructure for accelerated growth of international trade. The Department formulates, implements and monitors the Foreign Trade Policy (FTP) which provides the basic framework of policy and strategy to be followed for promoting exports and trade. The Trade Policy is periodically reviewed to incorporate changes necessary to take care of emerging economic scenarios both in the domestic and international economy. Besides, the Department is also entrusted with responsibilities relating to multilateral and bilateral commercial relations, Special Economic Zones, state trading, export promotion and trade facilitation, and development and regulation of certain export oriented industries and commodities.

The Department is functionally organized into the following 9 Divisions:

1. International Trade Policy Division:
2. Foreign Trade Territorial Division
3. Export Products Division
4. Export Industries Division
5. Export Services Division
6. Economic Division
7. Administration & General Service Division
8. Finance Division
9. Supply Division

Functions

The Department formulates, implements and monitors the Foreign Trade Policy (FTP) which provides the basic framework of policy and strategy to be followed for promoting exports and trade. The Trade Policy is periodically reviewed to incorporate changes necessary to take care of emerging economic scenarios both in the domestic and international economy. Besides, the Department is also entrusted with responsibilities relating to multilateral and bilateral commercial relations, Special Economic Zones, state trading, export promotion and trade facilitation, and development and regulation of certain export oriented industries and commodities.

11.3.2 Directorate General of Foreign Trade (DGFT)

This Directorate, with headquarters at New Delhi, is headed by the Director General. Keeping in line with liberalization and globalization and the overall objective of increasing of exports, DGFT is assigned the role of a "facilitator". It is responsible for implementing the Foreign Trade Policy with the main objective of promoting India's exports. The DGFT also issues licenses to exporters and monitors their corresponding obligations through a network of 35 Regional Offices. The Regional Offices are located at the following places. These are Ahmadabad, Amritsar, Bangalore, Bhopal, Chandigarh, Chennai, Coimbatore, Cuttack, Dehradun, Ernakulam, Guwahati, Hyderabad, Jaipur, Jammu, Kanpur, Kolkata, Ludhiana, Madurai, Moradabad, Mumbai, New Delhi, Nagpur, Panaji, Panipat, Patna, Pondicherry, Pune, Raipur, Rajkot, Shillong, Surat, Vadodara, Varanasi, Vishakhapatnam and Thiruvananthapuram.

All DGFT offices provide facilitation to exporters in regard to developments in the area of international trade, i.e. WTO agreements, Rules of Origin and Sanitary and Phytosanitary Measures (SPS) requirements, Anti-Dumping issues, etc. to help the exporters to strategize their import and export decisions in an internationally dynamic environment.

11.3.3 Directorate General of Commercial Intelligence and Statistics (DGCI&S)

The Directorate General of Commercial Intelligence & Statistics (DGCI&S) is the premier organization of Govt. of India for collection, compilation and dissemination of India's Trade Statistics and Commercial Information. This Directorate, with its office located at Kolkata, is headed by the Director General. It is entrusted with the work of collecting, compiling and publishing/disseminating trade statistics and various types of commercial information required by the policy makers, researchers, importers, exporters, traders as well as overseas buyers. DGCI&S collects the basic data from different customs formations in the form of DTR (Daily Trade Return) and then processes and compiles it using state-of-the-art technology.

The foreign trade data generated by the Directorate are disseminated through (i) Monthly Press Release brought out every month by the Ministry of Commerce and Industry, (ii) Monthly Foreign Trade Statistics of India by Principal Commodities & Countries, (iii) Monthly Statistics of Foreign Trade of India (Import & Export), and (iv) Quarterly Statistics of Foreign Trade of India by Countries. It also brings out an Assessment Report on India's Foreign Trade by Air, every year. As far as ancillary statistics is concerned, DGCI&S also compiles and publishes on regular basis the Inland Trade Statistics covering Inter-State Movements of Goods by Rail, River and Air, Statistics on India's Customs and Excise Revenue Collections (according to the tariff heads), Shipping Statistics, Inland Coastal Trade Statistics and Selected Statistics of Foreign Trade of India.

11.3.4 State Trading Corporation of India

Established in 1956, the State Trading Corporation (STC) is an international trading house owned by the Government of India that arranges the import of essential goods into India, including edible oils, sugar, wheat, and hydrocarbons. The STC exports a wide variety of both agricultural commodities and manufactured products, including various chemicals and agrochemicals. The STC also helps Indian manufacturers find markets overseas for their products.

Subsidiaries of State Trading Corporation:

- **Projects & Equipment Corporation of India:** was a subsidiary of the State Trading Corporation of India Ltd. It was created as a subsidiary, to take over the canalised business of STC's Railway Equipment Division and also to diversify in exports of engineering equipment and turnkey projects. The Corporation diversified in other areas like export and import of commodities etc. Its diversification was allowed by the Ministry of Commerce & Industry and by Government of India in order to enable it remain profitable and grow its business operations.
- **Tea Trading Corporation of India:** STC has been in Tea business for more than three decades. Presently, tea operations of STC are centralized at Coimbatore / Bangalore Branch. The entire tea operation viz. purchase of leaves, processing, blending, storage, inspection & dispatch is monitored and inspected by experienced professionals

to maintain high standards of quality and freshness. The tea produced by STC is sold in the domestic markets and is also exported.

- **Minerals and Metals Trading Corporation of India:** MMTC is major global player in the minerals trade and is the single largest exporter of minerals from India. With its comprehensive infrastructural expertise to handle minerals, the company provides full logistic support from procurement, quality control to guaranteed timely deliveries of minerals from different ports, through a wide network of regional and port offices in India, as well as international subsidiary.

MMTC has won the top export award from Chemicals and Allied Products Export Promotion Council (CAPEXIL) as the largest exporter of minerals from India for twentieth year in a row.

- **Handicrafts and Handlooms Export Corporation:** HHEC generates tremendous demand, response and confidence of foreign buyers through exhibitions that will provide a synergetic platform to various production houses to showcase their masterpieces and is regularly participating in the International Fairs & Buyer-Seller Meets. It also provides technical guidance to craftsmen enabling them to understand the finer details of Quality production, tools and technological infrastructure which helps them in designing and processing of their products. The focus of the corporation is towards maintaining a harmonious blending of its developmental role with commercial activities.

11.3.5 Export Promotion Board (EPB)

The Export Promotion Board functions under the Chairmanship of the Cabinet Secretary to provide policy and infrastructural support through greater coordination amongst concerned Ministries for boosting exports. All Ministries directly connected with facilitating foreign trade are represented on the Board by their Secretaries. This, inter-alia, includes Secretaries of Department of Commerce; Ministry of Finance, Department of Revenue; Department of

Industrial Policy & Promotion; Ministry of Textiles; Department of Agriculture & Cooperation; Ministry of Civil Aviation and Ministry of Surface Transport.

Terms of reference of the Board of Trade

- To advise the Government on Policy measures for preparation and implementation of both short & long term plans for increasing exports in the light of emerging national and international economic scenario;
- To review export performance of various sectors, identify constraints and suggest industry specific measures to optimize export earnings;
- To examine the existing institutional framework for imports and exports and suggest practical measures for further streamlining to achieve the desired objectives;
- To review the policy instruments and procedures for imports and exports and suggest steps to rationalize and channelize such schemes for optimum use;
- To examine issues which are considered relevant for promotion of India's foreign trade, and to strengthen the international competitiveness of Indian goods and services; and
- To commission studies for furtherance of the above objectives.

11.3.6 Board of Trade

The Board of Trade of Department of Commerce on May 5, 1989 with a view to provide an effective mechanism to maintain continuous dialogue with Trade and Industry in respect of major development in the field of International Trade. The Commerce and Industry Minister is Chairman of the Board of Trade.

The broad Terms of reference of the Board of Trade are as follows :

(i) To advise the Government on policy measures for preparation and implementation of both short and long term plans for increasing exports in the light of emerging national and international economic scenario.

(ii) To review export performance of various sectors, identify constraints and suggest measures to be taken both by Government and industry/ trade consistent with the need to maximise export earnings and restrict imports.
(iii) To examine the existing institutional framework for exports and suggest practical measures for re-organisation/ streamlining it with a view to ensure co-ordinated and timely decision making.
(iv) To review the policy instrument, package of incentives and procedures for exports and suggest steps to rationalise and channel incentives to areas where they are most needed.

11.3.7 Export Promotion Council

The basic objective of Export Promotion Councils is to promote and develop the exports of the country. Each Council is responsible for the promotion of a particular group of products, projects and services. The main role of the EPCs is to project India's image abroad as a reliable supplier of high quality goods and services. In particular, the EPCs shall encourage and monitor the observance of international standards and specifications by exporters. The EPCs shall keep abreast of the trends and opportunities in international markets for goods and services and assist their members in taking advantage of such opportunities in order to expand and diversify exports.

The major functions of the EPCs are:

- To provide commercially useful information and assistance to their members in developing and increasing their exports;
- To offer professional advice to their members in areas such as technology upgradation, quality and design improvement, standards and specifications, product development, innovation, etc.;
- To organise visits of delegations of its members abroad to explore overseas market opportunities;

- To organise participation in trade fairs, exhibitions and buyer-seller meets in India and abroad;
- To promote interaction between the exporting community and the Government both at the Central and State levels; and
- To build a statistical base and provide data on the exports and imports of the country, exports and imports of their members, as well as other relevant international trade data.

11.3.8 The Agricultural and Processed Food Products Export Development Authority (APEDA)

APEDA was established by the Government of India under the Agricultural and Processed Food Products Export Development Authority Act passed by the Parliament in December, 1985. The Authority replaced the Processed Food Export Promotion Council (PFEPC).

ASSIGNED FUNCTIONS

In accordance with the Agricultural and Processed Food Products Export Development Authority Act, 1985, (2 of 1986) the following functions have been assigned to the Authority.

- Development of industries relating to the scheduled products for export by way of providing financial assistance or otherwise for undertaking surveys and feasibility studies, participation in enquiry capital through joint ventures and other reliefs and subsidy schemes;
- Registration of persons as exporters of the scheduled products on payment of such fees as may be prescribed;
- Fixing of standards and specifications for the scheduled products for the purpose of exports;
- Carrying out inspection of meat and meat products in slaughter houses, processing plants, storage premises, conveyances or other places where such products are kept or handled for the purpose of ensuring the quality of such products;

- Improving of packaging of the Scheduled products;
- Improving of marketing of the Scheduled products outside India;
- Promotion of export oriented production and development of the Scheduled products;
- Collection of statistics from the owners of factories or establishments engaged in the production, processing, packaging, marketing or export of the scheduled products or from such other persons as may be prescribed on any matter relating to the scheduled products and publication of the statistics so collected or of any portions thereof or extracts therefrom;
- Training in various aspects of the industries connected with the scheduled products;

11.3.9 Marine Products Export Development Authority (MPEDA)

The Marine Products Export Development Authority (MPEDA) on 20th April 1972 by an Act of the Parliament. The MPEPC subsequently went into voluntary liquidation and all the staff members got absorbed into the MPEDA on 24th August 1972. MPEDA was given the mandate to promote the export of seafood from the country. MPEDA was to work for the holistic development of seafood industry in India to realise its full export potential as a nodal agency.

A glance at the roles and responsibilities of MPEDA

- Registration of infrastructural facilities for seafood export trade.
- Collection and dissemination of trade information.
- Promotion of Indian marine products in overseas markets.
- Implementation of schemes vital to the industry by extending assistance for infrastructure development for better preservation and modernised processing following quality regime.
- Promotion of aquaculture for augmenting export production through hatchery development, new farm development, diversification of species and up gradation of technolog

- Promotion of deep-sea fishing projects through test fishing, joint ventures and up gradation & installation of equipments to increase the efficiency of fishing.
- Market promotional activities and publicity.
- To carry out inspection of marine products, its raw material, fixing standards and specifications, training, regulating as well as to take all necessary steps for maintaining the quality of seafood that are marketed overseas.
- Impart trainings to fishermen, fish processing workers, aquaculture farmers and other stake holders in the respective fields related to fisheries.
- Conduct research and development for the aquaculture of aquatic species having export potential through Rajiv Gandhi Center for Aquaculture (RGCA).
- Conduct extension and awareness activities, trainings etc through Network for Fish Quality Management and Sustainable Fishing (NETFISH) & National Centre for Sustainable Aquaculture (NaCSA).
- To prescribe for itself any matters required for protecting and augmenting the seafood exports from the country in the future.

11.3.10 Commodity Boards

There are five statutory Commodity Boards under the Department of Commerce. These Boards are responsible for production, development and export of tea, coffee, rubber, spices and tobacco.

(i) Coffee Board

The Coffee Board is a statutory organisation constituted under Section (4) of the Coffee Act, 1942 and functions under the administrative control of the Ministry of Commerce and Industry, Government of India. The Board is mainly focusing its activities in the areas of research, extension, development, quality upgradation, economic & market intelligence, external & internal promotion and labour welfare. The Board has a Central Coffee Research Institute at Balehonnur (Karnataka) and Regional Coffee Research Stations at Chettalli (Karnataka), Chundale (Kerala), Thandigudi (Tamil Nadu), R.V.Nagar (Andhra Pradesh) and Diphu (Assam), and a bio-technology centre at Mysore, apart from the extension offices located in coffee growing regions of Karnataka, Kerala, Tamil Nadu, Andhra Pradesh, Orissa and North Eastern Region.

(ii) Rubber Board

The Rubber Board is a statutory organisation constituted under Section (4) of the Rubber Act, 1947 and functions under the administrative control of Ministry of Commerce and Industry. The Board is responsible for the development of the rubber industry in the country by way of assisting and encouraging research, development, extension and training activities related to rubber. It also maintains statistical data of rubber, takes steps to promote marketing of rubber and undertake labour welfare activities. The activities of the Board are exercised through nine departments viz. Rubber Production, Research, Processing & Product Development, Training, License & Excise Duty, Statistics and Planning, Market Promotion, Finance & Accounts and Administration.

(iii) Tea Board

Tea Board was set up as a statutory body on 1st April, 1954 as per Section (4) of the Tea Act, 1953. As an apex body, it looks after the overall development of the tea industry. For the purpose of tea promotion, three overseas offices are located at London, Moscow and Dubai. The functions and responsibilities of Tea Board include increasing production and productivity, improving the quality of tea, market promotion, welfare measures for plantation workers and supporting Research and Development. Being the regulatory body, the Board exerts control over the producers, manufacturers, exporters, tea brokers, auction organisers and warehouse keepers through various control orders notified under Tea Act.

(iv) Tobacco Board

The Tobacco Board was constituted as a statutory body on 1st January, 1976 under Section (4) of the Tobacco Board Act, 1975. The primary function of the Board is export promotion of all varieties of tobacco and its allied products, its functions extend to production, distribution (for domestic consumption and exports) and export promotion of Flue Cured Virginia (FCV) tobacco.

(v) Spices Board

The Spices Board was constituted as a statutory body on 26th February, 1987 under Section (3) of the Spices Board Act, 1986. It is responsible for the development of cardamom industry and export promotion of the 52 spices listed in the Schedule of the Spices Board Act, 1986. The primary functions of the Board include production development of small and large cardamom, development and promotion of export of spices. The activities of the Board include issue of certificate of registration as exporter of spices; undertaking programmes and projects for promotion of export of spices like setting up of spices parks, support of infrastructure improvement in spices processing, assisting and encouraging studies and research on medicinal properties of spices, development of new products, improvement of processing, grading and packaging of spices; and controlling & upgrading quality for export (including setting up of regional quality evaluation labs and training centres). With regard to cardamom, the Board's licenced auctioneers and dealers facilitate the domestic marketing through e-auctions. The research activities on cardamom are also done by the Board through its Indian Cardamom Research Institute

11.3.11 Service Support Organization

In India, there are various organizations which provide help to firms regarding export and import of goods and services. Some of these organizations are:

- **Indian Institute of Foreign Trade (IIFT)**

The Indian Institute of Foreign Trade was registered in May, 1963 under the Societies Registration Act, 1860. The Institute, with its head office at New Delhi and one regional branch at Kolkata, is headed by a Director. The Institute has been conferred "Deemed University" status and is engaged in the following activities:-

- Conducting academic courses leading to issue of degrees in International Business & Export Management;
- Training of personnel in international trade;
- Organizing research on issues in foreign trade, marketing research, area surveys, commodity surveys, market surveys; and
- Dissemination of information arising from its activities relating to research and market studies.

➢ **Indian Institute of Packaging**

The Indian Institute of Packaging is an autonomous body set up by the Department of Commerce, Govt. of India in 1966 in partnership with the leading Indian packaging and allied industries. The Institute is a Society registered at Mumbai and works under the administrative control of the Department of Commerce. The Institute has the objective of promoting exports by helping innovate in design and development of packaging and also upgrade the packaging standards at the national level. The Institute endeavors to achieve this by organizing educational courses and skill development programmes in packaging for the benefit of students and in-service packaging professionals, testing and certification of packaging, and provision of consultancy services to industry. The Institute has created research and model infrastructural facilities at its location for training, design and development in packaging.

Main activities of the Institute include training, education, research & development. The Institute has the potential of playing a vital role in assessing the adequacy and export worthiness of packages through quality evaluation (of packaging) for all export packages of different commodity goods like food, pharmaceutical, cosmetics, engineering products, electronic goods, footwear etc. Besides, it can act as a resource centre for notifications on packaging and labeling regulations issued by the importing countries and the WTO and take corrective/follow up actions.

- **Export Credit Guarantee Corporation of India Ltd. (ECGC)**

ECGC is a Government of India Enterprise which provides export credit insurance facilities to exporters and banks in India. It functions under the administrative control of Ministry of Commerce & Industry, and is managed by a Board of Directors comprising representatives of the Government, Reserve Bank of India, banking , insurance and exporting community. Over the years, it has evolved various export credit risk insurance products to suit the requirements of Indian exporters and commercial banks. ECGC is the seventh largest credit insurer of the world in terms of coverage of national exports. The present paid up capital of the Company is Rs. 1200 Crores and the authorized capital is Rs. 5000 Crores.

ECGC is essentially an export promotion organization, seeking to improve the competitive capacity of Indian exporters by giving them credit insurance covers comparable to those available to their competitors from most other countries. It keeps it's premium rates at the lowest level possible.

- **Export Inspection Council (EIC)**

EIC was set up by the Government of India in order to ensure sound development of export trade of India through Quality Control and Inspection and for matters connected thereof.

EIC is an advisory body to the Central Government, which is empowered under the Act to:

- Notify commodities which will be subject to quality control and/ or inspection prior to export,
- Establish standards of quality for such notified commodities, and

- Specify the type of quality control and / or inspection to be applied to such commodities.

Besides its advisory role, the Export Inspection Council, also exercises technical and administrative control over the five Export Inspection Agencies (EIAs), one each at Channai, Delhi, Kochi, Kolkata and Mumbai established by the Ministry of Commerce, Government of India, for the purpose of implementing the various measures and policies formulated by the Export Inspection Council of India.

- **Export-Import Bank of India (EXIM)**

EXIM is the premier export finance institution of the country. It commenced operations in 1982 under the Export-Import Bank of India Act 1981. Government of India launched the institution with a mandate to not just enhance exports from India, but also to integrate the country's foreign trade and investment with the overall economic growth. EXIM Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, EXIM Bank of India has evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium Enterprises through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.

- **Federation of Indian Export Organizations**

The Federation of Indian Export Organisations represents the Indian entrepreneurs's spirit of enterprise in the global market. set up in October, 1965, the Federation, known popularly as "FIEO", has kept pace with the country's evolving economic and trade policies, and provided the content, direction and thrust to India's expanding international trade. As the apex body of all Indian export promotion organisations, FIEO works as a partner of the Government of the India to promote Indian exports.

Today, FIEO expresses all the dynamism and resurgence that are the hallmark of India's open, liberal and progressively market-friendly economic and trade regime, representing the Indian export promotion effort in its entirely. Its membership, largely comprising professional exporting films or long experience called Government recognised Export Houses, Trading Houses, Star Trading Houses and Super Star Trading Houses and Consultancy exporting firms, contributes 72 % of the total exports of India.

In essence, FIEO represents directly or indirectly, over 100,000 exporters across India. Exports by FIEO members comprise a wide spectrum of products including Gems & Jewellery, Textiles, Garments, Engineering Goods, Leather and Leather Products, Handicrafts, Chemicals and allied products, Cosmetics, Drugs and Pharmaceuticals, etc. as well as a wide range of Consultancy Services covering Infrastructure, Engineering, Industries, Cement, Leather, Paper & Rubber Industries. Agro-based Industries, Small Scale Industries etc.

11.4 Conclusion

With a view to boost exports, Commerce Minister Nirmala Sitharaman said that PM Narendra Modi's pet projects, 'Make in India' and 'Digital India' will be integrated with the new Foreign Trade Policy. Beside this, Ministry of Commerce aims to regulate, develop and promote India’s international trade and hence formulate commercial policies with regard to international trade.

11.5 Check Your Progress

1. IIFT stands for:
    a. Indian Institute of Foreign Trade
    b. International Institute of Foreign Trade
    c. Indian Institute of Food Trade
    d. None of the above

2. To boost domestic manufacturing, FTP would reduce export obligations by

   a) 25% b)35% c)45% d)15%

3. The criteria for export performance for recognition of status holder have been changed from

   a) Rupees to US dollar earnings
   b) US dollar to Rupees earnings
   c) Rupees to Pound earnings
   d) None of the above

(Answers: 1A 2A 3A)

11.6 Glossary

- **Merchandise Exports from India Scheme (MEIS):**

  The objective of Merchandise Exports from India Scheme (MEIS) as per Indian Foreign Trade Policy 2015-20 (FTP 2015-20) is to offset infrastructural inefficiencies and associated costs involved in export of goods/products, which are produced/manufactured in India, especially those having high export intensity, employment potential and thereby enhancing India's export competitiveness.

- **Services Exports from India Scheme (SEIS):**

  The objective of Service Exports from India Scheme (SEIS) is to encourage export in India. This Scheme has been announced on 01.04.2015 under the New Foreign Trade Policy- 2015-2020 and has come into effect from 1.4.2015. It provides for rewards to all Service providers who are providing exporting services from India and the rate of reward under SEIS are based on net foreign exchange earned.

11.7 References

- www.exim-policy.com
- Jain T. R. "Banking and Foreign Trade" V. K. Publications.
- http://www.stc.gov.in/

11.8 Suggested Readings

- Seth, M. L. "Money, Banking and International Trade" Lakshmi Narayan Agarwal.
- Mishra, Jagannath "Money, Banking and International Trade" Thacker, Spink and Company.

11.9 Model Questions

1. Discuss the recent changes in India's export and import policies.
2. Explain the various Organizations and institutions that are involved in export and import management.

Chapter-12

Regulation of International Trade in India-1

Structure

12.1 Objectives

- To study the EXIM policy
- To understand the Foreign Exchange Management Act (FEMA), 1999

12.2 Introduction to regulation of international trade in India

Imports and exports are the two important components of the international trade. It is the exchange of goods and services between the two countries, across their international borders. 'Imports' refers to the physical movement of goods into a country from another country in a legal manner. It refers to the goods that are produced abroad by foreign producers and are used in the domestic economy to cater to the needs of the domestic consumers. Similarly, 'exports' refers to the physical movement of goods out of a country in a legal manner. It implies the goods that are produced domestically in a country and are used to cater to the needs of the consumers in foreign countries. Thus, the imports and exports have made the world a local market. The country which is purchasing the goods is known as the importing country and the country which is selling the goods is known as the exporting country. The traders involved in such transactions are importers and exporters respectively.

In India, exports and imports are regulated by the Foreign Trade Policy and Foreign Exchange Management Act (FEMA), 1999.

12.3 EXIM POLICY 2015-2020

A. SIMPLIFICATION & MERGER OF REWARD SCHEMES

Export from India Schemes:

1. Merchandise Exports from India Scheme (MEIS)

Earlier there were 5 different schemes (Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agri. Infrastructure Incentive Scrip, VKGUY) for rewarding merchandise exports with different kinds of duty scrips with varying conditions (sector specific or actual user only) attached to their use. Now all these schemes have been merged into a single scheme, namely Merchandise Export from India Scheme (MEIS) and there would be no conditionality attached to the scrips issued under the scheme.

Rewards for export of notified goods to notified markets under 'Merchandise Exports from India Scheme (MEIS) shall be payable as percentage of realized FOB value (in free foreign exchange). The debits towards basic customs duty in the transferable reward duty credit scrips would also be allowed adjustment as duty drawback. At present, only the additional duty of customs / excise duty / service tax is allowed adjustment as CENVAT credit or drawback, as per Department of Revenue rules.

2. Service Exports from India Scheme (SEIS)

Served From India Scheme (SFIS) has been replaced with Service Exports from India Scheme (SEIS). SEIS shall apply to 'Service Providers located in India' instead of 'Indian Service Providers'. Thus SEIS provides for rewards to all Service providers of notified services, who are providing services from India, regardless of the constitution or profile of the service provider.

The rate of reward under SEIS would be based on net foreign exchange earned. The reward issued as duty credit scrip, would no longer be with actual user condition and will no longer be restricted to usage for specified types of goods but be freely transferable and usable for all types of goods and service tax debits on procurement of services / goods. Debits would be eligible for CENVAT credit or drawback.

3. Incentives (MEIS & SEIS) to be available for SEZs

It is now proposed to extend Incentives (MEIS & SEIS) to units located in SEZs also.

4. Duty credit scrips to be freely transferable and usable for payment of custom duty, excise duty and service tax.

All scrips issued under MEIS and SEIS and the goods imported against these scrips would be fully transferable.

Scrips issued under Exports from India Schemes can be used for the following:-

(i) Payment of customs duty for import of inputs / goods including capital goods, except items listed in Appendix 3A.

(ii) Payment of excise duty on domestic procurement of inputs or goods, including capital goods as per DoR notification.

(iii) Payment of service tax on procurement of services as per DoR notification.

Basic Customs Duty paid in cash or through debit under Duty Credit Scrip can be taken back as Duty Drawback as per DoR Rules, if inputs so imported are used for exports.

5. Status Holders

Business leaders who have excelled in international trade and have successfully contributed to country's foreign trade are proposed to be recognized as Status Holders and given special treatment and privileges to facilitate their trade transactions, in order to reduce their transaction costs and time.

The nomenclature of Export House, Star Export House, Trading House, Star Trading House, Premier Trading House certificate has been changed to One, Two, Three, Four, Five Star Export House. The criteria for export performance for recognition of status holder have been changed from Rupees to US dollar earnings. The new criteria is as under:-

Status category	Export Performance
	FOB / FOR (as converted) Value (in US $ million) during current and previous two years
One Star Export House	3
Two Star Export House	25
Three Star Export House	100
Four Star Export House	500
Five Star Export House	2000

Approved Exporter Scheme - Self certification by Status Holders

Manufacturers who are also Status Holders will be enabled to self-certify their manufactured goods as originating from India with a view to qualify for preferential treatment under different Preferential Trading Agreements [PTAs], Free Trade Agreements [FTAs], Comprehensive Economic Cooperation Agreements [CECAs] and Comprehensive Economic Partnerships Agreements [CEPAs] which are in operation. They shall be permitted to self-certify the goods as manufactured as per their Industrial Entrepreneur Memorandum (IEM) / Industrial Licence (IL)/ Letter of Intent (LOI).

B. BOOST TO "MAKE IN INDIA"

6. Reduced Export Obligation (EO) for domestic procurement under EPCG scheme:

Specific Export Obligation under EPCG scheme, in case capital goods are procured from indigenous manufacturers, which is currently 90% of the normal export obligation (6 times at the duty saved amount) has been reduced to 75%, in order to promote domestic capital goods manufacturing industry.

7. Higher level of rewards under MEIS for export items with high domestic content and value addition.

It is proposed to give higher level of rewards to products with high domestic content and value addition, as compared to products with high import content and less value addition.

C. TRADE FACILITATION & EASE OF DOING BUSINESS

8. Online filing of documents/ applications and Paperless trade in 24x7 environment:

DGFT already provides facility of Online filing of various applications under FTP by the exporters/importers. However, certain documents like Certificates issued by Chartered Accountants/ Company Secretary / Cost Accountant etc. have to be filed in physical forms only. In order to move further towards paperless processing of reward schemes, it has been decided to develop an online procedure to upload digitally signed documents by Chartered Accountant / Company Secretary / Cost Accountant.

Henceforth, hardcopies of applications and specified documents would not be required to be submitted to RA, saving paper as well as cost and time for the exporters.

As a measure of ease of doing business, landing documents of export consignment as proofs for notified market can be digitally uploaded in the following manner:-

(i) Any exporter may upload the scanned copy of Bill of Entry under his digital signature.

(ii) Status holders falling in the category of Three Star, Four Star or Five Star Export House may upload scanned copies of documents.

9. Online inter-ministerial consultations:

It is proposed to have Online inter-ministerial consultations for approval of export of SCOMET items, Norms fixation, Import Authorisations, Export Authorisation, in a phased manner, with the objective to reduce time for approval. As a result, there would not be any need to submit hard copies of documents for these purposes by the exporters.

10. Simplification of procedures/processes, digitisation and e-governance

Under EPCG scheme, obtaining and submitting a certificate from an independent Chartered Engineer, confirming the use of spares, tools, refractory and catalysts imported for final redemption of EPCG authorizations has been dispensed with.

At present, the EPCG Authorisation holders are required to maintain records for 3 years after redemption of Authorisations. Now the EPCG Authorization Holders shall be required to maintain records for a period of two years only. Government's endeavour is to gradually phase out this requirement as the relevant records such as Shipping Bills, e-BRC are likely to be available in electronic mode which can be archived and retrieved whenever required.

11. Forthcoming e-Governance Initiatives

DGFT is currently working on the following EDI initiatives:

- Message exchange for transmission of export reward scrips from DGFT to Customs.
- Message exchange for transmission of Bills of Entry (import details) from Customs to DGFT.
- Online issuance of Export Obligation Discharge Certificate (EODC).
- Message exchange with Ministry of Corporate Affairs for CIN & DIN.
- Message exchange with CBDT for PAN.
- Facility to pay application fee using debit card / credit card.
- Open API for submission of IEC application.
- Mobile applications for FTP

D. Other new Initiatives

12. New initiatives for EOUs, EHTPs and STPs

EOUs, EHTPs, STPs have been allowed to share infrastructural facilities among themselves. This will enable units to utilize their infrastructural facilities in an optimum way and avoid duplication of efforts and cost to create separate infrastructural facilities in different units.

EOUs have been allowed facility to set up Warehouses near the port of export. This will help in reducing lead time for delivery of goods and will also address the issue of un-predictability of supply orders.

STP units, EHTP units, software EOUs have been allowed the facility to use all duty free equipment/goods for training purposes. This will help these units in developing skills of their employees.

100% EOU units have been allowed facility of supply of spares/ components up to 2% of the value of the manufactured articles to a buyer in domestic market for the purpose of after sale services.

At present, in a period of 5 years EOU units have to achieve Positive Net Foreign Exchange Earning (NEE) cumulatively. Because of adverse market condition or any ground of genuine hardship, then such period of 5 years for NFE completion can be extended by one year.

13. Facilitating & Encouraging Export of dual use items (SCOMET).

Validity of SCOMET export authorisation has been extended from the present 12 months to 24 months. It will help industry to plan their activity in an orderly manner and obviate the need to seek revalidation or relaxation from DGFT.

14 Facilitating & Encouraging Export of Defence Exports

Normal export obligation period under advance authorization is 18 months. Export obligation period for export items falling in the category of defence, military store, aerospace and nuclear energy shall be 24 months from the date of issue of authorization or co-terminus with contracted duration of the export order, whichever is later. This provision will help export of defence items and other high technology items.

A list of military stores requiring NOC of Department of Defence Production has been notified by DGFT recently. A committee has been formed to create ITC (HS) codesfor defence and security items for which industrial licenses are issued by DIPP.

15. e-Commerce Exports

Goods falling in the category of handloom products, books / periodicals, leather footwear, toys and customized fashion garments, having FOB value up to Rs.25000 per consignment (finalized using e-Commerce platform) shall be eligible for benefits under FTP. Such goods can be exported in manual mode through Foreign Post Offices at New Delhi, Mumbai and Chennai.

Export of such goods under Courier Regulations shall be allowed manually on pilot basis through Airports at Delhi, Mumbai and Chennai as per appropriate amendments in regulations to be made by Department of Revenue. Department of Revenue shall fast track the implementation of EDI mode at courier terminals.

16. Duty Exemption

Imports against Advance Authorization shall also be eligible for exemption from Transitional Product Specific Safeguard Duty. In order to encourage manufacturing of capital goods in India, import under EPCG Authorisation Scheme shall not be eligible for exemption from payment of anti-dumping duty, safeguard duty and transitional product specific safeguard duty.

17. Additional Ports allowed for Export and import

Calicut Airport, Kerala and Arakonam ICD, Tamil Nadu have been notified as registered ports for import and export.

18. Duty Free Tariff Preference (DFTP) Scheme

India has already extended duty free tariff preference to 33 Least Developed Countries (LDCs) across the globe. This is being notified under FTP.

19. Quality complaints and Trade Disputes

In an endeavour to resolve quality complaints and trade disputes, between exporters and importers, a Committee on Quality Complaints and

Trade Disputes (CQCTD) is being constituted in 22 offices and would have members from EPCs/FIEOs/APEDA/EICs.

20. Vishakhapatnam and Bhimavaram added as Towns of Export Excellence

Government has already recognized 33 towns as export excellence towns. It has been decided to add Vishakhapatnam and Bhimavaram in Andhra Pradesh as towns of export excellence.

12.4 FOREIGN EXCHANGE MANAGEMENT ACT, 1999:

The Parliament has enacted the Foreign Exchange Management Act,1999 to replace the Foreign Exchange Regulation Act, 1973. This Act came into force on the 1st day of June, 2000. The Central Govt. has established the Directorate of Enforcement with Director and other officers, for the purpose of taking up investigations of cases under the said Act.

The object of the Act is to consolidate and amend the law relating to foreign exchange with objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.

This Act extends to the whole of India and also apply applies to all branches, offices and agencies outside India owned or controlled by a person resident in India. It is also applicable to any contravention committed outside India by any person to whom this Act is applicable.

CHAPTER I

PRILIMINARY

1. Short title, extent, application and commencement

(1) This Act may be called the Foreign Exchange Management Act, 1999.

(2) It extends to the whole of India.

(3) It shall also apply to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention there under committed outside India by any person to whom this Act applies.

(4) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint:

Provided that different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

CHAPTER II

REGULATION AND MANAGEMENT OF FOREIGN EXCHANGE

BROAD SCHEME OF THE FOREIGN EXCHANGE MANAGEMENT ACT, 1999:

SECTION 3 - Dealing in foreign exchange

Prohibits dealings in foreign exchange except through an authorised person. This section states that no person can, without general or special permission of the RBI-

(a) Deal in or transfer any foreign exchange or foreign securities to any person not being an authorized person.

(b) Make any payment to or for the credit of any person resident outside India in any manner.

(c) Receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner.

(d) Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire any asset outside India by any person.

SECTION 4 – Holding of foreign exchange

Restrains any person resident in India from acquiring, holding, owning, possessing or transferring any foreign exchange, foreign security or any immovable property situated outside India except as specifically provided in the Act. The terms "foreign exchange" and "foreign security" are defined in sections 2(n) and 2(o) respectively of the Act. The Central Govt. has made Foreign Exchange Management (Current Account Transactions) Rules, 2000.

SECTION 5- Current account transactions

Any person may sell or draw foreign exchange to or from an authorized person if such sale or drawl is a current account transaction: Provided that the Central Government may, in public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed.

SECTION 6 – deals with capital account transactions

This section allows a person to draw or sell foreign exchange from or to an authorised person for a capital account transaction. RBI in consultation with Central Govt. has issued various regulations on capital account transactions in terms of sub-section (2) and (3) of section 6.

SECTION 7 - deals with export of goods and services

Every exporter is required to furnish to the RBI or any other authority, a declaration, etc., regarding full export value.

SECTION 8 - Realization and repatriation of foreign exchange

This Section casts the responsibility on the persons resident in India who have any amount of foreign exchange due or accrued in their favour to get the same realised and repatriated to India within the specific period and the manner specified by RBI.

SECTION 9-Exemption from realization and repatriation in certain cases

The provisions of sections 4 and 8 shall not apply to the following, namely:-

(a) possession of foreign currency or foreign coins by any person up to such limit as the Reserve Bank may specify;

(b) foreign currency account held or operated by such person or class of persons and the limit up to which the Reserve Bank may specify;

(c) foreign exchange acquired or received before the 8th day of July, 1947 or any income arising or accruing thereon which is held outside India by any person in pursuance of a general or special permission granted by the Reserve Bank;

(d) foreign exchange held by a person resident in India up to such limit as the Reserve Bank may specify, if such foreign exchange was acquired by way of gift or inheritance from a person referred to in clause (c), including any income arising there from;

(e) foreign exchange acquired from employment, business, trade, vocation, services, honorarium, gifts, inheritance or any other legitimate means up to such limit as the Reserve Bank may specify; and

(f) such other receipts in foreign exchange as the Reserve Bank may specify.

CHAPTER III

AUTHORISED PERSON

SECTIONS 10 to 12 - deals with duties and liabilities of the authorized persons

Authorised person has been defined in Sec.2(c) of the Act which means an authorised dealer, money changer, off shore banking unit or any other person for the time being authorized to deal in foreign exchange or foreign securities.

CHAPTER IV

CONTRAVENTION AND PENALTIES

SECTIONS 13 to 15 - of the Act deal with penalties and enforcement of the orders of Adjudicating Authority as well power to compound contraventions under the Act.

CHAPTER V

ADJUDICATION AND APPEAL

SECTION 16 to 35- of the Act deals with the appointment of Appellate Tribunal and the matters related to it. For the purpose of adjudication under

section 13, the Central Government may, by an order published in the Official Gazette, appoint as many officers of the Central Government as it may think fit, as the Adjudicating Authorities for holding an inquiry
in the manner prescribed after giving the person alleged to have committed contravention under section 13, against whom a complaint has been made under sub-section (3) (hereinafter in this section referred to the said person) a reasonable opportunity of being heard for the purpose of imposing any penalty

CHAPTER VI

Directorate of Enforcement

SECTION 36 to 37 - pertains to the establishment of Directorate of Enforcement and the powers to investigate the violation of any provisions of Act, rule, regulation, notifications, directions or order issued in exercise of the powers under this Act. The Director of Enforcement and other officers of Enforcement not below the rank of Assistant Director have been empowered to take up investigations.

12.5 Trade Related Intellectual Property Rights (TRIPS)

The Uruguay Round (1986 – 1994) was the turning point in the history of Intellectual Property Rights. This round included the Agreement on Intellectual Property Rights under which minimum uniform laws are to be carried out. The Agreement on TRIPs came into force on 1 January 1995 and is to be implemented over a six-year period ending 31 December 2000 for developed countries and over a ten-year period ending 31 December 2004 for developing countries.

India has always remained committed to the WTO and in every sphere; it has stood by those commitments. Going by such commitments to the WTO, India has amended its Intellectual Property Laws. TRIPs was one of the most contentious issues in the Uruguay Round of multilateral trade negotiations, which was concluded in 1994 at Marrakesh. As a member of the World Trade Organisation (WTO), and having signed the General Agreement on Tariff and

Trade (GATT), India has agreed to comply with all the instruments and annexes of GATT, including Trade Related Aspects of Intellectual Property Rights (TRIPs).Because of WTO, India has to amend its intellectual property laws .India was forced to comply with the TRIPs agreement. After the formation of WTO in 1995, the India being its member has to implement the TRIPs agreement in toto. The commitment under TRIPs agreement compelled India to amend its intellectual property laws.

Intellectual property Rights seek to protect the interest of inventors and developers of products and processes from being copied by others. The main features of TRIPs agreements :-

- Minimum Standards of protection to be provided by each member.
- Domestic procedures must be put in place for enforcement of IPRs by each member nation.
- Dispute Settlement between WTO members.

Agreement on TRIPs cover the following areas Copyright and related rights, trade marks including services marks, industrial designs, geographical indications, patents, layout designs of integrated circuits and protection of undisclosed information or trade secrets.

WTO's TRIPs agreement is an attempt to narrow down the gaps in the way these rights are protected around the world. Disputes over TRIPs agreement are to be governed by WTO dispute settlement procedures. TRIPs agreement desires to reduce distortions and impediments to international trade while protecting intellectual property rights.

12.5.1 POSITIVE IMPLICATIONS OF TRIPs AGREEMENT:-

1) Patents:-

Under Agreement on TRIPs, protection is given to patents, copyrights, layout designs etc. For Eg.:- when patented drugs get exclusive marketing rights for certain period, and if some other firm wants ' to use that products name, they have to take permission from patent holder. Permission may be given only after signing agreement for royalty or fees. TRIPs agreement has also given a boost to

Research and Development in the field of pharmaceuticals, engineering, electronics etc. Thus, agreement on TRIPs has benefited the member nations of WTO.

2) **Public Health:-**

The Doha Conference held in Doha, Qatar in Nov. 2001, recognized the need to protect public health and to provide medicines to all. Here the developing countries need not source their essential medicines at high cost from MNCs from developed countries, which have patents. Countries like India, China and Brazil would benefit as they possess the resources and technology to manufacture essential medicines and export these without having to secure compulsory licensing from patent holders.

3) **Geographic Indication Status (GIS):-**

WTO also provides GIS for certain items. Once a country gets GIS, the firms from only that country can use the generic brand name. For eg. :- India has obtained GIS for Darjeeling Tea and also for other products. This means, only Indian firms can use Darjeeling Tea brand, which shows Darjeeling Tea produced in India is unique.

12.5.2 NEGATIVE IMPLICATIONS OF TRIPs AGREEMENT

1) **Favours Developed Nations**

Agreement on TRIPs favours developed countries as under TRIPs protection .is given to IPRs such as patents, trademarks, layout designs etc. Thus it favours developed nations as they have large number of patents. But it has negative impact on developing countries like India.

2) **Agriculture**

In Agriculture patenting of plant varieties is done through TRIPs. This may have serious implications for developing countries like India. MNCs are in a position to develop almost all new varieties with the help of their financial resources and expertise. This may transfer all gains in the hands of MNCs.

3) **Micro - Organisms**

Research in Micro-organisms is closely linked with the development of agriculture, pharmaceuticals and industrial biotechnology. Patenting of Micro-organisms again will benefit MNCs which further favored the developed nations and had negative impact on developing country.

12.6 Conclusion

With the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India, Government came out with FEMA Act, 1999. With a view to promote exports and orderly management of foreign trade, Government framed EXIM policy. The basic purpose for the above too is promoting trade and hence economic development in the country.

12.7 Check Your Progress

1. In order to earn foreign exchange, a country should concentrate on

a. Exports b. International Tourism Operations

c. Imports d. Both (a) and (b)

2. The objective of FEMA is

a. Foreign Exchange Management

b. Foreign Exchange Restriction

c. Foreign Exchange Earnings

d. None of these

3. In India, foreign currency means any currency other than

a. Rupee b. Dollar c. Pound d. None of these

Answers-1d 2a 3a)

12.8 Glossary

- **The Directorate of Enforcement:** It is mainly concerned with the enforcement of the provisions of the Foreign Exchange Management Act and Rules and Regulation issued there under to serve the objectives of the Act. The officers of the Directorate perform adjudication function so as to impose penalty on persons for contravention of the Act.

- **Directorate General of Foreign Trade (DGFT):** It is an organisation is an attached office of the Ministry of Commerce and Industry and is headed by Director General of Foreign Trade. DGFT is responsible for implementing the Foreign Trade Policy with the main objective of promoting India's exports.

12.9 References

- http://dor.gov.in/fem
- http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/FEMA_act_1999.pdf

12.10 Suggested Reading

- Dr.D. M. Mithani "International Economics" Himalaya Publishing House, Delhi.
- K.C. Rana& K.N. Varma, International Economics" Vishal Publication Company, Jalander.

12.11 Model Questions

1. Discuss the Foreign Exchange Management Act 1999.
2. Explain the foreign trade policy of 2015-20.

Chapter 13- Regulation of international trade in India-2

Summary

13.1 Objectives:

- ❖ To understand GATT/ WTO objectives and measures
- ❖ To understand the trade agreements like agreement on agriculture and general agreement on trade in services.

13.2 Introduction to GATT / WTO:

After the Second World War, many countries planned down to be together to work on ways and means to promote international trade. The result was signing of (GATT) General Agreement on Tariffs and Trade by 23 countries in 1947. India was one among the founder members of GATT.

GATT was created to reduce the global depression and to liberalise and regulate the world trade by cutting down on tariff barriers. In 1995 GATT has been replaced by WTO. WTO is wider in scope as it regulates both world trade in goods, as well as in services intellectual property rights, and investment. In Jan 2010, the membership of WTO was 153 countries. Its rules and policies are the outcome of negotiations among WTO members. Thus, it is a member driven, consensus based organisation.

13.2.1 PRINCIPAL OBJECTIVES OF WTO

1) **Trade without Discrimination:-**

Trade without discrimination was achieved through the application of Most Favoured Nation (MFN) Principle. As per MFN clause, a member nation of WTO must provide the same preferential treatment to other member nations which it gives to any other member nation.

2) **Raising The Standard Of Living:-**

Raising the income level and standard of living and ensuring full employment of the citizens of its member nations.

3) **Optimum Use of World's Resources:-**

Ensuring optimum use of world's resources and, thereby, expanding world production and trade of goods as well as services.

4) **Settlement Of Disputes :-**

Settlement of disputes among members through consultation, conciliation, and as a last resort through dispute settlement procedures.

5) **Growth Of Less Developed Countries (LDCs) :-**

It recognises the need for positive efforts designed to ensure that developing countries especially the LDCs, secure a better share of growth in international trade.

6) **Protection Of Environment:-**

Preserving and protecting the environment of the world so as to benefit all the nations of the world.

7) **Enlargement Of Production And Trade:-**

WTO aims to enlarge production and trade of goods as well as services.

8) **Employment:-**

WTO aims at generating full employment in economies and increase in effective demand.

13.2.2 Functions of WTO[1]

Objectives

The Preamble to the WTO Agreement essentially sets out, in the broadest terms, the objectives of the whole body of agreements reached at the end of the

[1]https://www.wto.org/english/res_e/booksp_e/agrmntseries1_wto_e.pdf

Uruguay Round. Much of the language of the Preamble is taken over from the GATT, with several modifications. Thus, principal objectives of the WTO, as of the GATT, are raising standards of living, ensuring full employment, expanding production and trade, and allowing optimal use of the world's resources. The WTO Preamble adds three elements. It refers to production of and trade in goods and services (the GATT spoke only of goods); it states the objective of sustainable development, "seeking both to protect and preserve the environment"; and it recognizes the need for positive efforts to ensure that developing countries, and especially the least-developed countries, "secure a share in international trade commensurate with the needs of their economic development" (Preamble, paras. 1 and 2). The declared means of achieving these objectives is exactly the same as that laid down 47 years earlier in the GATT: "reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations.

Implementing agreements

The first, and broadest, function is to "facilitate the implementation, administration and operation, and further the objectives, of this Agreement and of the Multilateral Trade Agreements", and also to "provide the framework for the implementation, administration and operation of the Plurilateral Trade Agreements" (Article III:1). The wording reflects the difference between the multilateral agreements, to which all member governments are committed, and the plurilateral agreements which are under the WTO umbrella but cannot expect the same degree of support.

Negotiations

The WTO's second function is to be a negotiating forum. Again, a distinction is made between negotiations for which the WTO shall provide the forum, and those for which it may provide a forum (Article III:2). The first category, specifically reserved to the WTO, consists of multilateral negotiations on matters dealt with in the annexes to the agreement ¾ that is, on the subjects already covered by the GATT and the Uruguay Round. The second category is defined only as "further" negotiations concerning multilateral trade relations, as may be decided by the WTO's Ministerial Conference: should such negotiations take place, the WTO can also provide the framework for putting their results into effect.

Disputes and policy reviews

The third and fourth functions of the WTO are to administer the arrangements in Annexes 2 and 3 for the settlement of disputes that may arise between members and for the review of trade policies (Article III:3 and III:4). Finally, the WTO is to cooperate, as appropriate, with the International Monetary Fund and the World Bank "with a view to achieving greater coherence in global economic policymaking" (Article III:5).

Developing countries

The WTO Agreement's Preamble and Article III are buttressed by two separate texts that were adopted by Ministers on the same day that they signed the Marrakesh agreements. One text, of particular importance because it has a bearing on virtually every other agreement in the Uruguay Round package, is a decision on measures in favour of least-developed countries. Its central point is that these countries, as long as they remain in the least-developed category,2 will only be required to undertake commitments and concessions under the Uruguay Round agreements "to the extent consistent with their individual development, financial and trade needs, or their administrative and institutional capabilities"3, and that the rules and transitional arrangements in the agreements "should be applied to Para. 2 (iii)). The decision gave least-developed countries an additional year to submit their schedules of commitments on goods and services (Para. 1).4 Other provisions require regular reviews to ensure that special and differential measures in their favour are put promptly into effect; encourage early action to reduce trade barriers facing products of interest to them; and call on developed countries to be careful of the effects any import relief measures they take may have on exports of the least-developed countries. Finally, the decision promises the least-developed countries substantially increased technical assistance in the development, strengthening and diversification of their production and exports, as well as continuing review of their specific needs (Para. 2). There is no comparable general text covering developing countries other than those in the least-developed category. Special and differential treatment for developing countries is instead included in most of the separate agreements and arrangements reached in the Uruguay Round, where it usually takes the form of less stringent obligations (e.g. longer transition periods) than are imposed on developed countries.

Coherence:

The second ministerial text bearing on the functions of the WTO is a declaration on its role in achieving "greater coherence in global economic policymaking".5 As the title of the declaration suggests, it is directly linked with the fifth function of the WTO.

13.2.3 Positive Impact of Benefits/Gains from WTO:-

The Positive impact of WTO on India's economy can be viewed from the following points:-

1) **Increase In Export Earnings:-**

Estimates made by World Bank, Organisation for Economic Co-operation and Development (OECD) and the GATT Secretariat, shows that the income effects of the implementation of Uruguay Round package will be an increase in traded merchandise goods. It is expected that India's share in world exports would improve.

2) **Agricultural Exports :-**

Reduction of trade barriers and domestic subsidies in agriculture is likely to raise international prices of agricultural products. India hopes to benefit from this in form of higher export earnings from agriculture. This seems to be possible because all major agriculture development programmes in India will be exempted from the provisions of WTO Agreement.

3) **Export Of Textiles And Clothing :-**

With the phasing out of MFA (Multi - Fibre Arrangement), exports of textiles and clothing will increase and this will be beneficial for India. The developed countries demanded a 15 year period of phasing out of MFA, the developing countries, including India, insisted that it be done in 10 years. The Uruguay Round accepted the demand of the latter. But the phasing out Schedule favours the developed countries because a major portion of quota regime is going to be removed only in the tenth year, i.e. 2005. The removal of quotas will benefit not only India but also every other country'.

4) **Multilateral Rules And Disciplines :-**

The Uruguay Round Agreement has strengthened Multilateral rules and disciplines. The most important of these relate to anti - dumping, subsidies and countervailing measures, safeguards and disputes settlement. This is likely to ensure greater security and predictability of the international trading system and thus create a more favourable environment for India in the New World Economic Order.

5) **Growth To Services Exports :-**

Under GATS agreement, member nations have liberalised service sector. India would benefit from this agreement. For Eg:- India's services exports have increased from about 5 billion US $ in 1995 to 96 billion US $ in 2009-10. Software services accounted for about 45% of service exports.

6) **Foreign Investment :-**

India has withdrawn a number of measures against foreign investment, as per the commitments made to WTO. As a result of this, foreign investment and FDI has increased over the years. A number of initiatives has been taken to attract FDI in India between 2000 and 2002. In 2009-10, the net FDI in India was US $ 18.8 billion.

13.2.4 Negative Impact / Problems I Disadvantages Of WTO Agreements on Indian Economy :-

1) **TRIPs :-**

The Agreement on TRIPs at Uruguay Round weights heavily in favour of Multinational Corporations and developed countries as they hold a very large number of patents. Agreement on TRIPs will work against India in several ways and will lead to rponopoly of patent holding MNCs. As a member of WTO, India has to comply with standards of TRIPs.

The negative impact of agreement on TRIPs on Indian economy can be stated as follows

a) **Pharmaceutical Sector :-**

Under the Patents Act, 1970, only process patents were granted to chemicals, drugs and medicines. This means an Indian pharmaceutical company only needed to develop and patent a process to produce and sell that drug. This proved beneficial to Indian pharmaceutical companies as they were in a position to sell quality medicines at low prices both in domestic as well as in international markets. However, under the agreement on TRIPs, product patents needs to be granted. This will benefit the MNCs and it is feared that they will increase the prices of medicines heavily, keeping them out of reach of poor. Again many Indian pharmaceutical companies may be closed down or taken over by large MNCs.

b) **Agriculture :-**

The Agreement on TRIPs extends to agriculture through the patenting of plant varieties. This may have serious implications for Indian agriculture. Patenting of plant varieties may transfer all gains in the hands of MNCs who will be in a position to develop almost all new varieties with the help of their huge financial resources and expertise.

c) **Microorganisms :-**

The Agreement on TRIPs also extends to Microorganisms as well. Research in micro - organisms is closely linked with the development of agriculture, pharmaceuticals and industrial biotechnology. Patenting of micro - organisms will again benefit large MNCs as they already have patents in several areas and will acquire more at a much faster rate.

2) **TRIMs :-**

Agreement on TRIMs provide for treatment of foreign investment on par with domestic investment. This Agreement too weights in favour of developed countries. There are no provisions in Agreement to formulate international rules for controlling restrictive business practices of foreign investors. In case of developing countries like India, complying with Agreement on TRIMs would mean giving up any plan or strategy of self - reliant growth based on locally available technology and resources.

3) **GATS :-**

One of the main features of Uruguay Round was the inclusion of trade in services in negotiations. This too will go in favour of developed countries.

Under GATS agreements, the member nations have to openup services sector for foreign companies. The developing countries including India have opened up services sector in respect of banking, insurance, communication, telecom, transport etc. to foreign firms. The domestic firms of developing countries may find it difficult to compete with giant foreign firms due to lack of resources & professional skills.

4) **Non - Tariff Barriers :-**

Several countries have put up trade barriers and non - tariff barriers following the formation of WTO. This has affected the exports from developing countries. The Union Commerce Ministry has identified 13 different non - tariff barriers put up by 16 countries against India. For eg. MFA (Multi - fibre arrangements) put by USA and European Union is a major barrier for Indian textile exports.

5) **Agreement On Agriculture (AOA)**

The AOA is biased in favour of developed countries. The issue of food security to developing countries is not addressed adequately in AOA. The existence of global surpluses of food grains does not imply that the poor countries can afford to buy. The dependence on necessary item like foodgrains would adversely affect the Balance of Payment position.

6) **Inequality Within The Structure Of WTO**

There is inequality within the structure of WTO because the agreements and amendments are in favour of developed countries. The member countries have to accept all WTO agreements irrespective of their level of economic development.

13.3 Trade related investment measures (TRIMS) and its implications[2]:

The Agreement on Trade-Related Investment Measures (TRIMS) recognizes that certain investment measures can restrict and distort trade. It states that WTO members may not apply any measure that discriminates against foreign products or that leads to quantitative restrictions, both of which violate basic WTO principles. A list of prohibited TRIMS, such as local content requirements, is part of the Agreement. The TRIMS Committee

[2]https://www.wto.org/english/tratop_e/invest_e/invest_info_e.htm

monitors the operation and implementation of the Agreement and allows members the opportunity to consult on any relevant matters.

13.3.1 What is a "Trade-Related Investment Measure"?

The term "trade-related investment measures" ("TRIMs") is not defined in the Agreement. However, the Agreement contains in an annex an Illustrative List of measures that are inconsistent with GATT Article III:4 or Article XI:1 of GATT 1994. The objectives of the Agreement, as defined in its preamble, include "the expansion and progressive liberalization of world trade and to facilitate investment across international frontiers so as to increase the economic growth of all trading partners, particularly developing country members, while ensuring free competition".

Certain investment measures that discriminate against foreign investment were to be withdrawn such as

a) Obligation on foreign investors to use local inputs.
b) To produce for exports as a condition to obtain imported inputs.
c) To meet export obligation.
d) Employment of local people.
e) Technology Transfer requirements.
f) Use of specific production technology.
g) Local equity requirement.
h) Control on use of imported inputs.

13.3.2 The TRIMs Agreement and Regulation of Foreign Investment

As an agreement that is based on existing GATT disciplines on trade in goods, the Agreement is not concerned with the regulation of foreign investment. The disciplines of the TRIMs Agreement focus on investment measures that infringe GATT Articles III and XI, in other words, that discriminate between imported and exported products and/or create import or export restrictions. For example, a local content requirement imposed in a non-discriminatory manner on domestic and foreign enterprises is inconsistent with the TRIMs Agreement because it involves discriminatory treatment of imported products in favour of domestic products. The fact that there is no discrimination between domestic and foreign investors in the imposition of the requirement is irrelevant under the TRIMs Agreement.

13.3.3 POSITIVE IMPACT OF TRIMs :-

TRIMs agreement have positive impact on developing countries as foreign investment is treated at par with domestic investment. For Eg. TRIMs agreement will encourage foreign firms to invest in India. This will generate a good amount of competition. In order to survive, Indian firms will have to be proactive with competitive strategies, which not only would improve their performance, but also would provide better service to customers.

13.3.4 NEGATIVE IMPACT OF TRIMs :-

Developing countries (including India) have withdrawn a number of measures that restricts foreign investments. TRIMs agreement also favours developed nations. MNCs from developed countries with their huge financial and technological resources can displace Indian industry and play a dominant role. Besides foreign firms will be free to remit profits, dividends, etc. to parent company. This will cause foreign exchange drain on developing nations.

13.4 Agreement on agriculture and its implication[3]

The Agreement on Agriculture forms a part of the Final Act of the Uruguay Round of Multilateral Trade Negotiations, which was signed by the member countries in April 1994 at Marrakesh, Morocco and came into force on 1st January, 1995. The Uruguay Round marked a significant turning point in world trade in agriculture. For the first time, agriculture featured in a major way in the GATT round of multilateral trade negotiations. Although the original GATT – the predecessor of the World Trade Organisation (WTO) – applied to trade in agriculture, various exceptions to the disciplines on the use of non-tariff measures and subsidy meant that it did not do so effectively. The Uruguay Round agreement sought to bring order and fair

[3] http://commerce.nic.in/wto-may.pdfv

competition to this highly distorted sector of world trade by establishment of a fair and market oriented agricultural trading sector. The root cause of distortion of international trade in agriculture has been the massive domestic subsidies given by the industrialised countries to their agricultural sector over many years. This in turn led to excessive production and its dumping in international markets as well as import restrictions to keep out foreign agricultural products from their domestic markets. Hence, the starting point for the establishment of a fair agricultural trade regime has to be the reduction of domestic production subsidies given by industrialised countries, reduction in the volume of subsidised exports and minimum market access opportunities for agricultural producers world-wide. The obligations and disciplines incorporated in the Agreement on Agriculture, therefore, relate to

(a) Market Access;

(B) Domestic Subsidy or Domestic Support; And

(C) Export Subsidy.

Salient Features: The Agreement on Agriculture contains provisions in the following three broad areas of agriculture and trade policy:

(a) **Market Access:** On market access, the Agreement has two basic elements:

(i) Tariffication of all non-tariff barriers. That is to say, non-tariff barriers such as quantitative restrictions and export and import licensing etc. are to be replaced by tariffs to provide the same level of protection. Tariffs, resulting from this "tariffication" process together with other tariffs on agricultural products, are to be reduced by a simple average of 36% over 6 years in the case of developed countries and 24% over 10 years in the case of developing countries. With India being under balance of paymentscover (which is a GATT-consistent measure), we had not undertaken any commitments with regard to market access and this has been clearly stated in our schedule filed under GATT. The only commitment India has undertaken is to bind its tariffs on primary agricultural products at 100%; processed foods at 150%; and edible oils at 300%.

(ii) The second element relates to setting up of a minimum level for imports of agricultural products by member countries as a share of domestic consumption. Countries are required to maintain current levels (1986-88) of access for each individual product. Where the current level of import is negligible, the minimum access should not be less than 3% of the domestic consumption, during the base period and tariff quotas are to be established when imports constitute less than 3% of domestic consumption. This minimum level is to rise to 5% by the year 2000 in the case of developed countries and by 2004 in the case of developing countries. However, special Safeguards Provisions allow for the application of additional duties when shipments are made at prices below certain reference levels or when there is a sudden import surge. The market access provision, however, does not apply when the commodity in question is a 'traditional staple' of a developing country.

(b) Domestic support: Provisions of the Agreement regarding domestic support have two main objectives – first to identify acceptable measures that support farmers and second, to deny unacceptable, trade distorting support to the farmers. These provisions are aimed largely at the developed countries where the levels of domestic agricultural support have risen to extremely high levels in recent decades.

All domestic support is quantified through the mechanism of total Aggregate Measurement of Support (AMS). AMS is a means of quantifying the aggregate value of domestic support or subsidy given to each category of agricultural product. Each WTO member country has made calculations to determine its AMS wherever applicable. Commitment made requires a 20% reduction in total AMS for developed countries over 6 years. For developing countries, this percentage is 13% and no reduction is required for the least developed countries. The base period external reference price on which the reductions were calculated was 1986-88. AMS consists of two parts—product-specific subsidies and non-product specific subsidies. Product-specific subsidy refers to the total level of support provided for each individual agricultural commodity, essentially signified by procurement price in India. Non-product specific subsidy, on the other hand, refers to the total level of support for the agricultural sector as a whole, i.e., subsidies on inputs such as fertilisers, electricity, irrigation, seeds, credit etc.

There are three categories of support measures that are not subject to reduction under the Agreement, and support within specified deminimis level is allowed. These three categories of exempt support measures are:

1. Measures which have a minimum impact on trade and which meet the basic and policy specific criteria set out in the Agreement (the so-called Green Box measures in the terminology of WTO). These measures include Government assistance on general services like (i) research, pest and disease control, training, extension, and advisory services; (ii) public stock holding for food security purposes; (iii) domestic food aid; and (iv) direct payment to producers like governmental financial participation in income insurance and safety nets, relief from natural disasters, and payments under environmental assistance programmes.

2. Developing country measures otherwise subject to reduction which meet the criteria set out in paragraph 2 of Article 6 of the Agreement (the so-called 'Special and Differential Treatment' or the S&D Box). Examples of these are (i) investment subsidies which are generally available to agriculture in developing countries; and (ii) agricultural input services generally available to low income and resource poor producers in developing countries.

3. Direct payments under production limiting programme which conform to the requirement set out in paragraph 5 of Article 6 of the Agreement (the so-called Blue Box measures). These are relevant from the developed countries point of view only.

Under the de-minimis provision of Article 6.4 of the Agreement, there is no requirement to reduce support in this residual category whose value in any year, in the case of product specific support does not exceed 10% for developing countries of the total value of production of the basic agricultural product in question or of the value of total agricultural production in the case of non-product specific support. Where the support is below 10 per cent, as in the case of India, product-specific and non-specific de-minimis ceiling may be raised to those levels

(c) **Export subsidies:** The Agreement on Agriculture lists several types of subsidies to which reduction commitments apply. However, such subsidies are virtually non-existent in India as exporters of agricultural commodities do not get direct subsidy. Even exemption of export profits from income tax under Section 80-HHC of the Income Tax Act is not among the listed subsidies. It is also worth noting that developing countries are free to provide three of the listed subsidies, namely, reduction of export marketing costs, internal and international transport and freight charges.

Product coverage The Agreement defines agricultural products by reference to the harmonised system of product classification. The definition covers not only basic agricultural products such as wheat, milk and live animals, but the products derived from them such as bread, butter, other dairy products and meat, as well as all processed agricultural products such as chocolates and sausages. The coverage includes wines, spirits and tobacco products, fibres such as cotton, wool and silk, and raw animal skins destined for leather production. Fish and fish products are not included nor are forestry products.

13.4.1 Implications of the Agreement:

Implications of the Agreement would differ from country to country and would depend largely on the overall agricultural scenario in the country. Indian agriculture is characterised by a preponderant majority of small and marginal farmers holding less than two hectares of land, less than 35.7% of the land, is under any assured irrigation system and for the large majority of farmers, the gains from the application of the science & technology in agriculture are yet to be realised. Farmers, therefore, require support in terms of development of infrastructure as well as extension of improved technologies and provisions of requisite inputs at reasonable cost. India's share of world's agricultural trade is of the order of 1%. There is no doubt that during the last 30 years, Indian agriculture has grown at a reasonable pace, but with stagnant and declining net cropped area it is indeed going to be a formidable task to maintain the growth in agricultural production. The implications of the Agreement would thus have to be examined in the light of the food demand and supply situation. The size of the country, the level of overall development, balance of payments position, realistic future outlook for agricultural development, structure of land holdings etc. are the other relevant factors that would have a bearing on India's trade policy in agriculture. Implications of the Agreement on Agriculture for India should thus be gauged from the impact it will have on the following: i) Whether the Agreement has opened up markets and facilitated exports of our products; and ii) Whether we would be able to continue with our domestic policy aimed at improving infrastructure and provision of inputs at subsidised prices for achieving increased agricultural production.

Implications - Short Term :

As far as opening of markets and impact on trade in agriculture is concerned, it may be noted that the share of developing countries in world exports of food remained at 44% and of agricultural raw materials increased insignificantly from 32% in 1994 to 34% in 1996, that is the post-Agreement period. The average growth of developed countries imports of agricultural products increased by just 1% during 1994-96. Nearer home, agricultural exports of ten Asian developing countries increased from US $ 49252 million in 1994 to US $ 55902 million in 1996. India's share in total agricultural exports from developing Asia is 8%, behind China's 19%, Thailand's 17%, Malaysia's 14% and Indonesia's 10%. India's exports of agricultural products have increased from US $ 4151 million in 1993-94 to US $ 7054 million in 1997-98. No tangible opening up of the markets has thus been noticed 5 in the post-Agreement period so far. However, it may be premature on this basis to assess the long-term impact of the Agreement on opening up of markets. Regarding freedom to pursue our domestic policies, it is quite evident that in the short term India will not be affected by the WTO Agreement on Agriculture. The safeguards provided for developing countries give enough manoeuvres to insulate ourselves from any major impact of trade liberalisation in agricultural commodities. India has been maintaining quantitative restrictions (QRs) on import of 825 agricultural products as on 1.4.97. QRs are proposed to be eliminated within the overall time frame of six years in three phases – 1.4.97 to 31.3.2003. (All our trading partners barring the US have agreed to this phase-out plan and dispute with the US is pending with Dispute Settlement Body of WTO for adjudication). Within the provisions of the GATT Agreement India has bound tariffs at high levels of 100%, 150% and 300% for primary products, processed products and edible oils respectively. Therefore, the QRs can be replaced with high import tariff in case we want to restrict imports of these commodities.

Implication: long term:

As mentioned earlier, for a large majority of farmers in different parts of the country, the gains from the application of science and technology in agriculture are yet to be realised which would require infrastructural support, improved technologies and provision of inputs at reasonable cost. The Agreement on Agriculture thus recognised this and developing countries have been given the freedom to implement such policies under Article 6 relating to differential treatment, but any attempt in future to dilute provisions relating to differential treatment for developing countries could affect us adversely. Regarding the impact of liberalisation of trade in agriculture in the long term, Indian agriculture enjoys the advantage of cheap labour. Therefore, despite the lower productivity, a comparison with world prices of agricultural commodities would reveal that domestic prices in India are considerably less with the exceptions of a few commodities (notably oilseeds). Hence, imports to India would not be attractive in the case of rice, tea, sunflower oil and cotton. On the whole, large scale import of agricultural commodities as a result of trade liberalisation is ruled out. Even the exports of those foodgrains which are cheaper in the domestic market, but are sensitive from the point of view of consumption by the economically weaker sections are not likely to rise to unacceptable levels because of high inland transportation cost and inadequate export infrastructure in India. Through proper tariffication, however, we will have to strike a balance between the competing interest of 10% farmers who generate marketable surpluses and consumers belonging to the economically poor sections of the society. It is also argued that because of increasing price of domestic agricultural commodities following improved export prospects, farmers would get benefits which in turn would encourage investment in the resource scarce agricultural sector. With the decrease in production subsidies as well as export subsidies, the international prices of agricultural commodities will rise and this will help in making our exports more competitive in world market. Given our agro diversity, we have the potential to increase our agro exports in a substantial way. In the words of Shri A.V. Ganesan, "There will be growing pressure from the farmers to realise higher prices for their produce and to narrow the gap between the domestic and external prices. Our industrialists are pressing for a 'level playing field' visa-vis foreign enterprises; our farmers will press for a 'level playing field' for the prices of their products vis-a-vis international prices. Both the pattern of production and price expectations will increasingly be influenced by the demands and trends in world markets. On the one hand, the price incentive could be the best incentive and could give a strong boost to investment in agriculture as well as adoption of modern technologies and thereby to the raising of agricultural production and productivity. On the other hand, the rise in domestic prices would put pressure on the public distribution system and accentuate the problem of food subsidy. Furthermore, freedom to export agricultural products without restrictions will also need shedding the long-nurtured inhibition against their imports. The nature and character of State intervention and State support will have to undergo qualitative changes in order not only to realise the opportunities for exports, but also to cope with the implications of our agriculture coming into increasing alignment with the international market place".

13.5 General agreement on trade in services[4]:

The General Agreement on Trade in Services (GATS) is a relatively new agreement. It entered into force in January 1995 as a result of the Uruguay Round negotiations to provide for the extension of the multilateral trading system to services. All Members of the World Trade Organization are signatories to the GATS and have to assume the resulting obligations. By

[4]https://www.wto.org/english/tratop_e/serv_e/gsintr_e.pdf

the same token, they are committed, pursuant to Article XIX of the GATS, to entering into subsequent rounds of trade liberalizing negotiations. The first such Round started in January 2000 and was integrated later into the wider context of the Doha Development Agenda (DDA). So, regardless of their countries' policy stances, trade officials need to be familiar with this Agreement and its implications for trade and development. These implications may be far more significant than available trade data suggest. Hopefully, this introduction will contribute to a better understanding of the GATS and the challenges and opportunities associated with commitments under the Agreement. For users who are familiar with the General Agreement on Tariffs and Trade (GATT) and the underlying concepts, similarities and differences will be pointed out where relevant.

13.5.1 Basic purpose of General agreement on trade in services:

As stated in its Preamble, the GATS is intended to contribute to trade expansion "under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries". Trade expansion is thus not seen as an end in itself, as some critical voices allege, but as an instrument to promote growth and development. The link with development is further reinforced by explicit references in the Preamble to the objective of increasing participation of developing countries in services trade and to the special economic situation and the development, trade and financial needs of the least-developed countries.

The GATS' contribution to world services trade rests on three main pillars:

(a) ensuring increased transparency and predictability of relevant rules and regulations,

(b) providing a common framework of disciplines governing international transactions, and

(c) promoting progressive liberalization through successive rounds of negotiations.

Within the framework of the Agreement, the latter concept is tantamount to improving market access and extending national treatment to foreign services and service suppliers across an increasing range of sectors. It does not, however, entail deregulation. Rather, the Agreement explicitly recognizes governments' right to regulate, and introduce new regulations, to meet national policy objectives and the particular need of developing countries to exercise this right

Definition of Services Trade and Modes of Supply The definition of services trade under the GATS is four-pronged, depending on the territorial presence of the supplier and the consumer at the time of the transaction.
The GATS covers services supplied

(a) from the territory of one Member into the territory of any other Member (Mode 1 - Cross-border trade);

(b) in the territory of one Member to the service consumer of any other Member (Mode 2 – Consumption abroad);

(c) by a service supplier of one Member, through commercial presence, in the territory of any other Member (Mode 3 - Commercial presence); and

(d) by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member (Mode 4 - Presence of natural persons).

13.5.2 Scope

GATS apply to measures by Members affecting trade in services. It does not matter in this context whether a measure is taken at central, regional or local government level, or by non-governmental bodies exercising delegated powers. For purposes of structuring their commitments, WTO Member have generally used a classification system comprised of 12 core service sectors:

¬ Business services (including professional services and computer services)

¬ Communication services

¬ Construction and related engineering services

¬ Distribution services

¬ Educational services

¬ Environmental services

¬ Financial services (including insurance and banking)

¬ Health-related and social services

¬ Tourism and travel-related services

¬ Recreational, cultural and sporting services

¬ Transport services

¬ Other services not included elsewhere

These sectors are further subdivided into a total of some 160 sub-sectors. Under this classification system, any service sector, or segments thereof, may be included in a Member's schedule of commitments with specific market access and national treatment obligations.

13.5.3 POSITIVE IMPACT OF GATS :

GATS provide an opportunity not only to avail services from other member countries but also to increase the quality of its own services due to competition. Foreign firms are allowed in number of service sectors. Through joint ventures or partnership foreign firms may enter in India. This will enable Indian firms to expand and diversify their service activities with professional expertise and foreign support.

In many developing countries, sectors like travel and tourism, hotels, retail trading, banking, insurance, education and communication are open for international competition.

13.5.4 NEGATIVE IMPACT OF GATS :

In GATS agreement member nations have to open up the services sector for foreign companies. Developing countries including India have opened up the services sector in respect of banking, insurance, communication, telecom, transport etc. to foreign firms. Developing countries may find it difficult to compete with giant foreign firms due to lack of resources and professional skills.

13.6 Conclusion

WTO is the way and means to promote international trade. This enables Indian firms to expand and diversify their production and service activities with professional expertise and foreign support. But as developing countries like India have lack of resources and professional skills and hence find it difficult to compete with giant foreign firms. But the overall aim of WTO to increase trade among its member countries and hence promote economic development among these countries.

13.7 Check your progress:

1. The quota that restricted trade textiles was known as :
    1. TRIPS
    2. GATS
    3. MFA
    4. TRIMS

    ANSWER :3
2. The WTO was born out of negotiations in which round of the GATT
    1. Uruguay round
    2. Geneva
    3. Tokyo
    4. Taiwan

    ANSWER: 1
3. Which of the the following is referred to as predecessor to WTO:
    1. OPEC
    2. IMF
    3. GATT
    4. WORLD BANK

    ANSWER: 3

13.8 Glossary:

- **De Minimis:** Under the De Minimis provision of the Agreement, there is no requirement to reduce trade distorting domestic support or subsidy where the aggregate value of support does not exceed a certain limit or ceiling. In the case of developing countries, the De Minimis ceiling is 10%.

- ❖ **Green Box:** This refers to policies or support measures which have a minimum impact on trade and are, therefore, free from reduction commitments.
- ❖ **Tariff Quota:** A quota that allows for import of a commodity at less than the general applied rate. (e.g., if a country applies a general tariff of 100% on a particular commodity and then allows a limited quantity, say 20,000 tonnes, to be imported at a lower rate of say, for 20%).
- ❖ **Peace Clause:** A clause in the Agreement on Agriculture which regulates the application of other WTO Agreements (such as the Agreement on Subsidies and Countervailing Measures etc.) to subsidies given in respect of agricultural products. Peace Clause is also known as the "due restraint" clause.

13.9 References:

- ➢ https://www.wto.org/english/tratop_e/serv_e/gsintr_e.pdf
- ➢ http://commerce.nic.in/wto-may.pdf

13.10 Suggested readings:

- ➢ https://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm
- ➢ Jain T. R. "Banking and Foreign Trade" V. K. Publications.

13.11 Model questions:

1. What are the main features of the WTO Agreement on Agriculture which are of concern to India?

2. What is general agreement on trade and services .Write down its implications?

Chapter-14

Recent Development under the Ministerial Conferences

Structure

14.1 Objectives

- To study the Recent Development under the Ministerial Conferences

14.2 Highest authority: the Ministerial Conference of WTO

So, the WTO belongs to its members. The countries make their decisions through various councils and committees, whose membership consists of all WTO members. Topmost is the ministerial conference which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements.

Place of Meeting	**Period**
Singapore	9-13 December 1996
Geneva	18-20 May 1998
Seattle	November 30 – December 3, 1999
Doha	9-13 November 2001
Cancún	10-14 September 2003
Hong Kong	13-18 December 2005

Geneva	30 November - 2 December 2009
Geneva	15-17 December 2011
Bali	3-6 December 2013
Nairobi	15-18 December 2015

1. Singapore, 9-13 December 1996:

The inaugural ministerial conference was held in Singapore in 1996. Its primary purpose was to initiate an international effort among global trading nations to overhaul the structure and mechanisms of the General Agreement on Tariffs and Trade (GATT) while preserving the considerable progress and success achieved by that system since its inception in 1948.

Disagreements, largely between developed and developing economies, emerged over four issues initiated by this conference; afterward, these were collectively referred to as the "Singapore issues".

2. Geneva, 18-20 May 1998:

The Eighth Ministerial Conference was held in Geneva, Switzerland, from 15 to 17 December 2011. In parallel to the Plenary Session, where Ministers made prepared statements, three Working Sessions took place with the following themes: “Importance of the Multilateral Trading System and the WTO”, “Trade and Development” and “Doha Development Agenda”. The Conference approved the accessions of Russia, Samoa and Montenegro. In the final session, Ministers adopted a number of decisions like decisions on intellectual property, electronic commerce, small economies, least developed countries’ accession, a services waiver for least developed countries, and trade policy reviews and the Chair made a concluding statement.

3. Seattle, November 30 – December 3, 1999:

Third Ministerial Conference of World Trade Organization comprising of 137 members was held in America on November 30 to December 3, 1999 at Seattle. From the very beginning this conference was held amidst controversies.

Thousands protested in opposition of failure of WTO. The main objections raised by the protestors were the issues of Human Rights and preservation of ecology. The protestors raised the voice against the violation of the above issues by the WTO.

Medaline Albright, the State Secretary of U.S.A could not come out for inauguration of the conference due to large scale protests outside. The inauguration was cancelled and the proceeding of the conference started late by 5 hours. General Secretary Miche Moore inaugurated the Conference.

Developing countries including India strongly opposed the inclusion of labour standards in the list. The member countries could not reach on consensus regarding market access, agreements about the trade of agricultural services etc. The Indian side was represented by Murasoli Maran, the Commerce Minister. He represented his stand forcefully and successfully in the conference.

4. **Doha, 9-13 November 2001:**

The fourth Ministerial Conference of WTO was held at Doha (Qatar) from 9-14 November 2001 to decide upon the future work programme of the WTO. While there were strong pressures to launch a comprehensive round of negotiations including multilateral regimes on investment, competition policy, trade facilitation, government procurement and environment, India was opposed to over burdening of the multilateral trading system with non-trade or new issues on the agenda.

In this conference, India underlined the need for resolving the implementation issues arising from the current agreements in a time bound manner before addressing new issues for negotiations.

The substantial outcome of the Doha ministerial is the work programme aimed at reduction in customs tariffs and opening up of agriculture and services. Exporters of farm goods can expect to benefit from the reduction of domestic support and export subsidies in Europe and the United States.

In this conference India made significant gains on public health concerns in the TRIPs agreement. The agreement over amendment to TRIPs, which would allow countries access to low price patented drugs in case of a public health emergency, was a victory for India.

5. **Cancún, 10-14 September 2003:**

The fifth ministerial conference of WTO was held at the Mexican beach resort of Cancun on September 10-14, 2003. Anti globalization activists raised slogans against WTO in its inauguration itself. Activists wanted to evolve a trade policy which should not aggravate poverty.

The Cancun Ministerial Conference was meant mainly to be a forum to review the progress of negotiations under the Doha Work Programme mandated at Doha and give guidance directions wherever necessary with a decision expected only on one outstanding issue, namely the status of the Singapore issues.

The Conference also provided ample opportunity to test the seriousness of developed countries with regard to the development dimension of the Doha Work Programme. However, the Cancun Ministerial Conference became complex in view of the serious differences in the ambition levels of WTO member on the two most contentious issues, namely, Agriculture and Singapore issues.

Cancun conference aimed at revival of talks, which already started at Doha in 2001 and to be concluded by the end of 2004, on opening up of trade to spur growth in the world economy.

The important features of disagreement raised in Cancun conference are as follows:

i. Practical disagreement on agenda items – regarding imbalance in agriculture trade, market access improvements of industrial goods.

ii. Disagreement on Draft Ministerial Text proposed on September 14, 2003 which ignores concerns of developing countries like India, on agriculture. The draft circulated by the conference Chairman did little to cut farm subsidies by rich countries even as it sought to open up the markets of the developing countries for farm produce. It did not give any option to poor countries, but offered zero-for-zero tariffs for auto components and textiles.

Due to above main disagreement reasons, Cancun talks reminded failure and this failure is likely to postpone the implementation of the Doha Development Agenda, a road map for multilateral trade liberalization.

One positive outcome at Cancun is the solidarity expressed by developing countries for protecting their interests and their ability to stay together in spite of pressures exerted by developed countries to break the coalitions.

It should be seen as a positive development since up till now, the trade majors had decided among themselves on what the agenda should be and implanted such, decisions on the WTO membership.

Another positive development was the role of G-20 in effectively placing the view points of the world community dependent on agriculture for livelihood, before the Cancun Ministerial Meeting.

6. Hong Kong, 13-18 December 2005:

The sixth ministerial conference of WTO was held at Hong Kong on December 13-18, 2005.

The key outcomes of the conference were:

1. Resolve to complete the Doha Work Programme fully and to conclude negotiations in 2006.

2. Amendment to TRIPS Agreement reaffirmed to address public health concerns of developing countries.

3. To establish modalities in agriculture and non-agricultural market access by April 30, 2006 and prepare draft schedules by July 31, 2006.

4. To eliminate export subsidies in agriculture by 2013, with a substantial part in the first half of the implementations period. Developing countries without Aggregate Measurement of Support (AMS), such as India, will be exempt from reductions in de minimis and the overall cut in trade distorting domestic support, consisting of AMS, the Blue Box and de minimis, which is entitlement to provide Amber Box subsidies up to 10 percent of value.

5. Duty Free, quota free market access for all LDC's products to all developed countries. Developing country declaring itself to be in a position to do so, to also provide such access, though flexibility in coverage and in the phase in of their commitments is provided.

6. In Cotton export subsidies to be eliminated by developed countries in 2006 and trade-distorting domestic subsidies to be reduced more ambitiously and over a shorter period of time.

7. Geneva, 30 November - 2 December 2009:

The Seventh Session of the WTO Ministerial Conference took place in Geneva, Switzerland, from 30 November to 2 December 2009. The general theme for discussion was "The WTO, the Multilateral Trading System and the Current Global Economic Environment". In his report to the General Council on 17 November 2009, WTO Director-General Pascal Lamy said that while the Ministerial Conference would not be a negotiating session, it would be "a platform for ministers to review the functioning of this house", including the Doha Round, and an occasion "to send a number of strong signals to the world with respect to the entire WTO waterfront of issues — from monitoring and surveillance to disputes, accessions, Aid for Trade, technical assistance and international governance". The conference took place exactly ten years after 1999's Ministerial Conference in Seattle, a turning point in the struggle of the anti-globalization movement.

8. Geneva, 15-17 December 2011:

The Ministerial Conference of the World Trade Organization (WTO) is the organization's highest decision-making body and convenes every two (2) years. An issue of key concern for this 8th Ministerial is the future of the Doha Development Round which is now openly recognized as being deadlocked.

Day One was comprised of an Opening Session and a Plenary Session during which the primary players and various interest groups made their opening statements sharing their positions on the key issues facing the Ministerial:

1. Should the negotiations keep the single undertaking which requires all members to sign unto all decisions/agreements, or adopt alternative approaches in an attempt to jump-start the negotiations?
2. Is it possible to fast-track agreement on some issues, and if so, which ones?
3. What action should the body take on decisions made at the 6th Ministerial (2005) to provide duty-free/quota-free access for all goods from least-developed countries (LDCs) and remove developed country subsidies on cotton exports?
4. Should the WTO remain focused on concluding the Doha Round or begin to address new emerging issues, such as the financial crisis and climate change?
5. What is the role of the emerging economies?
6. Is it possible to conclude the Doha Round, and what is the future of the WTO?

9. Bali, 3-6 December 2013:

On Dec 7, 2013 WTO concluded its 9th Ministerial Conference in Bali and came out with an array of decisions collectively known as the "Bali Package". The conference was chaired by Indonesia's Trade Minister Gita Wirjawan. The outcomes to which were under the following tags:

1. Agriculture and Cotton– reducing export subsidies was on the highlight. More opportunities to developing nations for food security were sought. However, the distribution systems of the developing countries are likely to suffer as Bali Package seeks to legally track public stockpiles of these countries. The shielding of public food stocks was advocated for. But, the solution reached at is interim which allows flexibility to countries in maintaining their food stocks subject to transparency in systems and regular notifications to the Committee on Agriculture. The permanent solution is being worked upon and will be up after 4 years.

A list of services has been suggested for Green Box for the developing nations. More explanation to the "boxes" can be found towards the end.

Tariff Quota Administration: Means to handle the under-filled quota i.e. import quota inviting lower tariffs going under-filled were looked out for.

Improvised market access mechanisms for cotton exporters from least developed countries were also focussed upon as heavy import duties were levied in the past on cotton textiles pushing them out of market owing to their soaring prices.

2. Trade - Boost to least developed countries' (e.g. Somalia, Zimbabwe) trade was an agenda along with racing up port clearances, custom procedures, clear, transparent and simplified international trade.

3. Development – Feasibility of access to Richer Countries' Market by least developed nations was advocated for by making the access duty- free and quota-free. Another good outcome was the easy identification mechanisms provided to the goods from least developed nations so that they may be eligible for preferential treatment in countries which import them.

4. Routine Decisions of the General Council –

⇒ Members agreed not to bring cases of non-violation of intellectual property agreement where the agreement as such hasn't been violated, to the WTO dispute settlement process.

⇒ No charging of import duties on electronic transmissions.

⇒ Continuation in support to "Aid for Trade" programme to aid least developed/developing countries.

Yemen has been added as a new WTO member.

10. Nairobi, 15-18 December 2015:

To be held on 15-18 December 2015.

14.3 Ministerial Meeting of India with World Trade Organization (WTO)

14.3.1 MINISTERIAL CONFERENCE--Fifth Session, Cancún, 10 - 14 September 2003

INDIA

Statement by H.E. Mr Arun Jaitley

Minister of Commerce and Industry and Law and Justice

1. I thank you, Mr Chairman, and your Government for hosting this 5th Ministerial Conference and for the excellent arrangements and hospitality.

2. India has very warm and friendly ties with both Nepal and Cambodia. Nepal is also our close neighbour. We applaud the accession of these two least developed countries to the WTO.

3. We welcome the recent decision of the General Council that would make it easier for poorer countries to import cheaper generic drugs if they are unable to manufacture the medicines themselves. But we have a responsibility to ensure that the system we have put in place works to meet legitimate humanitarian needs without being held hostage to procedures.

4. The developing countries participate in the multilateral trading system in the hope that this would lead to their economic development and not because trade liberalization is an end in itself. The system has to meet this expectation. Effective measures are needed to make trade work as an engine of growth and human development. Given the differences in levels of development and the ability of countries to assume obligations, it is imperative to ensure that equal rules do not apply to unequal players. With very few exceptions, today's developed countries in the past practised and benefited from the same protection they now seek to deny to developing countries. Anyone can dismantle all protection after growing wealthier and powerful. The multilateral trading system has to acknowledge that developing countries cannot afford to travel at the same speed as developed countries to achieve gains. Therefore, obligations to be undertaken by the developing countries should not arise out of coercion. Rather, they should have a feeling that these obligations are in their interest and that they are in a position to accept and implement them.

5. Over the years we have seen gradual increase in lack of internal transparency as well as reduced participation of developing countries in the decision-making process in the WTO. We should not let the developing countries perceive the decision-making process of the multilateral trading system to be discriminatory, opaque and unresponsive to their needs. We look forward to this Ministerial Conference moving towards more inclusive decision-making process. There is also a need for prescribing clear and fair guidelines for conducting the preparatory process for Ministerial Conferences. The practice followed before Doha – and now, again – of sending the Chairman's text to the Ministers on the Chairman's own responsibility is not a healthy one. We need to deliberate on these issues and take appropriate decisions so that specific guidelines can be finalized before the next session of the Ministerial Conference. The proposals made by a large number of Members including India could serve as the basis for such discussions.

6. Although the Doha Work Programme was heavily overloaded and included a few issues that are not trade related, we saw some elements in it for a new beginning towards addressing issues of particular interest to developing countries. But as we see it now, we are engulfed in a sense of deep disappointment that the development dimension envisaged under the Doha Work Programme has been given short shrift. In our view the draft Cancún Ministerial Text is grossly inadequate on implementation issues and would severely affect the interests of developing countries in agriculture, industrial tariffs and Singapore issues. We cannot escape the conclusion that it does not accommodate the legitimate aspirations of developing countries and instead, seeks to project and advance the views of certain developed countries.

7. The progress achieved on implementation issues belies the understanding that Ministerial commitments once taken will be honoured. Negotiations on outstanding implementation issues were agreed to be "an integral part of the Work Programme" and were required to be addressed "as a matter of priority". Yet, all the time-lines set at Doha for their resolution have been breached. On certain issues even the mandate itself has been questioned.

To make matters worse, the draft Ministerial text accords low priority to these issues. It does not envisage any time-frame for taking decisions for resolving outstanding issues. This is in sharp contrast to the issues of interest to developed countries for which time-lines have been provided for taking decisions. If we do not restore the priority accorded to the outstanding implementation issues, the developing countries would be forced to conclude that the "development" element in the Doha Development Agenda is only rhetoric. Let it not be said in respect of implementation issues that "often expectation fails and most often there, where most it promises". It is also a matter of disappointment that the draft decision on Special and Differential Treatment provisions before us has left many issues unresolved. This is despite a clear decision from the Ministers that all S&D provisions should be made precise, operational and effective and non-mandatory provisions converted into mandatory ones within a specified time-frame.

8. The commitment by the developed countries to eliminate distortions in world agriculture caused by their policies holds the key to resolving differences amongst us in this area. The "Global Economic Prospects 2004", a World Bank publication, mentions that the protection in the developed countries faced by developing country exporters in agriculture is four to seven times higher than in manufactures. The effect is to stimulate over-production in high cost rich countries and to shut out potentially more competitive products from developing countries. It is no surprise that over the past few years, agricultural exports from developing countries to developed countries grew at just half the rate they did to other developing countries. Agricultural subsidies in developed countries are not targeted to keeping small struggling family farms in business but to provide hefty rents to large farmers or corporates. In many developed countries, the average income of farmers is higher than the national average, reaching almost 200 per cent of the average in certain cases. Let us also remind ourselves that the agriculture subsidies provided by the OECD countries are more than six times what they spend on official development assistance for developing countries. OECD Governments support sugar

producers at the rate of US$6.4 billion annually – an amount nearly equal to all developing country exports. Subsidies to cotton growers in a developed country totalled US$3.7 billion last year, which is three times that country's foreign aid to Africa. The net effect of subsidizing agriculture in developed countries at the expense of products of the relatively poor in developing countries is to aggravate global income inequalities. On the other hand, against equity, justice and fair play, developing countries are being asked to liberalize their agriculture. What the farmers in developing countries demand is protection from distortions in the trade of agricultural commodities, created through the high level of subsidies in the developed countries. The plight of these farmers are directly linked with the level and kind of subsidies in the farming sector in the developed world. Hence, it would be difficult for us to agree to negotiations, which could potentially place at high risk the very livelihood of 650 million people in India, who are solely dependent on agriculture. It is only when the developed countries agree to take five steps forward in the removal of trade-distorting subsidies that the developing countries can take one step forward in the area of market access. The legitimate concerns of billions of farmers in developing countries, for whom agriculture means survival and not commercial operation, cannot be sacrificed to sub-serve agri-business profits of a few millions elsewhere sustained through $1 billion in the OECD countries.

14.3.2 MINISTERIAL CONFERENCE, Sixth Session, Hong Kong, 13 - 18 December 2005

INDIA

Statement by HE Mr Kamal Nath Minister of Commerce and Industry

I thank you, Mr Chairman, and the Government and people of the Hong Kong Special Administrative Region, for the excellent arrangements made for our work, and for your hospitality.

I would like to warmly welcome Saudi Arabia and Tonga, both valued friends of India, into the WTO fraternity.

We meet at Hong Kong with a mandate to fulfil the Development Agenda crafted at Doha. Doha had aroused hope among millions of people of economic growth and prosperity. We are mandated to correct the 'development deficit' bequeathed to us by the Uruguay Round. Our negotiations here will have failed if they do not contribute towards creating a rules-based world order, which not only makes trade free, but also makes trade fair.

Development is not simply an adjunct to the global trading system. It is intrinsic to every aspect of this Round. It concerns nothing less than ensuring access of the world's poor to basic material necessities, a decent quality of life commensurate with human dignity. To this end, and with this hope, we are Members of the World Trade Organization; and this participation cannot be disruptive of the national development strategies of developing countries. Of course, our economies need the stimulus of external markets and technologies for the transition to a higher growth trajectory. We de believe this and are committed to it. But our problems and challenges are so manifold and our socio-economic contexts so diverse, that no single, 'harmonized' development strategy can be adopted. Each country must choose the path that best suits its own genius.

Trade commitments which throw hundreds of millions of people already on the edge of subsistence into a chasm of poverty and unemployment simply cannot be supported. The ambition of developed countries cannot and must not trample on the aspirations of four-fifths of humanity.

It is in agriculture that the structure of international trade is the most distorted and it is here that the development outcome of Doha would be the most critically judged. It is in agriculture again that many developing countries find a natural comparative advantage. But they are shut out from world markets by a complex edifice of protection, built on high tariff walls, domestic and export subsidies, and an intricate maze of non-tariff barriers. In many developing countries, including India, hundreds of millions of low-income and subsistence farmers eke out a precarious livelihood from agriculture. Unless the playing field is completely levelled, they cannot enter the arena of international competition. Our farmers are quite willing to deal with trade flows – but not with an avalanche of subsidy flows from developed countries.

To secure and ensure the livelihood and food security of millions an appropriate number of Special Products and a Special Safeguard mechanism which can be meaningfully and effectively applied is the bedrock of any agricultural outcome in this Round.

The small and medium enterprises in the developing world provide livelihood to hundreds of millions of industrial workers. They need the elimination of tariff peaks and tariff escalations to obtain effective access into developed country markets. It is no use having zero duty levels on aeroplanes, while maintaining a 30 per cent duty on leather handbags! Such traditional industries as textiles, clothing, leather products, footwear, and a range of other medium technology products have long faced barriers. Their future growth would be blunted in the absence of new markets and technologies. However, one NAMA proposal before us translates into a 75 per cent cut for developing countries as against a 25 per cent cut for developed countries. Surely there is a mistake somewhere!

Market access is not governed by tariffs alone. Exporters from developing countries face an impenetrable labyrinth of non-tariff barriers. These include the abuse of both anti-dumping measures and technical standards, often dealing with peripheral matters and extraneous considerations. If we are to pursue the so-called 'real' market access in the NAMA negotiations, the boot is surely on the other foot.

Globalization means not only an accelerated global flow of goods, but also of services and ideas. The youth in a number of developing countries have acquired globally valued skills in several professions. The opportunity of productive employment to the educated youth in the burgeoning populations of developing countries would require the development of robust services sectors in their economies. Access into overseas markets is an essential stimulus for this growth, and a powerful instrument to banish poverty. This is why the liberalization of professional services trade in Modes 1 and 4 needs to figure high on the development agenda. It is also, of course, a paramount need of businesses everywhere in a globalized economy. The services negotiations need a clear direction, without undermining the flexibilities available to developing countries under the GATS architecture.

On the unfinished agenda of development inherited from the Uruguay Round is the imbalance in the TRIPs Agreement between private IPRs and the intellectual heritage of communities. There is growing popular discontent among developing countries over bio-piracy and the misappropriation of their traditional knowledge for commercial gain. The Hong Kong Ministerial must pave the way for the launch of negotiations on the issues pertaining to the relationship between the TRIPs Agreement and the Convention on Bio-Diversity.

A Development Round has no credibility in the absence of substantial benefits for the weakest Members of the WTO. The Hong Kong Ministerial needs to address the burning issues of cotton and of preference erosion. We need to finalize the proposal for duty-free quota-free access for exports of LDCs to developed country markets, without hedging. Developing countries too are ready to play their part, according to their abilities. India shall not be found wanting in this respect.

In the name of completion, if the content of this Round only perpetuates the inequities of global trade, then it will be no Round. To redeem the pledge we made at Doha, let us resolve to make this a Round for those who need it. Le us make this a Round that truly reflects the development dimension in its most beneficial and most effective sense.

14.3.3 MINISTERIAL MEETING ON RE-ENERGISING DOHA: A COMMITMENT TO DEVELOPMENT, NEW DELHI 3-4 SEPTEMBER 2009

Background

Following the impasse in the talks at the mini-Ministerial meeting of the World Trade Organisation (WTO) held in July 2008, the general opinion amongst WTO Members was that the negotiations should resume at the earliest opportunity. Informal small group discussions took place in September 2008.

Multilateral discussions resumed at the WTO in October 2008 and continued through the month of November.

The Director General (DG), WTO made a strong push for convening another Ministerial meeting in December 2008 for finalising modalities for Agriculture and Non-Agricultural Market Access (NAMA). Several Members expressed their reservations on calling Ministers to Geneva with so many issues remaining unresolved. In the US, many voices were raised against a Ministerial meeting. Some important and influential members of the US Congress also urged the Bush Administration not to support the DG's plans for a Ministerial. India too expressed reservations about convening another Ministerial meeting in haste given the large number of unresolved issues.

The Chairs of the Negotiating Groups on Agriculture and NAMA brought out the fourth revisions of draft modalities for Agriculture and NAMA on 6 December 2008.

The DG subsequently decided against convening a Ministerial. He proposed the resumption of work in the Negotiating Groups early in 2009, using as a starting point, the revised draft modalities for Agriculture and NAMA issued on 6 December 2008.

Political Calls for Resumption of the Doha Round

The talks are yet to resume formally after the winter break in December. However, the Doha Round has been on the agenda of several major international meetings held in the recent past including meetings of the G-20 on 15 November 2008 and 2 April 2009; the Cairns Group meeting in Bali, Indonesia from 7 to 9 June 2009; the informal meeting of Trade Ministers on the occasion of the OECD Ministerial Council Meeting in June 2009; the G-8 plus 5 meeting in L'Aquila from 8 to10 July 2009; and the APEC Trade Ministers' meeting in Singapore on 21-22 July 2009. These occasions have been used by the DG, WTO and others to press for early resumption of talks.

Objective of the Delhi Meeting

The pronouncements by Ministers and Heads of State and Governments at various international meetings signal considerable political enthusiasm for an early conclusion of the Doha Round though in some quarters skepticism has been expressed on the anticipated outcome. The Delhi Ministerial meeting in September was intended to help to convert this spontaneous expression of will into commitment so as to re-energise the multilateral process at the WTO.

India is committed to a rule-based multilateral trade regime that is fair and equitable. Multilateralism best serves the needs of developing countries and must be strengthened particularly in this time of economic crisis. An early conclusion of the Doha Round is necessary not only to give a stimulus to the global economy but also to support the Least Developed Countries and Small and Vulnerable Economies and to counter the inevitable tendency of most countries to resort to protectionist measures.

The meeting was as an informal ministerial meeting and should be distinguished from ministerial meetings which are convened by the WTO.

The objective of the meeting is to create political consensus to get the Doha Round back on track so that a multilateral process of discussion can resume at the WTO. Accordingly, discussions on specific areas of the negotiations are not envisaged.

India's Stand

India is strongly in favour of a fair and equitable rule-based multilateral trade regime, therefore, we are keen to conclude the Doha Round early. We support resumption of the multilateral negotiations at an early date based on the following:

(a) The draft text of 6 December in respect to agriculture and NAMA should be the basis on which further negotiations are held. A substantial amount of work has gone into preparing these texts and there is no reason to review them or to introduce new elements into these texts.

(b) Development in the developing countries is at the core of these negotiations. Food and livelihood security of the poor is critical to developing countries and cannot be compromised under any circumstances.

(c) All issues being discussed in the negotiations are part of a single undertaking; therefore, adequate balance amongst major issues has to be ensured in the agreement.

All members of the G-20 alliance of developing countries were invited as this group and had been a major driving force in the negotiations. Apart from the G-20, country coordinators of other groups active in the negotiations as well as some key players such as the US, Australia and New Zealand were invited. Other invitees were the Director General of the WTO, Pascal Lamy and the Chairs of the Negotiating Groups on Agriculture, Non-agricultural Market Access and Services.

14.3.4 Chair Summary of Ministerial Meeting held on 3-4 September, 2009 in New Delhi

Chair's Summary (4 September 2009)

Excellencies, Director General Mr. Lamy, Senior Officials, Ambassadors, and distinguished delegates,

We have now reached the end of two days of intensive engagement. Let me first thank you all for your statements and interventions over the course of the last day or so. I am happy that we were able to cover so much ground in such a short span of time. I trust you will all agree that we have made good progress over the last two days or so and we now have a fair idea of the way forward.

The Delhi Ministerial meeting was conceived and designed as a representative forum of the WTO membership, bringing together groups from across the spectrum of interests and positions in the Doha negotiations, in a microcosm of the WTO itself, in a bid to give a determined push to the multilateral process.

The objective was to develop a broad-based consensus to remove the impediments coming in the way of multilateral discussions and to provide clear directions to negotiators to re-energise the multilateral process at the WTO.

I will now summarise the proceedings of 3rd and 4th September.

Ministers recalled the outcomes of meetings held earlier during the year at London (G20), Bali (Cairns Group), Paris (Trade Ministers), L'Aquila (G8 plus) and Singapore (APEC Trade Ministers). It was further recalled that leaders had set a timeline of 2010 for the conclusion of the Doha Round.

Ministers acknowledged that the unambiguous political signals emanating from earlier meetings had not been translated into action in Geneva. They were conscious that mere reaffirmation of commitment was not enough unless this was converted into effective instructions to negotiators to re-engage, with a view to concluding the Round successfully within 2010.

Ministers were also sensitive to the deleterious impact of the prolonged global economic crisis, which has put to the test the commitment of member countries to free, fair and equitable rule-based international trade. They were unanimous in expressing the view that strengthening the multilateral trading system by concluding the Doha Round at the earliest, was vital.

The Director General, WTO provided an overall perspective of the way forward. The Chairs of the Agriculture, NAMA and Services Negotiating Groups outlined their work plans in their respective areas.

The G-20 and the G-33 emphasised the need to respect the multilateral mandate as reflected in the work done on the Agriculture and NAMA modalities over the last seven years; both Groups were of the view that the texts of December 2008 must form the basis of future work. Regarding the negotiating process, they reiterated that bilateral and plurilateral meetings could only be used to supplement the multilateral process and not to substitute it. The G-20 called for the expeditious completion of the Round with contributions from all Members.

The Cotton-4 recalled the mandate of the Hong Kong Ministerial Declaration according to which the cotton issue must be addressed ambitiously, expeditiously and specifically. They expressed the hope that this issue would be taken up on priority when talks resumed. They were supported in this by all other Groups, particularly, the G-33, the G-20, the African Group and the ACP Group.

The African Group re-emphasized the importance of keeping development concerns as the main focus of negotiations. The Group stated that issues of concerns to LDCs needed to be tackled frontally in the negotiations.

The ACP Group reaffirmed the need for the banana issue to be specifically addressed outside of the modalities on agriculture, in order to reach a just and balanced outcome.

The two groups, supported by CARICOM, also drew the attention of participants to the progress made in July 2008 on preference erosion modalities. They expressed disappointment that the specific understandings developed then had not reached fruition on account of the delay in resumption; they emphasised the importance of this issue for their economies.

The G-10 group expressed its commitment to a successful and expeditious conclusion of the Doha Round to face the economic downturn and to fight the spread of protectionism. Citing the contributions being made by developed countries, the Group stressed the need for a balanced result in the single undertaking.

The LDC Group expressed concern that delay in concluding the Doha Round was costing them dearly. They called for an expeditious conclusion of the Round and progress on issues that were critical to them including DFQF.

Statements were made by coordinators of the groups on behalf of their groups and some of the Member countries in their individual capacities.

Let me turn now to what I believe are the understandings reached on a number of process-related issues that would determine the way ahead. These are summarized below:

There was a unanimous affirmation on the need to conclude the Doha Round within 2010. There was a clear recognition that differences subsist on issues and intensifying negotiations was the first step towards bridging these gaps.

There was a strong re-affirmation that development remains at the heart of the Doha Round.

Ministers also called upon Chief Negotiators/Senior Officials to meet in Geneva beginning 14 September 2009 to draw up a process of engagement for the next

2-3 months; and, to work with the Chairs of the Negotiating Groups to prepare an overall agenda of action.

Ministers agreed that Chairs of the Negotiating Groups on Agriculture and NAMA would be requested to draw up issue-based work plans in consultation with Chief Negotiators/ Senior Officials, for intensifying engagement to complete negotiations.

Ministers agreed that in consultation with Chief Negotiators/Senior Officials, Chairs of other Negotiating Groups would also draw up work plans, including, where applicable, tabling, discussion and finalization of texts where required and the timelines for submission of revised offers (Services), in line with the overall agenda of action.

Ministers agreed that negotiations should resume on the basis of progress achieved till December 2008.

Ministers agreed that work agenda for LDCs covering all specific issues across the entire spectrum should be put on a faster track for negotiating convergence with the DG Lamy and Chairs of Negotiating Groups taking the lead in this process.

Ministers were of the view that the multilateral process should continue to be the main process of negotiations for the strength of its inclusiveness and transparency. Other forms of engagements can work as an adjunct for developing a better understanding among members.

Ministers agreed to review progress and provide further guidance on how to complete negotiations within the expected 2010 timeline. All opportunities for political guidance, including at the level of leaders to be used between now and the end of November 2009 as also to iteratively track progress.

Mindful of the fact that the Doha Round has been in progress for eight years, it was agreed that all efforts must be made to bring the Round to an ambitious and development oriented conclusion within 2010 as resolved by world leaders.

This brings me to the end of my summary of proceedings.

I thank you all once again for your enthusiastic support and participation. I am glad that you have made the effort and taken the time to participate in this

Ministerial meeting. I am sure that our efforts will bear fruit and we will see a constructive resumption of Doha Round talks very soon.

I wish you all a safe and pleasant journey home and look forward to our continued association.

Thank you.

14.3.5 Ministerial Conference of WTO at Bali- Ninth Session, 17 December 2013

Statement of Shri Anand Sharma, Minister of Commerce and Industry in the Lok Sabha and Rajya Sabha on the

I attended the 9th WTO Ministerial Conference at Bali from 3 to 7 December 2013. The 2001 Conference at Doha had mandated a comprehensive development agenda for multilateral trade negotiations. Ever since the WTO was established in 1995, Member States were unable to arrive at a consensus on any multilateral agreement. The Bali meet was the first occasion where members were able to reach an agreement. In the backdrop of the global economic downturn of 2008 and the inability of the membership to reach consensus on the full Doha Development Agenda, it was decided at the 8th Ministerial Conference in 2011 to focus on areas where convergence was possible. Accordingly, after deliberations amongst members in 2012, it was agreed that members would strive for an agreement on Trade Facilitation, a few areas in agriculture, development issues and issues of relevance for Least Developed Countries (LDCs). Considering the limited sectoral agenda set out for the Bali Conference, India decided to bring the issue of food security in agriculture firmly on the negotiating table.

The existing Agreement on Agriculture does not bar public stockholding programmes for food security. However, if food for such programmes is acquired at administered prices and not at market prices, then it is deemed as support to farmers. WTO rules negotiated in the Uruguay Round provided that all such support has to be kept within a limit of 10% of the value of production of the product in question. However, rules for calculating the support are based on a reference price of 1986-88, without taking inflation into account. India, as part of a G-33 coalition of developing countries proposed an amendment of the WTO's Agreement on Agriculture to change these rules. The proposal is not new. Similar suggestions were tabled by other groups of developing countries. It was also a stabilized part of draft agricultural negotiating text of December 2008.

The G-33 proposal met with strong resistance. India, however, stood firm and through sustained efforts, managed to bring the US, EU, Australia, Canada and others to the negotiating table. The G-33 suggested several alternatives including inflation adjustment of administered prices.

However, the developed countries effectively blocked any discussion on such proposals.

The counter proposal made to the G-33 was a two year due restraint mechanism to provide temporary protection from challenge through the WTO Dispute Settlement Process, with a number of conditions attached.

This would have rendered the mechanism entirely ineffective and have implications for India's policies on procurement and public distribution including the implementation of National Food Security Act passed by Parliament.

India's consistent position in the WTO has been that matters pertaining to livelihood, food security and rural development are of vital importance. Special and differential treatment is a must for developing countries.

In accordance with the decision of the Cabinet, in my plenary statement, I made it clear that the issue of food security was non-negotiable for India as it directly relates to the livelihood concerns of millions of subsistence farmers and food security of the poor and vulnerable sections of the society. I underscored that an interim solution cannot be a temporary solution nor be terminated and must remain in place till such time that a negotiated permanent solution is in place.

I also stated that without a satisfactory decision on food security, we considered the Bali Package as lacking in horizontal balance and would, therefore not be able to lend our support to it.

Though a concerted bid was made to isolate India at Bali, our principled position resonated with the developing countries of Africa, Asia and Latin America including South Africa, Mauritius, Brazil, Egypt, Nigeria, Kenya, Zimbabwe, Namibia, Uganda, Argentina, Tanzania, Cuba, Bolivia, Ecuador, Venezuela, Nicaragua, Sierra Leone and Nepal. The African Caribbean Pacific (ACP) Group, the LDC group and the African Group of countries also lent support to India's view that a solution had to be found to the problem raised by India.

We were able to build a broader coalition of support forcing US and EU to cede ground. India declined a country specific carve out and insisted that protection must be available to all developing countries. After intense negotiations over 3 days, a few hours before the Conference was scheduled to end, a revised draft text was placed before the membership, which addressed our core concerns. It provides for an interim mechanism to be put in place and to negotiate for an agreement for a permanent solution for adoption by the 11th Ministerial Conference of the WTO. In the interim, until a permanent solution is found, Members will be protected against challenge in the WTO under the Agreement on Agriculture in respect of public stockholding programmes for food security purposes. It unambiguously stated that the interim solution shall continue until a permanent solution is found. By implication, India will have the flexibility of providing support to its farmers without the apprehension of breaching its WTO entitlements. It has also effectively led to a commitment from Members of the WTO to work on a permanent solution as part of a post-Bali work programme. Now we will be preparing for negotiations for arriving at a permanent solution. Countries which do not run such public stockholding programs also retain the flexibility to introduce them if they so wish to.

I would also like to make it clear that nothing in the aforesaid agreement impinges on our food security program for the poor and vulnerable sections of society, which is very much part of our sovereign space.

On Trade Facilitation, our proposals on Customs Cooperation and those relating to agricultural exporters found acceptance amongst the membership. The Trade Facilitation Agreement which was also endorsed by India is basically aimed at greater transparency and simplification of customs procedures, use of electronic payments and risk management techniques and finally faster clearances at ports, all of which would reduce transaction costs and bring about enhanced trade competitiveness. Many of these have already been implemented by India as part of our broader efforts for liberalization and simplification of procedures. I would like to conclude by saying that the Bali Ministerial meeting was a landmark one in the history of WTO. It re-affirmed India's leadership role amongst the developing countries and also demonstrated our diplomatic ability to build consensus. We were able to arrive at a balanced outcome which secures our supreme national interest. India was key to arriving at a breakthrough and shaping the first agreement since the creation of the WTO 18 years ago.

India's constructive approach in negotiations was acknowledged by all member states. We have managed to retain the centrality of the development dimension in the Doha Round. A positive outcome at Bali has also strengthened the credibility of the WTO as an institution. We have been able to give a clear signal to the world that while India is prepared to engage, it will not accept an un-balanced agreement. It will under no circumstances compromise the fundamental issues pertaining to food security, livelihood security and the welfare of its subsistence farmers and poor.

14.3.6 STATEMENT BY SMT. NIRMALA SITHARAMAN, MINISTER OF STATE IN THE MINISTRY OF COMMERCE AND INDUSTRY IN PARLIAMENT ON 5 AUGUST, 2014 REGARDING "INDIA'S STAND IN THE WTO".

1. I am making this intervention in the House today in order to place before the Hon'ble Members the facts relating to the stand taken by India in the World Trade Organization (WTO) recently.

2. The Bali Ministerial Declaration was adopted on 7 December 2013 on conclusion of the Ninth Ministerial Conference of the WTO in Bali. Ministerial Decisions were adopted on ten issues relating to the Doha Development Agenda which is the agenda for the unfinished Doha Round of trade negotiations, underway in the WTO since 2001.

3. Amongst these Ministerial Decisions, two are of particular significance – the Ministerial Decision for an Agreement on Trade Facilitation and the Ministerial Decision on Public Stockholding for Food Security Purposes.

4. The Trade Facilitation Agreement is basically aimed at greater transparency and simplification of customs procedures, use of electronic payments and risk management techniques and faster clearances at ports. We have autonomously taken several similar measures such as the 'Indian Customs Single Window Project' announced in the Budget 2014-15 to facilitate trade, under which importers and exporters will be able to lodge documents at a single point, reducing interface with Governmental agencies, dwell time and the cost of doing business.

5. The Protocol of the Trade Facilitation Agreement (TFA) was to be adopted by 31 July 2014 by the WTO. After this the Agreement would automatically come into force from 31 July 2015 if ratified by two-thirds of the members of the WTO.

6. In contrast to their efforts on Trade Facilitation in the WTO, some developed countries have been reluctant to engage on other issues.

7. Seeing the resistance to taking forward the other Decisions, the apprehension of developing countries was that once the process of bringing the Trade Facilitation Agreement into force was completed, other issues would be ignored, including the important issue of a permanent solution on subsidies on account of public stockholding for food security purposes.

8. India, therefore, took the stand that till there is an assurance of commitment to find a permanent solution on public stockholding and on all other Bali deliverables, including those for the Least Developed Countries (LDCs), it would be difficult to join the consensus on the Protocol of Amendment for the Trade Facilitation Agreement.

9. Without a permanent solution, public stockholding programmes in India and other developing countries will be hampered by the present ceiling on domestic support which is pegged at 10 per cent of the value of production and is wrongly considered as trade-distorting subsidy to farmers under existing WTO rules. The existence of such a subsidy element is determined by comparing present day administered prices with fixed reference prices of the 1986-88 period which is unrealistic.

10. The problem is a very real one. Developing countries are finding themselves hamstrung by the existing rules in running their food stockholding and domestic food aid programmes. The developed world too had market price support programmes and was able to move away from such support - though not fully even now - because of their deep pockets. This is not possible for developing countries. It is important for developing countries to be able to guarantee some minimum returns to their poor farmers so that they are able to produce enough for themselves and for domestic food security.

11. Developed countries continue to have large entitlements to provide support to farmers. These would have been cut in the Doha Development Round which unfortunately remains unfinished. Had this Round, which has development at its core, concluded as per the agreed timelines and its development agenda, the world would have had an outcome in a single undertaking in which competing interests could have been balanced. Today, developing countries are fighting to keep the negotiations focused on development against the single-minded mercantilist focus of most of the rich developed world on market access issues.

12. Overall balance is important even in a limited package of outcomes. The Bali outcomes were negotiated as a package and must be concluded as such.

13. It is regrettable indeed that today the WTO is unable to agree even to fast track negotiations on an issue of such importance to millions of subsistence farmers across the developing world, while the rich world can continue to subsidise their farmers unabatedly.

14. The matter came up for discussion in the margins of the BRICS Trade Ministers meeting in Brazil on 14 July and the G20 Trade Ministers meeting in Sydney on 19 July. It was also raised by the representatives of some countries in their interactions with the Indian government. On each occasion I explained that India is a signatory to the Bali Decisions, including Trade Facilitation and is not standing in the way of its implementation but is seeking an equal level of commitment and progress in working on the issue of public stockholding which affects the country's live lihood and food security. A permanent solution on food security is a must for us and we cannot wait endlessly in a state of uncertainty while the WTO engages in an academic debate on the subject of food security which is what some developed countries seem to be suggesting before they are ready to engage on this important issue.

15. Food security is a humanitarian concern especially in these times of uncertainty and volatility. Issues of development and food security are critical to a vast swathe of humanity and cannot be sacrificed to mercantilist considerations.

16. Developing countries such as India must have the freedom to use food reserves to feed their poor without the threat of violating any international obligations. This is our sovereign right. It is our duty to protect our citizens' fundamental rights to life and livelihood.

17. Agriculture is the mainstay of the Indian population. In a country of the size of India with 60% of the population dependent on a relatively unremunerative agriculture sector, we cannot give up administered prices. This is the only way we can procure food for the Public Distribution System (PDS), the central pillar on which our efforts to ensure food security, rest. Public stockholding is a widely used means to ensure food security in many developing countries where agriculture is largely rainfed.

18. We have to look after both consumer and producer interests. We have to enable our people to live a life of dignity by ensuring access to an adequate quantity of quality food at affordable prices.

19. On 25 July 2014, India made a statement in the WTO General Council conveying, inter alia, that the adoption of the TF Protocol must be postponed till a permanent solution on public stockholding for food security is found.

20. India offered suggestions on the procedure to be followed in order to ensure time-bound delivery of an outcome on public stockholding for food security. We also urged that a similar approach be adopted on all other elements of the Bali Package notably the LDC issues.

21. The integrity of India's stand is reflected in our unwavering efforts to offer a way forward in the face of criticism.

Even on 31 July 2014, India offered a way to achieve not only a permanent solution on the issue of public stockholding for food security but also to implement the Trade Facilitation Agreement in the agreed timeframe as well as deliver favourable outcomes for LDCs.

22. We have offered practical suggestions for the way forward. The issue of a permanent solution on public stockholding is a simple one that can be addressed very easily as there are already several proposals on the table. A solution to this simple problem will be a tremendous relief for millions of farmers and poor consumers.

23. However, despite India's efforts, our concerns were not satisfactorily addressed.

24. The Director General of the WTO reported to an informal meeting of the Trade Negotiations Committee on 31 July 2014 that a solution could not be found to bridge the gap.

25. The General Council meeting was, thereafter, formally declared closed without adopting the TF protocol.

26. India stood firm on its demands despite immense pressure. The Government of India is committed to protecting the interests of our farmers against all odds.

Our farmers work in extremely adverse conditions, most of them at the mercy of the vagaries of the monsoon, aggravated today by climate change. For farmers in many developing countries farming is a subsistence activity, not a commercial one. We are committed to their welfare and I am grateful for the support and understanding extended by farmers' organizations in this cause.

27. I must also thank Hon'ble Members of Parliament, many civil society groups and academicians who have lent their voice in support of the Government's efforts to ensure a fair deal.

28. It is evident from the expressions of support that India's stand has resonated across the world and I take this opportunity to also thank the countries that have stood by India in the WTO.

29. India is an unwavering votary of the multilateral trading system and we reiterate our commitment to the WTO. We continue to believe that it is in the best interest of developing countries, especially the poorest, most marginalized ones among them and we are determined to work to strengthen this institution. The timely correction of any imbalances or anomalies in the working of the system or its rules is critical to ensure that the WTO works impartially and fairly in the interest of all its Members and not just a select few.

30. I am confident that India will be able to persuade the WTO Membership to appreciate the sensitivities of India and other developing countries and see their way to taking this issue forward in a positive spirit. This would be a major contribution by this institution towards meeting the global challenge of food insecurity and would convey a strong message that the WTO is genuinely committed to the cause of development.

14.4 STRENGTHENING THE WTO

Communication from India

The following communication, dated 2 July 2009, is being circulated at the request of the Delegation of India.

The Seventh Session of the WTO Ministerial Conference will be held from 30 November to 2 December 2009. The Conference is taking place four years after the last Ministerial Conference in 2005, where the emphasis will be on transparency and open discussion. The Conference provides an opportunity to look at some systemic issues in the WTO with a view to strengthening the multilateral trading system. At the General Council meeting on 26 May 2009 India had stated its intention to submit a few proposals that it considers important from the perspective of improving the functioning and efficiency of the WTO as a rules-based system. In that context, India is submitting a set of five proposals which are intended to enhance the usefulness of the WTO and to make the system more relevant, vibrant and user friendly for both the member states and the larger trading community.

The proposals made in this submission are not cast in stone. These are made to initiate discussion at the General Council. The delegation of India wishes to build on these proposals taking into account the views and suggestions from Members.

A. Trade Information System based on Member Notifications

1. Proposal : Ministers direct the setting up of a project to enhance the Integrated Database to include in an appropriate format non-tariff data, based on the current notification obligations under WTO Agreements. The project should be designed to be efficient and effective by inter alia limiting additional resource requirements; optimising the design and structure of present notification systems; enhancing co-operation with related multilateral agencies; and providing technical assistance to developing countries, in particular the LDCs.

2. Background : In the realm of trade information, there is a significant gap in the information available on non-tariff measures (NTMs). Closing this gap is of particular importance to governments as well as for trade operators. The WTO took a step in the right direction when it implemented the Integrated Data Base (IDB) covering tariff (applied and bound) and trade data (partner-wise) which are electronically available at the national tariff line level. This has proved to be of immense assistance in formulating not just negotiating

positions but also for various research activities. It is time that NTMs are integrated with the IDB in a common format and for similar use.

3. Regarding NTMs, the WTO is uniquely placed as the biggest repository of certified trade information about its members' regimes through its system of notifications under various WTO agreements. However, at present this information has at best archival value because of the way information is submitted and stored. It is incomplete, not comparable amongst members or even timely. This pool of information has to be worked upon for it to become an asset. What is needed is better integration and coherence in database form and more effective public visibility of the existing information. In our view such an exercise need not be resource intensive. Improvements in the notification formats; content; and integration with existing database will assist in the project without any immediate additional resource requirement . Long-term resource implications can be contained by coordinating the activities with related multilateral agencies like the UNCTAD and ITC.

4. For the trade operatives, the proposal is to create a comprehensive information system that provides at the national tariff line level the tariff and non-tariff measures imposed by any member. This kind of a system will grant member regimes a level of transparency that is not presently available from any source would be an invaluable improvement to the present situation.

5. It is recognized that there are many issues and problems inherent in this proposal, it is therefore considered prudent that that project be developed in phases to enable it to address the arising demands based on experience gained and utility.

B. Revitalise WTO Committees

1. Proposal : Direction from Ministers to include in the agenda of formal WTO Committee meetings inter alia – monitoring of recent developments in members

on the trade disciplines covered by the committee, based on a compilation by Secretariat of developments between formal meetings and verified by the member concerned; regular discussions on general developments in the areas covered by the committee, including in the presence of outside experts; and through adoption of appropriate procedures, discussion on and resolution of low threshold specific trade concerns in small group settings.

2. Background : Given the widely perceived declining utility of the committee work, it is imperative that measures to revitalise them be adopted. Following are some suggestions on how the committees can be reinvigorated.

Monitoring Developments

3. The recent exercise in the TPRB of the WTO of monitoring developments in the trade regimes of various members has proved to be a useful tool for all members, particularly the developing countries that have an inherent disadvantage in gathering such information. This practice could be formalized and be made a regular agenda item for all formal meetings of all trade related WTO Committees.

4. Along with member notified measures, the Secretariat may make factual presentation on developments in various members on the disciplines covered by a committee. The Secretariat may base its factual report on information gathered from publicly available and reliable sources and after the gathered information being verified by the member concerned.

Discussions on Trade Disciplines

5. Another way to improve the relevance of the WTO Committees may be to include on the agenda, on a mandated basis, a discussion on the current practices and developments in the trade disciplines covered by a particular Committee. It may be considered to invite outside experts to present their views on such developments. Such a topical discussion will keep members

abreast of the latest developments. Improve the knowledge and performance ofdelegates and while it is not suggested or foreseen that the exercise will be recommendatory in nature, such discussions could help identify possible improvements to the WTO agreements/disciplines.

Forum to Address Specific Trade Concerns

6. One other measure would be to enable the Committees to discuss and offer possible solutions to the specific trade concerns of members. As a forum to discuss and resolve the specific trade concerns, it is important that members have access to at least a limited committee process right through the year and not just the periodical formal committee meetings. Working procedures that balance the need for confidentiality, to meaningfully discuss and resolve a specific trade concern, with that of transparency, i.e. information to the membership as a whole about the issue and its resolution, has to be devised and adopted. To be quick, efficient and economic, working procedures should allow formation of appropriate sub-groups of interested members to form and deal with the matter at hand.

7. Needless to say, such a procedure will bring into the WTO low threshold concerns of developing countries with the promise of at least gaining a better understanding of the matter and at best a resolution of the problem. [1]

Frequency of Meetings

8. Finally, keeping the above in view members may like to review the frequency of the WTO meetings. The frequency of the meetings refers to both, the formal meetings as well as informal meetings. These could be increased to allow discharge of its work efficiently.

C. WTO's Engagement with RTAs

1. Proposal : Directions from Ministers to monitor the developing trends in RTAs and develop non-binding best practice guidelines for reference while negotiating new RTAs. To ensure robust and regular monitoring the two transparency mechanism should be implemented on a permanent basis; the Secretariat to produce an Annual Review of RTAs based on the factual reports; and members to discuss trends and formulate non-binding best practices in the CRTA.

2. Background : The fact that RTAs are proliferating and most of global trade is conducted on preferential terms is well documented. The work in WTO on RTAs which earlier focused entirely on evaluating the RTAs for their compatibility with GATT/ WTO provisions was for long log-jammed. Members could neither definitively establish standards for the examination or evaluation, and even where they had clear yardsticks such as for "reasonable length of time", they could not agree whether indeed the RTAs under examination met the standards or not.

3. Given this situation the membership responded with the implementation of the RTA Transparency Mechanism, which was earlier agreed to by members as an early and provisional outcome of the Doha Round. Certainly, one can say today that the RTA Transparency Mechanism is a success. It has contributed immensely to our understanding of the contents of RTAs. The success of the existing mechanism is reflected by the desire of the membership to design a similar mechanism for the unilateral preferential schemes as well. Even this mechanism, which is not Doha mandated, is close to finalisation. Thereby, all agreements offering preferences of any kind to participants will be covered by the transparency regime in WTO.

4. Given the accepted benefits of the RTA Transparency Mechanism and the expectation that the transparency mechanism on preferential schemes will be

as useful, Ministers could now agree to implement both on a permanent basis, albeit with in-built provisions for periodic review.

5. At this stage, the issue for discussion is whether the two transparency mechanisms are enough. Is this all that the WTO can do? Or are there other aspects of RTAs that can be fruitfully examined in the WTO? Can more be done to reduce the adverse impact of RTAs on multilateral trade? Can the information provided by the Transparency Mechanism on RTAs currently in force, help members to identify what future RTAs should look like?

6. The basic problem with examination of RTAs in WTO has been the lack of a clear understanding amongst the members about the yardsticks on trade coverage; implementation periods; means to evaluate trade diversion; etc. In the present environment of multiplicity of such agreements involving all varieties of obligations, it is and will remain a challenging task coming to any common understanding on them and consequently a strict evaluation of any RTA is likely to remain a difficult task.

7. Therefore, while the work on the substantive issues may continue in the NGR, it will be useful to, in parallel, put in place measures that will allow us to move further on implementing the Transparency Mechanisms and best utilise the knowledge gathered on RTAs through them. In this context it is suggested that the Secretariat be requested to prepare an annual RTA Review. This publication, based on the factual presentations prepared by the Secretariat of individual RTAs, will inter alia review horizontally, across RTAs, the trends in content and structure of the RTAs that have come into effect during the year concerned.

8. Based on the trends detected in the annual reviews members in the CRTA may examine from an educative perspective ways to reduce the adverse impact of RTAs on multilateral trade. Aspects like, trade coverage/substantially all

trade; reasonable length of time; non-trade issues; preferential rules of origin; etc. can be examined. To the extent that there is consensus, the outcome could be a series of non-binding "best practices/guidelines" on various elements/ aspects of RTAs for reference by members in negotiating future RTAs. In this way there will not just be greater insight about RTAs, but WTO may be able to influence the evolution of the RTAs based on the trends over the past years.

D. Omnibus Legal Instrument for Preferential Market Access to LDCs

1. Proposal : Direction from Ministers for establishing a "Steering Group" or a subsidiary body under the General Council to comprehensively examine all WTO-related instruments allowing members to grant preferential access to LDCs. Following such examination, members to consider; propose and adopt a single instrument that would address all forms of preferential market accessfor LDCs.

2. Background : Within the GATT/WTO, members have provided special and differential treatment for Least-Developed Country members (LDCs) on a preferential basis under a variety of legal instruments and agreements. These preferential schemes have evolved over time both from the perspective of coverage, depth of concessions and the members granting the concessions.

3. The basic instruments providing legal coverage for preferential market access for LDCs include the Enabling Clause [2] , adopted in 1979, which allows developed country members to grant deeper preferences to LDCs within the GSP schemes they established for developing countries. In 1999, the General Council adopted the LDC Decision [3] which established a 10-year waiver for developing countries to grant preferential market access to LDCs. This 1999 waiver was recently extended until 30 June 2019. [4]

4. A momentum for granting greater preferential market access to LDCs was generated when the DFQF Decision was adopted at the Hong Kong Ministerial Conference in December 2005. This decision has effectively extended both the product coverage and the depth of concessions. This Decision applies to both developed countries and "developing-country members declaring themselves in a position to do so".

5. In addition to the existing instruments covering preferential market access in goods, a legal instrument which would grant preferential access to LDC service providers under GATS is being considered in the Special Session of the Council for Trade in Services. [5]

6. The multiple and sometimes overlapping instruments have different types of legal coverage and a variety of procedural requirements. This, combined with differential levels of market access commitments made in favour of LDCs, has created an environment of uncertainty both for the LDC preference receivers and the members granting or establishing such preferential market access schemes. For example, just on the procedural front, the developed country GSP schemes under the Enabling Clause are notified in the CTD while developing countries will have to notify their schemes through the Council for Trade in Goods under the cover of the Decision contained in WT/L/759. The implementation of the DFQF Decision is being notified to the CTD. The situation regarding the future services instrument is not yet clear.

7. For the purposes of certainty, predictability and transparency on all aspects of preferential market access for LDCs, an Omnibus Legal Instrument is necessary.

E. Reaffirm primacy of International Standards and Standard Setting for WTO Obligations

1. Proposal : Statement from Ministers in the Conference outcome document, reaffirming the provisions relating to the need to adopt international standards

in respect of sanitary, phytosanitary and technical barriers to trade, stressing the need for members to primarily base domestic regulations on such international standards for all trade in goods. Encourage increased participation in international standard setting activities.

2. Background : Lack of common product standards and framing of technical regulations on national rather than international standards is increasingly a major hindrance to a smooth flow of trade. Arguably alignment of standards amongst the membership and reduction of costs related to adherence, i.e. conformity assessment procedures, will bring about the most significant benefit to world trade.

3. This matter is being discussed in many different fora in the WTO like the SPS and TBT Committees, as also partly in negotiating bodies under the DDA. A reaffirmation by Ministers will be an important signal to the membership that the increasing divergence from international standards and conformity assessment/testing practices is a matter of concern and it is time to roll back the complications brought about by the divergent national regulatory regimes.

In submitting this paper, it is recognized that the ideas included above do not represent a comprehensive list of possible improvements to the WTO's functioning. Other members have suggested other measures or similar measures, but to be implemented in different ways. In the period leading up to the Ministerial Conference in November/December 2009 it is expected that members would come to a consensus on the list of measures as also the format in which the direction from the Ministers would be sought.

14.5 Conclusion

WTO is an organization which regulates both world trade in goods, as well as in services intellectual property rights, and investment. WTO belongs to its members and every ministerial conference of WTO is to provide benefit to its member countries.

14.6 Check your Progress

1. Theoretically, what is the most significant organ of the WTO?
   (a) The Committee on Trade and Development
   (b) The Council for Trade in Goods
   (c) The General Council
   (d) The Ministerial Conference
2. Which of the following was the name of one of the GATT negotiating rounds?

a. NAFTA b. Wilbur c. Nixon d. Uruguay

3. Which of the following is not one of the international economic institutions that were created at the end of World War II?

a. International Monetary Fund

b. International Bank for Reconstruction and Development

c. General Agreement on Tariffs and Trade

d. World Trade Organization

(Answers: 1d 2d 3d)

14.7 Glossary

NAMA Proposal: This proposal is based on "self-supply energy systems, i.e.non-conventional renewable energy" in Chile. The proposal was developed by Ecofys and Fundación Chile financed by the International Climate Initiative of the German government through the Mitigation Momentum project. The development of the proposal was undertaken in a consultative process involving key governmental, private sector and civil society stakeholders building on existing knowledge and initiatives in the sector as well as the government's immediate and longer-term policy and development objectives.

Anti-globalization movement: It is also known as counter-globalisation movement. It is a social movement critical of the globalization of corporate capitalism. The movement is also commonly referred to as the global justice movement

14.8 References

- http://commerce.nic.in/MOC/international_world_trade_india_proposal.asp
- https://www.wto.org/

14.9 Suggested Readings

- Dr.D. M. Mithani "International Economics" Himalaya Publishing House, Delhi.
- K.C. Rana& K.N. Varma, International Economics" Vishal Publication Company, Jalander.

14.10 Model Questions

1. Discuss in brief the ministerial conferences of WTO.

2. Explain the changes that took place in Ministerial Conference of WTO at Bali- Ninth Session held on 17 December 2013**.**