



MCM-501

BUSINESS AND ECONOMIC ENVIRONMENT



Department of Commerce

School of Management Studies & Commerce

MCM-501

BUSINESS AND ECONOMIC ENVIRONMENT



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MCM-101 BUSINESS AND ECONOMIC ENVIRONMENT

BLOCK-1 Concepts and Dimensions

UNIT-1 Contemporary Global and Indian Environment UNIT -2 Business and Society

UNIT 3 Social Responsibility of Business UNIT -4 Consumerism and Business

BLOCK-2 Macro Economic Concepts and Macro Environment

UNIT -5 Macro Economic Environment and Modern Theories of Economic Growth UNIT -6

Aggregate Demand and Supply)

UNIT 7 Inflation

UNIT -8 Unemployment

BLOCK-3 Economic Reforms, Economic Planning and Economic Policy

UNIT -9 Economic Planning in India

UNIT -10 New Economic Policy

UNIT 11 Economic Reforms in India-I

UNIT -12 Economic Reforms in India-II

BLOCK-4 Industrial Policy & Industrial Financial Institutions

UNIT -13 Industrial Policy and Industry Licensing

UNIT -14 Public Sector Enterprises and Small and Medium Enterprises UNIT 15 Micro-Finance

UNIT -16 (Financial Institutions (IDBI, IFCI, ICICI, UTI and SIDBI

BLOCK -5 Foreign Trade, Foreign Capital and Forex Management

UNIT -17 Foreign Trade: Theories, Issues and Modern Context)

UNIT 18 FDI and FII

UNIT 19 Foreign Exchange Rates and Foreign Exchange Markets)

UNIT -20 IS-LM-BOP Curve Analysis)

BLOCK-6 Globalization and World Trading System UNIT -21 Globalization, Liberalization and Privatization UNIT -22 Regional Trading Blocks

UNIT -23 World Trade and Emerging Environment UNIT -24 Multilateral Trading System

UNIT -25 Goods and Services Tax



UNIT 1 CONTEMPORARY GLOBAL AND INDIAN ENVIRONMENT

Structure:

- 1.1 Introduction
- 1.2 Characteristics of Environment
- 1.3 Characteristics of Contemporary Business
 - 1.3.1 Business in Transition
 - 1.3.2 Pressure of Competition
 - 1.3.3 Immense Opportunities
 - 1.3.4 Globalization
 - 1.3.5 Technology
 - 1.3.6 Information
- 1.4 Global Environment
 - 1.4.1 The Global Economic Performance
 - 1.4.1.1 Global Crisis and Recession in Major Economies
 - 1.4.1.2 Impact on Developing Economies
 - 1.4.2 Global Recession and Policy Response
 - 1.4.3 Dominance of MNCs in the Global Trading System
- 1.5 Indian Business Environment
 - 1.5.1 Indian Economy
 - 1.5.2 Macroeconomic Scenario
 - 1.5.3 Fluctuations in Economic Growth
 - 1.5.4 Erratic Industrial Growth
 - 1.5.5 Savings and Investment Growth in Recent Years
 - 1.5.6 Prices and Inflation
 - 1.5.7 Fiscal Imbalance
 - 1.5.8 Capital Market Developments
 - 1.5.9 External Sector
 - 1.5.10 Economic Slowdown in 2008-09
- 1.6 Globalization in India
 - 1.6.1 The 'Push' Towards Globalization
 - 1.6.2 Steps towards Globalization
 - 1.6.2.1 Exchange Rate Adjustment and Rupee Convertibility
 - 1.6.2.2 Import Liberalization

- 1.6.2.3 Opening up to Foreign Capital
- 1.6.3 Effects of Globalization
 - 1.6.3.1 Effects of the External Sector
 - 1.6.3.2 Effect on the Indian Enterprises
- 1.7 Summary
- 1.8 Keywords
- 1.9 Check Your Progress
- 1.10 Answer to Check Your Progress
- 1.11 Terminal Questions
- 1.12 References

Objectives:

After studying this unit, you should be able to:

- Explain the nature and scope of business environment
- Review the characteristics of contemporary business
- Analyze the dominant forces in the Global environment
- Explain the Indian Business Environment
- List out the impact of Globalization on India

1.1 introduction

Environment literally means the surroundings, external objects, influences or circumstances under which someone or something exists. The environment of any organization is the aggregate of all conditions, events and influences that surround and affect it. Environment refers to all external forces that have a bearing on the functioning of a business. Jauch and Gluecke define environment as the environment includes factors outside the firm which can lead to opportunities or a threat to the firm. Although there are many factors, the most important of these sectors are socio-economic, technological, supplier, competitor and the government. Business is all about reaping profits from the opportunities available in the environment. Opportunity can manifest themselves in the form of short supply, excess demand, latent need or new, better and economical sources of supply or manufacturing. Every business operates in a particular environment and each business unit has its own environment. A change in environment presents opportunity to some and threat to others. Sometimes, in the same industry, a

relevant change in environment can have a favourable or the opposite impact on different units of the same industry.

In this unit you will learn the characteristics of environment, Global and Indian Business Environment.

1.2 Characteristics of Environment

1. Environment is Complex: The environment consists of a number of factors, events, conditions and influences arising from different sources. All these interact with each other to create new sets of influences.

2. It is Dynamic: The environment by its very nature, is a constantly changing one. The varied influence operating upon it impart a dynamism to it and cause it to continually change its shape and character.

3. Environment is multi-faceted: The same environmental trend can have different effects on different industries. For instance GATS that is an opportunity for some companies but a threat for others.

4. It has a far-reaching impact: The environment has a far-reaching impact on organizations in that the growth and profitability of an organization depends critically on the environment in which it exists.

5. Its impact on different firms within the same industry differs: A change in environment may have different bearings on various firms operating in the same industry. In the pharmaceutical industry in India, for instance, the impact of the new IPR (Intellectual Property Rights) law will be different for research-based pharmacy companies such as Ranbaxy and Dr Reddys Lab and will be different for smaller pharmacy companies.

6. It may be an opportunity as well as a threat to expansion: Developments in the general environment often provide opportunities for expansion in terms of both products and markets. For example, liberalization in 1991 opened lot of opportunities for companies and HLL took the advantage to acquire companies like Lakme, TOMACO, KISSAN etc. Changes in environment often also pose a serious threat to the entire industry. Like Liberalisation does pose a threat of new entrants to Indian firms in the form of Multi National Corporation (MNCs).

7. Changes in the environment can change the competitive scenario: General environmental changes may alter the boundaries of an industry and change

8. the nature of its competition. This has been the case with deregulation in the telecom sector in India. Since deregulation, every second year new competitors emerge, old foes become friends and M & As follow every new regulation.

9. Sometimes developments are difficult to predict with any degree of accuracy: Macroeconomic developments such as interest rate fluctuations, the rate of inflation, and exchange rate variations are extremely difficult to predict on a medium or a long term basis. On the other hand, some trends such as demographic and income levels can be easy to forecast.

1.3 Characteristics of Contemporary Business

When we describe the characteristics of today's business, we keep in our mind the Indian business. The Indian business has some interesting and unique features such as – transition, competition, opportunities, globalization, technology and information.

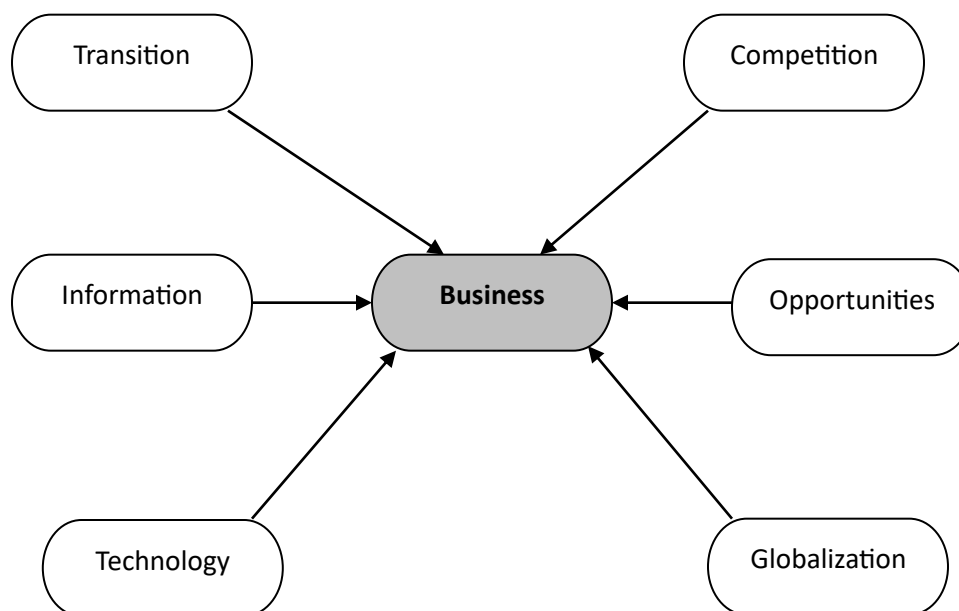


Figure 1.1 Characteristics of Business

1.3.1 Business in Transition

For a long time, business in India was conducted in sheltered markets covering up inefficiencies; low productivity and high cost. Then came 1990s which lifted

all protectionist measures. This followed by increased globalization, changed the scenario altogether. The Indian business leaders find totally a new environment characterized by competition, both from within and from foreign businesses. Those who are competent are able to survive and those who fail are perishing. A typical business leader finds himself sandwiched between the compulsions of the new business environment and of the old practices of doing business.

1.3.2 Pressure of Competition

As stated above, Indian businesses are competing among themselves and are exposed to competition from foreign firms. Competition though unwelcome to managers, is a boon to customers. Look at the experience of buyers and users in India. Recollect the scenario about 20 years back. Businesses enjoyed monopoly and this advantage they used to squeeze customers. Scarcities, high prices and low quality were the order of the day. One had to wait for 6 to 7 years to get a phone connection, 3 to 4 years to have a cooking gas connection, 8 to 10 years to get a new two-wheeler released and the list goes on. Competition benefits rival firms by defining new ways of doing business, helping build new capabilities, building new customer satisfaction standards, making business executives become proactive.

1.3.3 Immense Opportunities

Though Indian business faces stiff competition, it also has plenty of opportunities which can be exploited to one's advantage. BPO, Call Centres, IT, ITEs, wealth management, risk management and private banking are the new names that are doing rounds in business. But the real opportunities lie in the traditional sector, viz., industry. Globally competitive manufacturing can be done in India. In diverse sectors – pharmaceuticals, chemicals, textiles, metals, refining, cement, auto and ancillaries, India has factories doing well and even exporting large portions of their output. Many MNCs look at India as export-base. Suzuki and Hyundai perceive India as a car club. ABB plans to make India a global sourcing base for some of its products. India has potential to emerge as the second global manufacturing base after China. In its recent report 'Made in India', McKinsey and Co. has stated that the second and much bigger wave of manufacturing

outsourcing is yet to come. The first wave was \$460 billion and consisted of low technology products like toys and garments. The second wave would reach \$1.6

trillion and will include high technology sectors like automotives, engineering and chemicals. When the second wave comes, the beneficiaries will be India or China, or both.

Commodity business is another area where Indian companies are in a stronger position. L.N. Mittal in Steel, Ambanis in Polyester, K.M. Brila in Viscose Fibre, and Bharat Forge in forgings are only some names that come to one's mind while we talk about the commodities stage. What makes Mittal, Birla, Ambanis and the others command such enviable positions? Three reasons explain their commanding positions. First the low cost production. Second is the confidence these entrepreneurs love – confidence derived from their increased competitiveness and global outlook. Third, countries that were traditionally centres of manufacturing are finding their competitiveness eroded by other low cost countries, and are therefore opting out of the race. In Europe, for example, a number of small auto-component manufacturers are selling out and are being taken over by the likes of Bharat Forge.

Table No 1.1: Commodity Czars

Company	Product	Annual Capacity	Rank
Mittal Steel	Steel	70 million tones	1
Birla Viscose	Viscose fibre	251,850 tonnes	1
Basell (Chatterjee /Access)	Polypropylene	8 million tones	1
Reliance Industries	Polyester	1.8 million tones	1

Hero Cycles	Cycles	5.2 million units	1
Essel Propack	Laminated Packaging	4 billion units	1
Bharat Forge	Forgings	102,900 tonnes	2
Moser Baer	Optical media storage	2.5 billion units	3
Hero Honda	Two-wheelers	2.6 million units	1
Jubilant Organosys	Pyridine	22,500 tonnes	2
Orchid Chemicals	Cephalosporin	1,100 tonnes	5

(Source: Business Today, June 5, 2005)

1.3.4 Globalization

Going international is yet another trend followed by modern business houses.

Political boundaries are no barriers to business. Production facilities are being set-up in different countries and products are being sold through a global network. Gradually, business houses are exposed to global competition which augurs well for consumers. Modern business necessitates globalization. Technological innovation, crumbling trade barriers, FDI, information explosion, infusing of market competition, changing life styles and demand for new products are the triggers of globalization.

Due to modernization in infrastructure and increased use of air services in international trade, transportation costs have reduced. The gradual development of ICT, rapid expansion of ICT etc. also had their impact. TNC has acted as a representative of the expansion of economic globalization. The organization of production of various goods and services has become globalized. New methods of trading such as Out sourcing and Production Network etc also came into vogue in the

market and with the passage of time they developed, matured and became popular. The advancement of information technology has proved to be a new and essential factor in the significant changes in globalisation and economic industry. The use of the Internet has reduced transportation and communication costs considerably. Sending information from one place to another has become very easy and cheap. The advancement of information technology has positively influenced the pace and scale of globalisation, and mature industrial economies have adopted an expanded level of globalisation in terms of goods production and services.

Dramatic changes in the value chain and supply chain management not only transformed the manufacturing process but also reduced production costs. In the production process, techniques such as global distributed suppliers and just in Time (JIT) etc. have increased the efficiency of production. Another important feature of contemporary globalization is the formation of joint ventures in various forms through cross-border cooperation, such as technical and financial cooperation in the production of goods or services. Such cooperative ventures have gradually increased since the early 1980s.

Contemporary globalization has marked a great expansion of the trade of goods and services. The expansion of commercial services has proved to be an important component of multifaceted trade. If defined broadly, then globalization has reduced multi-continental distances and increased closeness at the social, cultural and informational level. Through this, diversity of relations has emerged among different countries and economies and a global feeling has developed. Modern business houses have become international. Political boundaries are no longer a barrier to trade. Production facilities are available in all countries and sales are being done through a global system. his global competition among business houses is in the interest of the customers. The main points of globalization are- technological advancement, encroachment of trade restrictions, information explosion, adjustment with market competition, changed lifestyle and demand for new products. The most important one is related to the economy - global distribution of produced goods and services and reduction of international trade restrictions such as export duties, import quotas, etc.

1.3.5 Technology

Business is analyzed as a new and advanced technology. The impact of technology on business is very wide. Production method, organization's workforce, marketing method, service management, motivation method, financial processes etc. all activities are affected by technology. Technology makes globalization and expansion possible at a rapid pace. Large and resource-rich industrial units lead any economy technologically and also take the initiative to form such joint ventures. At present, small and medium sized organizations have also ensured their increasing participation in such inter-institutional joint ventures. Common areas of such joint ventures include space, electronics, communications, computers and automobiles etc. Industrial sectors which have research and development intensity are suitable for cross border joint venture collaboration.

These sectors are relatively more profitable and global in nature. Information communication technology is the use of general technology in electricity and traffic, while gross factors affect production capacity in a broad sense. Gross factors evaluate the amount of productivity improvement, labor and technology.

The modernity of information and communication technology and new information products are also responsible for the birth of the information economy. Where there is continuous change and improvement in the manufacture/production of goods and services through advanced ideas and technology, it is called knowledge based economy. It is through modern technology that it has become possible to perform the activities and components of individual and corporate businesses more rapidly in the present than in the past. An important contribution of information and communication is the integration of labour force in business. Through technological innovation, specialized markets have been created to provide service opportunities to the labour force which reach even the remotest places. Any product or service which is cost-effective can be delivered anywhere at almost zero cost.

1.3.6 Information

Another characteristic of contemporary business is the recognition of and the need for information. The whole area of retrieving and extending information, including data processing, information systems analysis and preparation of effective records and reports, has achieved a major status. The complexities of modern business and government requirements have spearheaded this growth. But the vital reason for

progress in this area is the availability of the computer and electronic devices that have made feasible the quick and accurate gathering, processing and distributing information. Man is now free from the drudgery of much detailed paper work. He can further enhance progress by feeding proper information to proper people. Meanwhile, Information Technology (IT) itself is subject to revolutionary changes. From a handwritten sheet of paper to typing to stencil cutting to photocopying to floppies to cyberspace, the advancement in information technology is commendable. As business gets globalize, online communication across the world would be highly useful. This can be seen in all spheres of human endeavour to succeed.

1.4 Global Environment

The global environment of business has witnessed drastic changes during the last two decades. The fast growing economy of Japan has been caught repeatedly in recession and has not recovered as yet. The collapse of the east European socialist economies in 1989 and the Soviet Union in 1991 led to demise of socialism in these countries. The transformation of these economies from socialism to capitalism has not been smooth. Moreover, the package of structural reforms imposed by the IMF and the World Bank on these countries has resulted in their underdevelopment. Meanwhile, the Chinese economy has been registering a growth rate of around 10 per cent per annum. However, the USA remains the only super power in the world. This unipolar world has conferred immense power on the USA to bully other countries to tow its line. In 1995 the World Trade Organisation (WTO) was set up to serve as a watchdog in the spheres of trade in goods and services, foreign investment, intellectual property rights, etc. However, as expected, all WTO agreements are heavily loaded in favour of the rich countries. Along with the spread of multilateralism and opening up of global trade under the aegis of WTO, another opposite tendency of regionalism and bilateralism has been gaining ground in recent years and a number of RTAs (Regional Trade Agreements) are being signed by different countries.

1.4.1 The Global Economic Performance

The world economy registered a rate of growth of 4.0 per cent in GDP in 2006. The rate of growth declined to 3.7 per cent in 2007 and further to 2.5 per cent in 2008. High income countries registered a marked slow down over these years with their average rate of growth declining from 3.0 per cent in 2006 to 2.6 per cent in 2007 and

further to just 1.3 per cent in 2008. The largest economy of the world, USA, grew by 2.8 per cent in 2006 and this rate of growth fell to 2.0 per cent in 2007 and just 1.4 per cent in 2008. World's second largest economy, Japan, saw its rate of growth falling from 2.4 per cent in 2006 to 2 per cent in 2007 and to merely 0.5 per cent in 2008. All through this period, the developing countries as a group recorded significant growth. These countries witnessed a rate of growth of as high as 7.7 per cent in 2006 and 7.9 per cent in 2007 although their growth rate declined to 6.3 per cent in 2008. In the group of developing countries, most notable progress has been registered by the two large countries – China and India. China registered a remarkable 11.6 per cent growth in GDP in 2006, 9.0 per cent growth in 2007 and 6.3 per cent growth in 2008.

This period of change created a situation of uncertainty in various countries of the world, which continued in many countries till 2013. China's situation remained relatively optimistic, The economy here resumed its growth momentum after the recession by 2012, whereas Japan could not reach the expected position till 2012. The Indian economy too, after a period of recession, improved its conditions.

1.4.1.1 Global Crisis and Recession in Major Economies

Since mid-2008, USA, Eurozone, UK and Japan have been in recession (in the sense of having experienced two successive quarters of negative growth). This recession is projected to extend into 2009 yielding a marked slow down in major economies of the world and even negative rate of growth in some of them. There is enormous uncertainty about the depth and duration of the current global recession. In fact, the rapid outset of recession in high-income countries has clearly overwhelmed the forecasting abilities of many institutions, including the IMF. In July 2008, the IMF predicted that the world economy would grow at 3.9 per cent in 2009, advanced economies at 1.4 per cent and developing countries at 6.7 per cent. By early November 2008, (just four months later) these forecasts were slashed to 2.2 per cent, -0.3 per cent and 5.1 per cent. For its projections for the US economic growth in 2009, the IMF swung from 0.8 per cent in July 2008 to -0.7 per cent in 2009. In its estimates released in January 2009, IMF projected that the world economy would grow by only 0.5 per cent in 2009 (i.e., it would be almost at a standstill) while US economy would register -1.6 per cent growth. These estimates also projected a -2.8 per cent growth for UK and a -2.0 per cent growth for Euro area in 2009. In July 2009, IMF predicted that global economy would contract by 1.4 per cent in 2009, and the volume of world

trade by 12.1 per cent. Estimates by other international institutions and research originations also follow a similar pattern. All analysis now agree that the present global recession is likely to be the worst since the Great Depression of the 1930s.

The present crisis has its roots in sub-prime leading crisis that created stress in the financial markets of the USA in the summer of 2007. These stresses transformed themselves into full-blown financial crisis in the fall of 2008: credit markets froze; stock markets crashed and a sequence of insolvencies threatened the entire international financial system. Massive liquidity injections by central banks and a variety of stop gap measures by governments proved inadequate to contain the crisis.

1.4.1.2 Impact on Developing Economies

During the initial phases of the financial crisis in 2007, the effects of the financial turmoil on developing countries were relatively limited. However, as the crisis intensified in 2008 and especially since mid-September (when Lehman Brothers collapsed), risk aversion has increased and capital flows to developing countries have seized up. As of mid-November, developing country equity markets had given up almost all of their gains since the beginning of 2008 and initial public offerings had disappeared. Risk premium increased to more than 700 basis points on sovereign bonds and to more than 1,000 basis points on the debt of developing country firms. As corporate bonds had been one of the most important source of developing country finance, these developments suggest that a sharp slowing in developing country investment growth is to be expected. Bank lending and FDI (foreign direct investment) inflows were also down, but less dramatically. The increased volatility and losses emanating from the banking sector have caused investors worldwide to sell stocks and increase their holdings of less risky assets, notably US treasuries. As a result, the currency of virtually every developing country in the world has depreciated vis-à-vis the dollar. Of the 20 developing countries whose economies have reached most sharply to the deterioration in conditions (as measured by exchange rate depreciation, increase in spreads, and equity market declines), 6 come from Europe and Central Asia and 8 from Latin America and the Caribbean. To illustrate, the rate of growth of GDP for Argentina and Mexico in Latin America fell from 8.7 per cent and 3.2 per cent respectively in 2007 to 4.9 per cent in 2008. The rate of growth of GDP in Venezuela fell from 8.4 per cent in 2007 to 4.9 per cent in 2008. In Europe and Central Asia, the rate of growth for Russia fell from 8.1 per cent in 2007 to 7.3

per cent in 2008, the rate of growth for Poland fell from 6.8 per cent to 4.8 per cent and that for Turkey from 4.6 per cent to just 1.0 per cent over the same period. In Sub-Saharan Africa, the rate of growth in South Africa declined from 5.1 per cent in 2007 to 3.1 per cent in 2008. The two large and fast growing economies in the world in 2007, China and India also faced a slow down. China's rates of growth of GDP fell from 11.9 per cent in 2007 to 9.0 per cent in 2008. India's rate of growth of GDP fell from 9.0 per cent in 2007 to 7.0 per cent in 2008.

1.4.2 Global Recession and Policy Response

As stated earlier, the present global recession is the worst that the world is facing after the Great Depression of 1930s. Plummeting global output and trade in the last quarter of 2008 has brought the global economy to a standstill after years of remarkable growth, throwing millions of work. Global growth could be almost zero or even negative in 2009, and growth in developing economies is expected to fall sharply from the 6 per cent or higher rates of 2008. This reflects both a sharp decline in export demand from high-income economies and a major reduction in access to commercial finance and an increase in its cost. Thus, the overall global economic environment for business is gloomy.

The primary response to this crisis was given by the central banks of modern countries like America, Europe, England, Switzerland, Japan etc. This response was to provide deep liquidity as a supportive action. Central banks conducted extensive and significant activities to make the markets functional in these modern economies, among which fiscal policies were also important. Mutual coordination between the central bank and fiscal authorities was essential for this entire process.

This was a transitional period for China's leadership, with questions being raised about government policies and the new leadership's ability to cope with the economic challenges. It is interesting that outgoing President Hu Jintao had set a goal of doubling China's GDP growth rate from 2010 to 2020. To achieve this goal, it was necessary to adopt reformist policies to achieve sustainable development in relation to geographical challenges.

The Japanese scenario remained relatively weak and fragile. The recession in Europe till the second half of 2013 also had a negative impact on the exports of the

Japanese economy. The policies of the then Japanese government not supporting development was also a reason.

While the global economy was on the path of recovery and restoration, the negative side of India was the increase in risk hazards. In the current year's gross growth rate, India registered an average growth of 5.4% in the first half and this growth rate may increase further by the end of the year. The implementation of the current reforms and their widespread success raises hopes of returning the economy to pre-crisis levels.

1.4.3 Dominance of MNCs in the Global Trading System

At present the global economy is dominated by 40,000 corporations. The activities of these enterprises cross national boundaries. These firms operate in overseas markets through some 2,50,000 foreign affiliates. According to an estimate of the Washington based Institute for Policy Studies (IPS) the top 100 of these global firms account for a growing share of the world's economic

activity. Illustrating the growing economic clout of the global giants the IPS report states that out of the 100 largest economies in the world, 51 are corporations; only 49 are countries. Wal-Mart the number 3 corporation is bigger than 161 countries including Greece, Poland and Israel, Mitsubishi is larger than the fourth most populous nation on earth i.e., Indonesia, Toyota is bigger than Norway, General Motors is bigger than Denmark and Ford is bigger than Portugal.

In their capital structures, size and strategies, top 200 mega corporations are neither homogeneous nor are the individual rankings immutable. Over the last two decades there has been a sharp differentiation within the top 200 and, therefore, their respective rankings have shifted; several have been pushed to the wall, gobbled through mergers and acquisitions. Presently, the number of US firms in the top 200 mega corporations is 61 while the number of Japanese firms is 25. Switzerland, a relatively small country, has 5 in the top 200 corporations. Companies of many developing countries have also penetrated the top 200 corporations. These include Korea, China, India, Malaysia, Mexico, Saudi Arabia, Thailand, Turkey, etc.

At present, one-third of the world trade is simply in the form of transactions among various units of the same corporation. These corporations are net job-destroyers. The total employment provided by top 200 mega corporations is only 18.8 million which is

just 0.75 per cent of the world work force. The world's largest 500 firms have shed over 4,00,000 workers yearly notwithstanding the upsurge in their revenue. This strategy of revenue maximisation with cost reduction looks wonderful at the firm level. However, when all firms presume this policy, it leads to a drastic reduction in aggregate demand which eventually causes recession. The corporate managers ignoring this basic principle of macroeconomics have actually pushed the global economy into a recessionary situation. The giant corporations with massive resources at their command, in the face of falling demand, are engaged in ruthless competition with relatively smaller companies. Peter F. Drucker has rightly pointed out that medium and small businesses also operate in the world economy and they are not always visible. These firms in the prosperity phase of the business cycle grow and generate substantial revenues. However, with the onslaught of global recession their existence is threatened. In this period no goal setting, no vision and no strategy will help these small corporate enterprises in their growth pursuit.

1.5 Indian Business Environment

Business Environment consists of all those factors that have a bearing on the business. The survival and success of a business firm depend on its innate strength – resources of its command – and its adaptability to the environment and the extent to which the environment is favourable to the development of the firm. The survival and success of a firm, thus, depend on two sets of factors, viz., the internal factors – the internal environment – and external factors - the external environment. However, the term business environment often refers to the external factors. The external environment has, broadly, two components, viz., business opportunities and threats to business, similarly, the organizational environment has two components: strengths and weaknesses of the organization. As the company, generally, has control over; the internal factors, they are generally regarded as controllable factors because it can alter or modify such factors as its personnel, physical facilities, organization and functional means, such as marketing mix, to suit the environment. The external factors, on the other hand, are, by and large, beyond the control of a company. The external or environmental factors such as the economic factors, socio-cultural factors, government and legal factors, demographic factors, geo-physical factors etc., are, therefore, generally regarded as uncontrollable factors. Those external factors which have a direct and intimate impact on the firm (like the suppliers and distributors of the firm) are classified as micro environment, also

known as task environment and operating environment. There are other external factors which affect an industry very generally (such as industrial policy, demographic factors etc.). They constitute what is called macro environment, general environment or remote environment.

India is today a land of business opportunities and a perfect destination for new ventures. New business opportunities in India are enormous and ever growing. India is emerging market and among the hottest destinations in the World today. For starting a business in India or starting a new company in India, it is mandatory for foreign investors to obtain government of India approval. Foreign investors can start a new company or business in the form of Company incorporation in

India, or forming a joint venture in India. Major laws that affect the growth of foreign investments in India are Foreign Exchange Management Act 1999 (FEMA), the Companies Act 1956, the Industrial Act 1951, the New Industrial Policy of 1991 (NIP). Business set up in India requires proper legal advice to ascertain the eligibility and applicable restrictions. The foreign investors can start a business in India in various forms such as Branch office, Liaison office, or Project office.

India's business environment has improved considerably after the initiation of economic reforms in early 1990s. Domestic and foreign investors are finding it easier to do business after the reforms, which are aimed at reorientation of the centrally-controlled economy to a market-oriented one in order to foster greater efficiency and growth. This is being done by introducing greater competition in the economy through progressive internal deregulation accompanied by foreign direct investment and trade liberalization. However, the turmoil which surfaced in the US financial system has also adversely hit the Indian economy. Compared to other emerging economies, India has several strengths that can help mitigate the adverse effects of the global economic crisis. In spite of the global meltdown, Indian economy offers ample opportunities for business, both to the domestic and foreign entrepreneurs.

1.5.1 Indian Economy

The Indian economy is a mixed economy. It acquired this form with the adoption of economic planning and growth of a large public sector since Independence. In India, the Second Five Year Plan summed up the objectives of planned economic development in the phrase “socialist pattern of society” implying that “the basic criterion for

determining lines of advance must not be private profit, but social gain...” and yet the character of the economy that has emerged as a result of planned development does not resemble even remotely socialism. Nationalization of banks, setting up a number of enterprises in the public sector and such other measures may create an illusion that the economy has advanced towards socialism but in fact socio-economic relations have not undergone any such change as to warrant the conclusion that the Indian economy has drifted away from its capitalist form. The main features of India’s economy that determine its character as a mixed economy are as follows:

1. Private ownership of the means of production. Under Indian Constitution private ownership of the means of production has been allowed. It is this reason why the private sector in this country remains pervasive. The share of the public sector in the total national output is less than 25 per cent.

2. Predominance of the market holds a predominant position in the Indian economy. At present this country has markets for commodities as well as productive factors. In these markets prices are determined by the interplay of demand and supply forces. Business firms guided by the product prices usually decides as to what commodities they will produce. Even the choice of inputs depends on their prices. However, the market mechanism in India has not been completely free from the State control. In 1951, Industries (Development and Regulation) Act was passed to provide a regulatory system for industrial activity in the country. Apart from the licensing system, the government also introduced certain other controls and incentive measures for influencing the decisions in the markets. Among these, most notable were import controls, distribution of essential goods at fair price shops and government purchase of agricultural products at support prices. These controls and incentive measures, however, do not alter the basic character of market mechanism. Their importance lies only in their capacity to undermine the irrationality of certain market decisions by changing them for the better.

3. Growth of private sector monopolies. Since Independence, monopoly houses have grown rapidly and with it the concentration of economic power in the country has increased. This trend was first noted by the Committee on Distribution of Income and Levels of Living chaired by P.C. Mahalanobis. Since then, monopoly trends appear to have become stronger and the grip of big business on the economy seems to have increased, in spite of the governmental measures to control them.

4. Public sector. In India, a large public sector co-exists with the private sector and this fact alone is enough to determine the character of the economy as mixed. The creation of a large public sector by the government in the country has not been inspired by any ideological considerations. At the time of Independence the private enterprise lacking both resources and will to make heavy investments had expected from the government to develop infrastructure and basic capital goods industries. The government's intervention in the form of expansion of public sector was thus a historical necessity and it did not aim at altering the character of the economy.

5. Economic planning. Economic planning has been an integral part of the Indian economy since 1951. The nature of economic planning in India has always been different from the one adopted in former Soviet Union and other East European countries. This country adopted planning while retaining its capitalistic structures, whereas former Soviet Union and other East European countries had transformed their economies into socialist economies and the planning was an important instrument in this exercise.

The Indian experience shows that the mixed economy framework is a feasible proposition for a developing country as it allows for a modest rate of growth, which is both steady and less subject to fluctuations in the economic activity at the international level.

1.5.2 Macroeconomic Scenario

The macroeconomic scenario of the Indian economy as a robust macroeconomic scenario is a sine qua non of expansions in business activity. For this purpose, we have examined the rate of economic growth in recent years, industrial growth trends, saving and investment growth in recent years, prices and inflation, fiscal imbalances in the economy, recent capital market trends and trends in the external sector of the economy. We have also discussed the economic slowdown during the financial year 2008-09 elaborately (Which has been mainly a result of global recession) in a separate section further in this unit as this is bound to affect the business confidence and activity in the financial year 2009-10.

1.5.3 Fluctuations in Economic Growth

The CSO has released a new series with 1999-2000 as base for the entire period of planning. According to this series, GDP rose at the rate 6.5 per cent per annum over the

Eighth Plan Period (1992-97). However, this rate of growth fell to only 5.5 per cent per annum during the Ninth Plan (1997-2002). This slipped to 3.8 per cent in 2002-03 largely because of setback to the agricultural sector. In fact, the agricultural sector had grown at an annual rate of 3.5 per cent during the early 1990s. This naturally supported industrial growth. However, since 1995-96, agricultural growth has been both slow and erratic. It was a mere 0.2 per cent in 1995-06 and shockingly negative in 1997-08. 2000-2001 and 2002-03. In terms

of composition, despite good monsoons, the average growth of agricultural production for the 1990s (1992-2001) was 2.5 per cent compared to 3.5 per cent in the 1980s (1981-90). A mere 1.2 per cent per annum increase in food grains output during 1990s led to an annual increase of 5.0 per cent in food grains prices since 1995-96. In an agrarian economy when prices of food grains increase rapidly, demand for manufactured goods fails to expand at a rate that would make industrial growth buoyant. During the latter half of the 1990s this was precisely India's experience. However, economic growth picked up during the Tenth Plan period (2002-07) and the rate of increase in national income in this plan was as high as 7.8 per cent per annum. The rate of growth of GDP rose further to 9.0 per cent in 2007-08. This created a conducive business environment and there was an all round optimism. However, following global recession, there was a marked slowdown in the economy during the year 2008-09. Most of the international agencies and economic analysts predicted that the rate of growth in this year would be around 5 to 5.5 per cent. The figure of 6.7 per cent presented by Economic Survey, 2008-09, for this year is definitely more than these predictions but is much less than the rate of economic growth registered in 2007-08. In fact, there was considerable slowdown in business activity in this year as business confidence had hit a low ebb. As a result, recruitment levels fell considerably and in many sectors across the economy, there was large-scale retrenchment of employees.

1.5.4 Erratic Industrial Growth

Since 1996-97 industrial growth in this country has been erratic. The rate of industrial growth had collapsed to 5.6 per cent in 1996-97 from 12.12 per cent in 1995-96. It was 6.7 per cent in 1999-2000 but registered a further decline to 5.0 per cent in 2000-01 and to 2.7 per cent in 2001-02. There was some recovery in 2002-03. However, industrial growth remained modest at 5.8 per cent. In 2002-03, the industrial production increased by 7.0 per cent. During Ninth Plan as a whole, the rate of growth of industrial production

averaged just 5.0 per cent. This rose considerably to 8.2 per cent per annum in the Tenth Plan (which was nevertheless less than the target of 10 per cent per annum). The year 2007-09 recorded 8.5 per cent growth in industrial production. However, this growth slipped to just 2.7 per cent in 2008-09.

This is without doubt a mixed picture of the industrial sector. It seems that a deceleration in exports, reduction in consumer demand due to growing income inequalities and low growth of rural incomes, slow down in industrial investment and infrastructural bottlenecks contributed most to the erratic nature of industrial growth. The last few years have witnessed a sharp fall in exports of manufactured goods due to both domestic and external factors. An overvalued exchange rate and infrastructural bottlenecks made India's exports non-competitive. Further, steep fall in demand for Indian goods from Russia and East European countries and global recession caused major setback to our exports. In this difficult situation, the relatively cheaper imports but competitive pressure on several industries like steel, electronics and chemicals forcing them to cut-down their production.

There has been a significant decline in industrial investment in many years since 1996-97. This steep fall in industrial investment led to a decline in the rate of industrial growth. Not only this caused a slow down in capacity expansion which constrained increase in industrial production, but it also adversely affected the demand for manufactures due to low income generation in the industrial sector.

Community, social and personal services sector includes government administration and defence, community, social and personal services. In fact, the largest contribution to GDP growth during the last few years has come from the service sector taken as a whole. Obviously, growth in the services sector does not add to the material output of the economy and thus weakens the fundamentals of the economy. Likewise, the growth of income of financial services, most importantly the higher income arising from interest rate increases and the increase in trading income arising from profiteering in period of temporary shortages do not improve the fundamentals of the economy. Shankar Acharya has rightly argued, "Services are hugely important, but they cannot, by themselves, assure rapid and sustained growth of the Indian Economy."

1.5.5 Savings and Investment Growth in Recent Years

The gross domestic savings rate failed to increase during the 1990s. It was 22.8 per cent in 1990-91. Thereafter for three years it continued to decline and in 1993-94 was at a level reached in 1978-79. The recovery started in 1994-95 and for two years the gross domestic savings rate fluctuated around 25.0 per cent.

Thereafter it declined again to 23.5 per cent in 2001-02. However, since 2002-03 it registered a spectacular increase. According to CSO's estimate, the gross domestic savings rate was as high as 29.8 per cent in 2003-04 and this rose further to 37.7 per cent in 2007-08. Validity of these estimates has been doubted.

Gross domestic capital formation has been generally higher than gross domestic savings by 1.2 per cent of GDP. Foreign capital inflows bridged this investment savings gap. Domestic capital formation which was 25.3 per cent of GDP in 1997-98 declined to 22.8 per cent of GDP in 2001-02. CSO's estimates for 2002-03 and subsequent years indicate spectacular increase in gross domestic capital formation. According to these estimates, the rate of investment was 25.2 per cent in 2002-03, 32.1 per cent in 2004-05 and as high as 39.1 per cent in 2007-08. Much of this increase is attributable to a rise in the rate of investment by the corporate sector (capital formation in the private sector was 16.6 per cent of GDP in 2001-02 and this rose to 28.5 per cent of GDP in 2007-08). According to Economic Survey 2008-09, "the rise in the rate of investment has been on account of various factors, the most important being the transformation in the investment climate, coupled with an optimistic outlook for the growth prospects of the economy." However, R. Nagaraj has recently pointed out that the main reason for the rapid increase in capital formation in the private sector has been the defective method of estimation. As far as investment in infrastructure is concerned, it has remained low. Investments by non-resident Indians and foreign institutional investors have largely gone to the corporate sector. But there is also evidence to suggest that a sizeable part of these "investible resources have been used for trading existing capital stock leading to speculative activities. Such asset price bubbles certainly do not augur well for the economy's real sector in the long-run".

1.5.6 Prices and Inflation

Inflation is conventionally estimated in terms of movement of wholesale prices. However, from the point of view of the consumers, retail prices are far more relevant and thus inflation is to be measured in terms of consumer price index. In India, presently,

apart from Wholesale Price Index (WPI), three different indices of consumer prices are available. These are Consumer Price Index for Industrial Workers (CPI-IW). Consumer Price Index for Urban Non-Manual Employees (CPI-UNME) and Consumer Price Index for Agricultural Labourers (CPI-AL). During 2005-06, the average annual rate of inflation (based on WPI) was 4.4 per cent while it was 5.5 per cent in 2006-07. Towards the last quarter of 2007-08, inflationary pressures started building up and the inflation rate rose to 8.02 per cent in March 2008. The inflation rate touched the high level of 12.6 per cent on August 9, 2008. However, during the last quarter of the financial year 2008-09, the inflation rate started coming down due to declining commodity prices and crude oil prices. For the week ended April 4, 2009, inflation rate dropped to just 0.18 per cent. Thus, the inflation rate based on WPI touched almost zero level.

It is generally argued that as compared to Wholesale Price Index, Consumer Price Index for Industrial Workers CPI(IW) is a more appropriate index to determine the impact of price rise on the cost of living of the common man. The CPI (IW) is measured on the basis of retail prices and is used to determine the dearness allowance of employees in both the public and private sectors. Annual point to point CPI (IW) inflation declined from 5.1 per cent per annum in April 2003 to 2.2 per cent in April 2004. CPI(IW) inflation rate began rising in April 2004 and reached 6.3 per cent per annum in December 2006. The CPI (IW) annual average inflation rate for the year 2007-08 was 6.2 per cent which rose to 9.1 per cent in 2008-09.

1.5.7 Fiscal Imbalance

Fiscal imbalance has persisted over the years in the form of large government deficits. Although concepts of revenue deficit and primary deficit are very much relevant to understand the malaise in the government finance, lately main attention is being given to fiscal deficit. This approach is not entirely correct and therefore in our discussion we shall refer to estimates of other deficits as well. The gross fiscal deficit refers to the difference between the revenue receipts (net) plus non-debt capital receipts and the total expenditure including loans net of repayments. Non-debt capital receipts arise from the sale of assets. In the present case, such receipts arise from the sale of government equity in public sector enterprises. According to Arun Ghosh et al., “This is not only odd, it is accounting fudge, and by taking a capital receipt into the revenue account as a normal receipt, we are violating all canons of accounting honesty.” This criticism of the concept of gross fiscal deficit is valid. Nonetheless with all its limitations, estimates of gross

fiscal deficit in India reveal the quantum of fiscal imbalance. Gross fiscal deficit of the Central government was 7.8 per cent of GDP in 1990-01. This was certainly unsustainable and thus should have been brought down. Reduction in fiscal deficit to a sustainable level actually formed a significant component of the economic reforms limited in 1991. As a result, gross fiscal deficit was brought down to 4.5 per cent of GDP in 2003-04. The government adopted the FRBM Act in 2004 committing itself to fiscal discipline and brought down the gross fiscal deficit to 3.5 per cent of GDP in 2006-07 and 2.7 per cent of GDP in 2007-08. However, the gross fiscal deficit rose to as high as 6.2 per cent of GDP in 2008-09 as government introduced massive expenditure programmes to tackle the problem of economic slowdown.

Revenue deficit of the Central government was 2.5 per cent of GDP in 1991-92 and this rose to 3.5 per cent of GDP in 1990-2000 and further to 4.4 per cent of GDP in 2001-02 (revenue deficit refers to excess of current expenditure over current revenue). Following the adoptions of the FRBM Act, it was reduced to 1.9 per cent of GDP in 2006-07 and further to 1.1 per cent of GDP in 2007-08. However, due to massive expenditure in 2008-09, revenue deficit rose to 4.4 per cent of GDP in 2008-09.

Primary deficit is computed by deducting interest payments from fiscal deficit. It thus reflects the borrowings of the government to meet expenditures other than interest payments. The primary deficit of the Central government was 4.1 per cent of GDP in 1990-91 and just 0.4 per cent of GDP in 2005-06. It was negative in 2006-07 and 2007-08. However, it rose to 2.5 per cent of GDP in 2008-09.

1.5.8 Capital Market Developments

Capital market plays a crucial role in fund raising by the corporate sector. In 2001-02, the Indian private sector companies raised Rs. 5,692 crore through capital issues. This amount rose to Rs. 21,154 crore in 2005-06, Rs. 30,603 crore in 2006-07 and further to Rs. 63,638 crore in 2007-08. Capital issues consist of two parts – shares and debentures. Prior to 1992-93, debentures were a more popular means of raising long-term funds and provided almost 70 per cent or more resources raised through new capital issues. However, there has been a drastic change in recent years. For example, in 2004-05, 87.6 per cent and in subsequent years, almost the entire resources have been raised through shares. This reflects the soundness of the secondary market (the stock exchanges) on the

one hand, and the willingness of the investors to invest in the private sector companies on the other hand.

The following factors are the main contributors to the development of institutional market:

1. Progress and development of development banks and financial institutions:-

In 1948 to provide long term loans to industries The government established the IFCI, followed by ICICIC in 1955, IDBI in 1964, IRCI in 1971, FIPB in 1991, OTCEI in 1992 etc. Major Institutes were established. In 1969, 14 banks were nationalized and in 1980, 6 banks were nationalized again. These financial institutions and banks have made a significant contribution in strengthening the capital market.

2. Establishment of SEBI :-

SEBI was established in 1988 and it was given statutory form in 1992.

3. Credit Rating Agency:-

Credit rating agencies provide guidance and advice to investors regarding credit risk. CBRPs were established in 1988 and CBRPs were established in 1991 for this very purpose. These institutions also contribute to the development of the capital market.

4. Development of Mutual Funds:-

Through Mutual Funds, funds are collected through various investors and invested in the primary and secondary markets in the form of corporate investment. The first mutual fund was established in 1964 by the Unit Trust of India.

5. Increase in Knowledge:-

In the last few years, there has been an increase in the knowledge and inclination of the people towards investment opportunities. Business newspapers and financial magazines (eg. Economic Times, Financial Express, Business India etc.) Through Indian news and TV channels like CNBC, ZEE, BUSINESS, BLOOMBERG, etc.), consumers get latest information regarding securities market and long term investment.

6. Increasing trust of the public:-

Various big corporate institutions have shown impressive performance in the field of development, due to which the public's trust in them has strengthened. Apart from this, small investors have also become inclined towards debentures and shares.

7. Constitutional measures:-

The government has the right to develop and regulate the corporate sector through the Companies Act 1956 which is amended by the government from time to time as per the need. Apart from this, various other acts are also in operation to protect the interests of the regulators.

8. Development of underwriting business:-

The developing underwriting business has contributed significantly to the confidence of the capital market.

10. Development of Risk Capital Fund:-

After the process of economic liberalization after 1991, such institutions which have the development potential but are unable to raise capital from the primary market due to various reasons, Investments can be obtained from various foreign, domestic and banks from individuals and institutions who invest in high risk projects in the hope of higher rate of return.

11. Development of Multinational Companies:-

For the purpose of setting up and expanding new projects, multinational companies require medium and long term funds for which they collect funds through banks and foreign investors. The presence of multinational companies has boosted the capital market.

11. Growth of Entrepreneurs:-

Since 1980, there has been a significant increase in the number of entrepreneurs. This has created a demand for medium and long term funds. Foreign investors, banks and securities markets provide opportunities to provide funds to entrepreneurs, which has increased the development of the capital market.

12. Development of Merchant Banking:-

Grindlays Bank started merchant banking facilities in 1967 and Citibank in 1970. Apart from managing capital issuance, merchant banks also provide advisory services and other services to the corporate sector in connection with various projects.

After 1991, extensive efforts have been made at the government level regarding the reforms and development measures implemented for the development of the capital

market, which have taken the capital market to new heights. These major and important measures are as follows-

1. Securities and Exchange Board of India (SEBI)
2. National Stock Exchange (NSE)
3. Dematerialisation of Shares (DMS)
4. Frontline Trading
5. Protection of Investors
6. Cyclical Performance
7. Clearing Corporation of India Ltd. (CCIL)
8. National Securities Clearing Corporation Ltd. (NSCL)
9. Trading in Central Government Securities
10. Credit Rating Agencies
11. Assessment of Global Fund Markets
12. Mutual Funds
13. Internet Trading
14. Derivative (IPO) Trading
15. Repurchase of Shares
16. Legal Requirements PAN & KYC

1.5.9 External Sector

India's external trade position looked satisfactory in the first half of the 1990s. In fact, in the mid 1990s for three years when exports registered an impressive growth (in the range of around 20 per cent per annum) several policy makers argued that the strategy of export led growth was going to put this country in the company of Asian Tigers. However, all this changed during the three years since the middle of 1996. The export trends for India were rather disappointing. Imports in this period were restrained because of the domestic industrial recession. Nonetheless, the trade balance worsened and the trade deficit amounting to \$9,170 million in 1998-99 was extremely worrisome. There was a sense of urgency on the trade front due to 5.1 per cent decline in exports in dollar terms in 1998-99. The causes of the export decline were not clearly established. The official policy makers attributed most of the decline in exports in 1998-99 to external factors such as the general lack of recovery in the world trade after 1996, the economic slowdown in developed countries, especially Japan and Germany and the dramatic depreciation of the currencies of several East Asian countries.

However, exports have shown considerable growth during the Tenth Plan period. From \$52.719 million in 2002-03 (the first year of the Tenth Plan) exports rose to \$1,26,414 million in 2006-07 (the last year of the Tenth Plan). The average rate of growth of exports during this Plan has been 24 per cent as against the target of 12.38 per cent. Exports rose further to \$1,68,704 million in 2008-09. Both external and domestic factors have contributed to this satisfactory performance. Improved global growth and recovery in world trade aided the strengthening of Indian exports. As far as domestic factors are concerned, the opening up of the economy and corporate restructuring has enhanced the competitiveness of Indian industry. There has been substantial increase in earnings from invisibles in recent years. This has enabled the country to register surplus in current account in three years in a row 2001-02, 2002-03 and 2003-04. The net capital inflows have also increased considerably. As a result, there has been a large build-up of foreign exchange reserves. However, the increased dependence upon relatively hot money flows such as portfolio investment and short term credits has become a cause of concern because reversals can suddenly occur. The government thus maintains a very high level of foreign exchange reserves. They touched \$316 billion in May 2008. However, the experience of other countries suggests that even such a high level of reserves may not be adequate to ward off crises in the face of determined speculative pressure.

1.5.10 Economic Slowdown in 2008-09

The global financial crisis surfaced around August 2007 and its origin lay in structured investment instruments (Collateralised Debt Obligations) created out of subprime mortgage lending in the United States. The securitization process, however, was not backed up due diligence and led to large-scale default. The complexity of the instruments and the role of credit rating agencies played a contributory role. The high ratings assigned to certain CDO tranches, which were then quickly reversed with the onset of the crisis, created a panic situation among investors and precipitated the crisis. The collapse of the Lehman Brothers in mid-September 2008 further aggravated the situation leading to a crisis of confidence in the financial markets. A pronounced recession is believed to have begun in mid-2008 in Europe, Japan and USA. This recession is projected to extend into 2009.

The effect on the Indian economy was not significant in the beginning. The initial effect of the subprime crisis was, in fact, positive, as the country received accelerated FII (foreign institutional investment) flows from September 2007 to January 2008. This

contributed to the debate on “decoupling”, where it was believed that the emerging economies could remain largely insulated from the crisis and provide an alternative engine of growth to the world economy. The argument soon proved unfounded as the global crisis intensified and spread to the emerging economies through capital and current account of the balance of payments. The net portfolio flows to India soon turned negative as foreign institutional investors rushed to sell equity stakes in a bid to replenish overseas cash balances. This adversely affected the stock market and the exchange rates through creating the supply-demand imbalance in the foreign exchange market. The current account was affected mainly after September 2008 through slowdown of exports. In fact, export growth turned negative in October 2008 and remained negative till the end of the financial year. The continued decline in export growth was due to the recessionary trends in the developed markets where the demand had plummeted. Decline in export growth adversely affected the industrial growth as well. In fact, most of the sectors of the economy (whether linked to the global economy or not) witnessed a marked slowdown in the year 2008-09.

1.6 Globalisation in India

Globalization in India is generally taken to mean integrating the economy of the country with the world economy. This, in turn, implies opening up the economy to foreign direct investment by providing facilities to foreign companies to invest in different fields of economic activity in India; removing constraints and obstacles to the entry of MNCs in India (through dilutions and ultimate scrapping of restrictive laws like FERA); allowing Indian companies to enter into foreign collaborations in India and also encouraging them to set up joint ventures abroad; carrying out massive import liberalization programmes by switching over from quantitative restrictions to tariffs in the first place (so that there is more ‘transparency’ in import policy), and then bringing down the level of

import duties considerably; and instead of a plethora of export incentives (like duty drawbacks, cash compensatory support, replenishment licenses and other fiscal incentives, etc.) opting for exchange rate adjustments for promoting exports.

1.6.1 The ‘Push’ Towards Globalization

The period after 1980-81 in India was marked by severe balance of payments difficulties. The second oil shock in 1979-80 which was the result of a steep hike in oil

prices by OPEC countries (from around \$ 13.00 per barrel in late 1978 to around \$ 35.00 per barrel in 1979) pushed up India's import bill substantially while exports lagged considerably behind. Thus trade deficit rose to astronomical heights. During Seventh Plan private remittances also showed a tendency of flattening out. As a result, net invisibles could finance only 24 per cent of trade deficit in the Seventh Plan. The problems were compounded by the Gulf War in 1990-91. Trade deficit in this year soared to Rs. 16,934 crore and invisibles also recorded negative earnings. As a result, current account deficit was as large as Rs. 17,369 crore in 1990-91. The problem got further accentuated by India's increased reliance on high cost external commercial borrowings and non-resident deposits all through the 1980s as the flow of concessional assistance was considerably less than the requirements. Much of this borrowing on commercial terms was in the form of relatively short-term and potentially volatile instruments increasing the vulnerability of Indian economy to changes in investors' confidence and expectations. With the downgrading of India's credit rating by some international agencies consequent upon the large deficit in India's balance of payments in 1990-91 and the political uncertainties at home, the investors' confidence in the Indian economy was shaken suddenly and there was a substantial capital outflight. For example, over the period October 1990 to the second quarter of 1991, over \$ 300 million per month were withdrawn from the NRI deposits. Despite drawing \$ 1.8 billion from the Contingency Compensatory Financing Facility (CCFF) in January 1991, adopting import compression measures, and pledging gold abroad, the crisis could not be stemmed. Foreign exchange reserves dwindled to \$1.1 billion in June 1991 – less than sufficient for two weeks of import requirements. Default on debt servicing appeared imminent and the Government of India was pushed to the wall. Default could be avoided only if credit was made available from the IMF or the World Bank. Assistance was indeed made available by these institutions but on their own terms and conditions. These terms and conditions entailed the adoption of a 'stabilisation and structural adjustment programme' by India.

The above discussion shows that the conditions that prevailed in 1990 and 1991 'pushed' India into adopting the structural adjustment programme of the IMF and World Bank. Since globalization is a part of the structural adjustment programme, it is rightly said that it were the desperate conditions of 1990 and 1991 that 'pushed' India towards globalization.

1.6.2 Steps towards Globalization

The main policy measures initiated towards globalization by the Government of India can be discussed under the following headings:

1.6.2.1 Exchange Rate Adjustment and Rupee Convertibility

The most important measure of integrating the economy of a country with the global economy is to make its currency fully convertible, i.e., allow it to determine its own exchange rate in the international market without official intervention. This measure has to be accompanied by the lifting of exchange control measures in a phased manner. As a first step towards this measure, the IMF insisted on devaluation of the Indian. Accordingly the Government of India make a two-step downward adjustment of 18-19 per cent in the exchange rate of the rupee on July 1, and 3, 1991. Therefore, the first important condition laid down by the IMF for the grant of assistance was met.

In the subsequent years, the Government of India has progressively moved forward towards full convertibility. 'Export-Import Policy and Trade Liberalisation' the 1992-93 Budget introduced a dual exchange rate system implying partial convertibility of rupee. The 1993-94 Budget introduced full convertibility of the rupee on trade account and switched over to a unified exchange rate system. India achieved full convertibility on current account on August 19, 1994. Current account convertibility has been defined as the freedom to buy or sell foreign exchange for the following international transactions: (i) all payments due in connection with foreign trade, current business, including services, and normal short-term banking and credit facilities; (ii) payments due as interest on loans and as net income from other investments; (iii) payments of

moderate amount of amortization of loans or for depreciation of direct investments; and (iv) moderate remittances for family living expenses. The Reserve Bank accepted obligations under Article VIII of the IMF, under which India is committed to forsake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments. Many other relaxations of restrictions were announced in subsequent years.

1.6.2.2 Import Liberalization

In its Report India: Strategy for Trade Reform released in 1990, the World Bank had advocated redesigning of the import policy so that there is only one negative (restricted)

list and imports of all items not explicitly on the restricted list are allowed, lowering of import tariffs on all goods, and freer entry to capital goods, intermediate goods, raw materials and consumer goods into the Indian economy. In line with these proposals, the 1992-97 export-import policy allowed the free import of all items including capital goods, except a negative list. The supplementary trade policy announced on August 13, 1991 decanalised the import of 20 items. In addition, import duties on a wide range of commodities were drastically cut down. For instance, customs duties on 35 items were slashed from 255 per cent ad valorem to 150 per cent ad valorem on February 9, 1993. This was followed by substantial reduction of import duties in the 1993-94 Budget. For example, the Budget reduced the import duty on a number of capital goods by 20 to 30 percentage points. Duties on a host of other commodities were also reduced. In fact, the maximum rate of duty on all goods was reduced from 110 per cent to 85 per cent except for a few items including passenger luggage and alcoholic beverages. The maximum rate of import duty has been reduced in successive Budgets in stages. The peak import duty on non-agricultural goods is now only 10 per cent.

In addition to the phased reduction of import duties, India, as a member of World Trade Organisation (WTO), had also committed itself to the phasing out of quantitative restrictions over a six-year period beginning 1997. This period was further reduced following the ruling of the Disputes Settlement Body of the WTO against India on an appeal made by the USA. In terms of the agreement arrived at with USA, the quantitative restrictions have now been totally removed. Moreover, as a part of the Agreement on Trade Related Intellectual Property Rights (TRIPs), the Patents (Amendment) Act, 1999 was passed in March 1999 to provide for Exclusive Marketing Rights (EMRs). This was followed by the adoption of Patents (Amendment) Act, 2002, in May 2002 and Patents (Amendment) Act, 2005. The stock argument in favour of import liberalization is that competition from imports would improve efficiency, quality and technology besides making international quality capital goods and inputs available to our export industries (hence increasing their competitive strength in the international markets).

1.6.2.3 Opening up to Foreign Capital

In a bid to attract foreign capital and integrate the Indian economy with the global economy, the Government of India has thrown open the doors to foreign investors. Various incentives and facilities have been offered to the foreign investors and non-resident Indians in the new economic policy. In 1991, the government announced a

specified list of high technology and high-investment priority industries (listed in Annexure III) wherein automatic permission was granted for direct foreign investment upto 51 per cent foreign equity. This limit was raised from 51 per cent to 74 per cent and subsequently to 100 per cent for many of these industries. Presently FDI is permitted upto 100 per cent on the automatic route in most sectors subject to sectoral rules/regulations, applicable. FDI is prohibited only in the following sectors: (1) retail trading (except single brand product retailing), (2) atomic energy, (3) lottery business, and (4) gambling and betting.

1.6.3 Effects of Globalization

1.6.3.1 Effects of the External Sector

The process of globalization initiated in 1991 and the far reaching changes in industrial and other policies have led to considerable changes on the external sector front. The Finance Minister in his Budget Speeches in 1994 and 1995 claimed the following achievements on the external front: (1) Our foreign currency reserves which had fallen to barely one billion dollars in June 1991 rose substantially to over 20 billion dollars on March 10, 1995; (2) Exporters are responding well to sweeping reforms of exchange rate and trade policies. This would be clear from the fact that as against a fall in the dollar value of exports by 1.5 per cent in 1991-92, the exports grew by over 17 per cent in the first 10 months of 1994-95. This follows a 20 per cent increase in 1993-94. Though imports also grew in line with the revival of the economy yet the balance of payments situation is comfortable; (3) The fears expressed in some quarters that our trade policy would generate a disruptive flood of imports and weaken our economy have been shown to be completely unfounded. Liberalisation and openness have actually increased our self-reliance. Exports now finance over 90 per cent of imports, compared to only 60 per cent in the latter half of the 1980s; (4) The current account deficit was over 3 per cent of GDP in 1990-91. It is expected to be less than 0.5 per cent in 1994-95 . (5) At the time of crisis, our external debt was rising at the rate of \$ 8 billion a year. In 1993-94, the increase in external debt was reduced to less than \$ 1 billion. In the first half of 1994-95, our external debt stock actually declined by almost \$ 300 million; (6) Contrary to what many feared, the exchange rate for the rupee has remained remarkably steady despite the introduction of full convertibility first on trade account and then on current account. Foreign exchange is flowing through legal channels in ample quantities instead of through illegal (hawala) channels as earlier; and (7) International confidence in India

has been restored. As a result, foreign direct and portfolio investment has increased rapidly in the last 3-4 years.

However, in 1995-96, the current account deficit, as a proportion of GDP, rose to 1.7 per cent from the level of 1.0 per cent in 1994-95. Yet, as noted by the Economic Survey 1996-97, there was no cause of alarm as the increased deficit was easily financed by a higher level of capital inflows and a reduction in foreign exchange reserves of US \$ 2.9 billion. Despite the reserve drawdown, the level of foreign currency assets at the end of 1995-96 was \$ 17.0 billion, which was quite comfortable. During 1996-97, the current account deficit was 1.2 per cent of GDP. This was significantly higher than the average accumulation of \$ 3.4 billion during 1991-92 to 1996-97. The balance of payments position in 1997-98 and 1998-99 also remained comfortable as the surplus in the capital account exceeded the deficit in the current account by a substantial margin, resulting in large accretion to foreign exchange reserves amounting to \$ 3.9 billion in 1997-98 and \$ 3.8 billion in 1998-99. The situation improved further in 1999-2000 and subsequent years. For example, reserve accumulation was \$ 6.14 billion in 1999-2000 and \$ 5.84 billion in 2000-01. Things were still better in 2001-02, 2002-03 and 2003-04 as there was a current account surplus in these years because of

strong positive earnings from invisibles (it was after a long gap of 24 years that a current account surplus was recorded, the last current account surplus having been registered in 1977-78). There was a substantial surplus on capital account also in these years. As a result of these two tendencies – surplus on current account and substantial inflows of capital – there was a large accretion to foreign exchange reserves of \$ 11.76 billion in 2001-02, \$ 16.98 billion in 2002-03 and \$ 31.42 billion in 2003-04. After registering surplus for three consecutive years, the current account again saw a deficit in 2004-05. This deficit was of \$ 2.5 billion. However, there was a substantial surplus of \$ 28.6 billion in the capital account with the result that there was an accretion of \$ 26.1 billion to foreign exchange reserves in 2004-05. Accretion to reserves in 2005-06 was \$ 15 billion. During 2006-07, the current account deficit stood at \$ 9.8 billion while surplus on capital account was as high as \$ 46.3 billion with the result that accretion to foreign exchange reserves was \$ 36.6 billion. During 2007-08, current account deficit rose to \$ 17.4 billion because of a massive trade deficit of \$ 90.00 billion. However, there was a surplus of as much as \$ 109.6 billion in the capital account with the result that the accretion to foreign exchange reserves was as high as \$ 92.2 billion (highest in

any year during the entire period of planning). As a result of substantial accretion to foreign exchange reserves for most of the post-reform period, the stock of foreign exchange reserves rose from only \$ 1.1 billion in June 1991 to as high as \$ 316 billion as on May 23, 2008 (though it fell to \$ 253.09 billion during the week ended April 24, 2009).

1.6.3.2 Effect on the Indian Enterprises

The process of globalization in India had led to an ‘unequal competition’ – a competition between ‘giant MNCs’ and ‘dwarf Indian enterprises.’ Even the large Indian enterprises are just pygmies compared to the multinational corporations and while some of them have already been gobbled up by the latter, some others are awaiting their turn with bated breath. As once noted by an MP from West Bengal, the globalization of the Indian economy is like integrating a mouse into a herd of elephants.

In the early euphoria of liberalization, the private sector welcomed the measures of the government but it soon came to realize that opening up the Indian economy to foreign competition meant more and cheaper imports, more foreign investment, opportunities to the MNCs to raid and take over their enterprises, and worse, their inability to meet the challenge from MNCs due to their weak economic strength vis-avis the MNCs. The first serious omens of discontent appeared when several top industries met under the initiative of Rahul Bajaj (the owner of the scooter manufacturing giant Bajaj Auto) in 1993 in Mumbai to voice their concern at the hasty exposure of Indian enterprises to the stormy gales of foreign competition. This particular group of businessmen came to be dubbed as the ‘Bombay Club’. Even the Confederation of Indian Industry (CII) which had all been supportive of MNC initiatives started feeling uneasy. Its Director General, Tarun Dass, sharply attacked the behaviour of foreign multinationals in India, particularly referring to their ‘cowboy’ approach toward their local partners. Addressing a CII national conference, EID Parry’s managing director M.V. Subbiah complained, “The multinationals have a strong financial power. They are buying Indian brands and gradually killing them. There should be some sort of regulatory mechanism to prevent this. The idea of inviting multinationals into India is to promote competition and not to build up monopolies by killing the Indian brands.” Another noted industrialist S.K. Birla argued that “Multinationals should not be allowed unfettered freedom in India. If the multinationals are allowed to hold a majority stake in Indian joint ventures in a unfettered way, Indian would be second class citizens in their own country.” Assocham

president H. Somany stated, “We would like to caution (against the predatory nature of foreign capital, sometimes manifesting in the form of hostile takeovers.”

1.7 Summary

Environment literally means the surroundings, external objects, influences or circumstances under which someone or something exists. The environment of any organization is the aggregate of all conditions, events and influences that surround and affect it. Environment refers to all external forces that have a bearing on the functioning of a business. Business Environment consists of all those factors that have a bearing on the business. The survival and success of a business firm depend on its innate strength – resources of its command – and its adaptability to the environment and the extent to which the environment is favourable to the development of the firm. The survival and success of a firm, thus, depend on two sets of factors, viz., the internal factors – the internal environment – and external factors - the external environment. For a long time, business in India was conducted in sheltered markets covering up inefficiencies; low productivity and high cost. Then came 1990s which lifted all protectionist measures.

Globalization in India is generally taken to mean integrating the economy of the country with the world economy. This, in turn, implies opening up the economy to foreign direct investment by providing facilities to foreign companies to invest in different fields of economic activity in India; removing constraints and obstacles to the entry of MNCs in India (through dilutions and ultimate scrapping of restrictive laws like FERA); allowing Indian companies to enter into foreign collaborations in India and also encouraging them to set up joint ventures abroad; carrying out massive import liberalization programmes by switching over from quantitative restrictions to tariffs in the first place (so that there is more ‘transparency’ in import policy), and then bringing down the level of import duties considerably; and instead of a plethora of export incentives (like duty drawbacks, cash compensatory support, replenishment licenses and other fiscal incentives, etc.) opting for exchange rate adjustments for promoting exports. The process of globalization unleashed in 1991 has ‘created’ a new world – a world in which not only there has been an inflow of substantial foreign capital, but the domestic corporate sector for the first time saw itself as the ‘target’ rather than the ‘beneficiary’ of the heightened activities of foreign investors.

1.8 Keywords

Environment: It refers to all external forces that have a bearing on the functioning of a business.

Business: A business also known as enterprise or firm is an organization engaged in the trade of goods, services, or both to consumers.

Globalization: It refers to the process or processes of international integration.

Liberalization: It refers to a relaxation of previous government restrictions, usually in areas of social or economic policy.

Macroeconomics: It is a branch of economics dealing with the performance, structure, behavior, and decision-making of the whole economy.

Inflation: In economics, it is a rise in the general level of prices of goods and services in an economy over a period of time.

1.9 Check Your Progress

1. literally means the environment, the external elements by which something or someone is surrounded or influenced.
2. first used the term globalization in his article titled 'Globalization in 1983'.
3. When fiscal expenditure exceeds fiscal receipts it is called fiscal
4. To provide long term loans to industries, the government established in 1948.

1.10 Answer to Check Your Progress

1. Environment 2. Theodore Levitt 3. Imbalance 4. IFCI

1.11 Terminal Question

1. State the characteristics of environment.
2. How does environment affect a business?
3. Explain in detail the main features of contemporary business.

4. Write a detailed note on the main elements of Indian business environment.
5. Describe the factors that drive Indian globalization.
6. Explain the main factors that enrich and strengthen Indian globalization.
7. Describe the effects of globalization in India.
8. “Study of environment is essential in present business.” Explain.
9. Is globalisation a challenge or an opportunity for Indian organisations?
Analyse.
- 1.10 Describe in detail the characteristics of global business environment.
- 1.11 Describe in detail the scenario of Indian business environment.

1.11 references

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UNIT 2 BUSINESS AND SOCIETY

Structure:

2.1 Introduction

Learning Objectives

2.2 Changing Concept and Objectives of Business

2.2.1 Values

2.2.2 Viability

2.2.3 Public Visibility

2.3 Environmental Issues

2.4 Energy Issues

2.4.1 Alternative sources of power:

2.5 Women and Business Opportunities

2.5.1 Women in Business

2.5.2 Problems of Female Employment

2.6 Child Labour

2.6.1 Why are children employed?

2.6.2 Universal Phenomenon Child labour

2.6.3 The Remedies

2.7 Rural Development

2.8 Projects and People

2.9 Physically handicapped

2.10 Acquired Immune Deficiency Syndrome (AIDS)

2.11 Social Audit

2.11.1 Meaning

2.11.2 Objectives and Benefits of Social Audit

2.11.3 Methods of Social Audit

2.11.4 Obstacles to Social Audit

2.11.5 Social Audit in India

2.13 Summary

2.14 Keywords

2.15 Terminal Questions

2.16 Answers to Self Check Questions and Terminal Questions

2.17 References

Objectives:

After studying this unit, you should be able to:

- Explain contemporary business definition and objectives
 - Recognize the issues in concern with the environment
 - Review the importance of women in business
 - Problems of Child Labour, Rural Development, Physically Challenged, etc
 - Describe the social audit
-

2.1 Introduction

The main aspect of the linkages between business and society includes, its immediate accountability to consumers, employees, owners and. In this unit, it is proposed to discuss the second part of social responsibility, namely, business's responsibility to society. Responsibility of business towards society includes such broad areas as concern for ecology, consumerism; improving the lot of women; rural development, new projects; physically handicapped people and fighting AIDS. Business may or may not have direct or day-to-day interaction with these interest groups. But business has obligations towards women, child labour, ecology and village development which are a part of society. The well-being of society is the well-being of business.

In this unit you will study object of business and its issues, Women and Business Opportunities, Rural Development, Social audit.

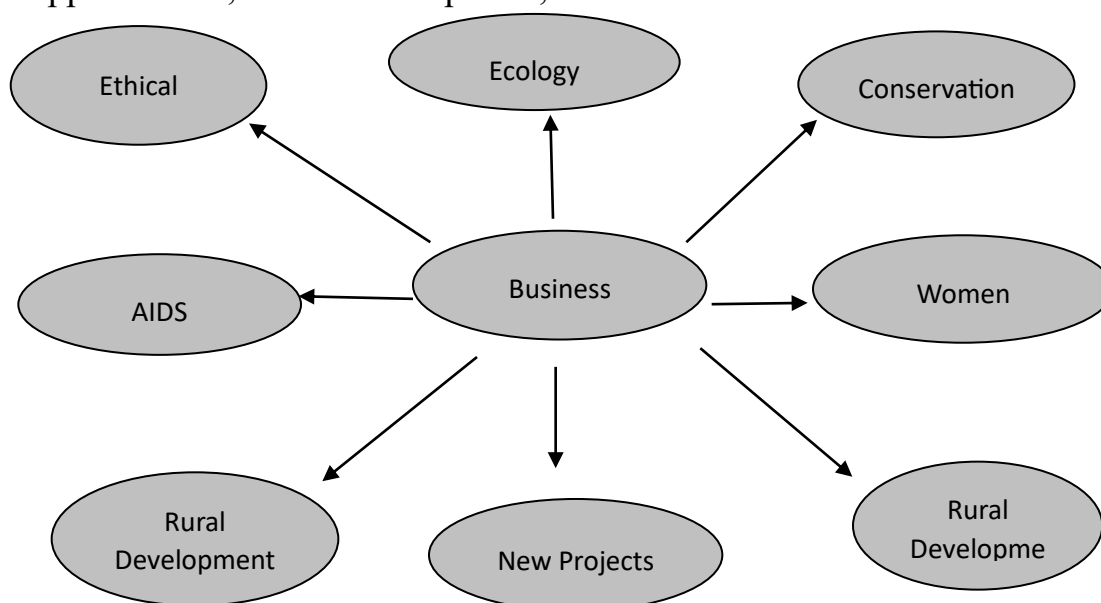


Figure 2.1: Business and Society

2.2 Changing Concept and Objectives of Business

Traditionally, the term business commonly referred to commercial activities aimed at making a profit or to organizations formed to make a profit. Indeed, in the past, economic theory made a fundamental assumption that profit maximization was the basic objective of every firm. The modern outlook, however, is different. For them, profit is only secondary. There are, more over, many organizations, both private and public, which do not aim at profit from their business. In short, the definition of a business as a commercial activity to make a profit or an organization formed to make a profit is a narrow one. Yet, to a layman, business still means industry and commerce.

The old concept of business, confining it to commerce and private profit, has undergone a radical change. Today, business is regarded as a social institution forming an integral part of the social system. As Davis and Blomstorm observe, business is “social institution, performing a social mission and having a broad influence on the way people live and work together”. As Calkins remarks: “It is now recognised that the direction of business is important to the public welfare, that businessmen perform a social function.”

Thus, “viewed in a broad way, the term business typically refers to the development and processing of economic values in society. Normally, we use the term to apply to the private (non-government) portion of the economy whose primary purpose is to provide goods and services to the customers at a price, but the lines of distinction are getting hazy as business and government overlap their functions in organisations such as the Communications, Satellite Corporation and the Tennessee Valley Authority. In addition, business is a term applied to economic and commercial activities of institutions having other purposes, such as the business office of an opera association.” Thus, organizations which do not aim of making a profit, like the Delhi Development Authority, charitable hospitals, or other institutions, public relations organizations, government departments, etc., invest capital, price and market their products, services or ideas, manage their human resources, and so on.

According to Davis and Blomstorm, “our modern view of society is an ecological one. Ecology is concerned with the mutual relations of human populations or systems with

their environment. It is necessary to take this broad view because the influence and involvement of business are extensive. Business cannot isolate itself from the rest of society. Today the whole society is a business's environment.

Davis and Blomstorm point out that, in taking an ecological view of business in a systems relationship with society, three ideas are significant in addition to the systems idea. The three ideas are values, viability and public visibility.

2.2.1 Values

Business, like other social institutions, develops certain belief systems and values for which they stand, and these beliefs, and values are a source of institutional drive. These values derive from a multitude of sources, such as the mission of business as a social institution, the nation in which a business is located, the type of industry in which it is active and the nature of its employees. These values become guides for employees' decisions in their interface of business. Second, they become strong motivators for people in a business.

2.2.2 Viability

Davis and Blomstorm define viability as the drive to live and grow, to accomplish the potential not yet reached, and to achieve all that a living system is capable of becoming. If a business is to be a viable, vigorous institution in society. It must initiate its share of forces in its own environment, rather than merely adjust to outside forces as a bucket of quicksand does. Every business needs a drive and spirit all its own to make it a positive actor on the social stage rather than a reactor or a reflector. To expect the business to be otherwise is to deny it the opportunities available to other institutions, the authors have pointed out.

2.2.3 Public Visibility

The term public visibility refers to the extent that an organisation's activities are known to persons outside the organization. Public visibility is different from the idea of a public image. The term public image refers to what people think about an organisation's acts, while public visibility refers to the extent to which its acts are known. The importance of public visibility is that it subjects business activities to public examination, discussion and judgement. If acts are not known, they cannot be judged.

In short, according to modern thinking, business is an integral part of the social system. It is a social organ to help accomplish the social goals.

2.3 Environmental Issues

Primarily, environmental issues may be said to hinge on the inter-related factors connected with industrialization and growth of population. The establishment of diversified industries and the growing urban and rural population in India have produced pressures on the air, water, and land resources, which are largely reflected in the degradation of environment.

The process of industrialization over the years has resulted in a pattern of industrial activity which involves use of hazardous materials and generation of solid wastes. The storage, dumping and treatment of solid wastes such as fly-ash, phosphogypsum and blast furnace slag are emerging as a major problem in industrial areas. The problem of regulating toxic, flammable and explosive chemicals in the wake of growth of chemical and petro-chemical industries is also formidable. Many industries discharge waste water into river and water courses without adequate treatment. Industrial effluents are not easily biodegradable and are often beyond the natural assimilation capacity of rivers, with the result that water bodies remain polluted, affecting the health of people. According to a survey undertaken by the Central Pollution Control Board, in 241 Class II cities spread over 17 States, about 90 per cent of the water supplied was found polluted.

Air pollution by way of suspended particulates is caused mainly by industrial undertakings. Thermal power plants using fossil fuels (coal, petroleum or gas) cause atmospheric pollution through gaseous emissions of sulphur dioxide, nitrogen oxide, carbon monoxide, carbon dioxide, etc. Pollutants emitted from automobile exhausts may be more lethal as high rise buildings in cities do not permit disposal and they are inhaled by the public. The mining industry also is a source of air and water pollution in the surrounding region. Land and property in the area are also damaged due to mining rejects and dumps. Gaseous emissions may also cause acid rain damaging soil, vegetarian and aquatic life of the region.

Suspended particulate matter is mostly found in cities that are hubs of industrialization and places where there is large density of vehicles. The suspended particulate matter (SPM) and respirable particulate matter (RPM) result in dust-related health hazards, such as respiratory allergy, dry cough, asthma, and chronic obstructive pulmonary diseases (COPD). Dust pollution is generally the direct result of construction work which involves dumping and storing of building materials, such as stone chips, sand, cement and bricks on the roads and vacant plots. The average permissible limit of SPM is 140 Hg/M^3 annually and 200 Hg/M^3 for 24 hours. For RPM, the average limit is 60 Hg/M^3 annually and 100 Hg/M^3 for 24 hours. Dust particles larger than 10 microgram settle down from the air whereas smaller ones remain suspended in the air indefinitely.

Noise pollution in large cities caused by road traffic and aircrafts poses a threat to human health and hearing and result in both physical and mental stress. Use of firecrackers on festive and ceremonial occasions like Diwali and marriages are also found to cause noise pollution in cities and suburban areas. High population growth has driven communities, particularly in metropolitan cities, to settle nearer airports and thus get exposed to noise of flying aircrafts. This is sometimes due to lack of proper land use planning.

Land degradation may take different forms, including depletion of soil nutrients, salinisation, agro-chemical pollution, soil erosion, vegetative degradation as a result of over-grazing, and deforestation. Human activities contributing to land degradation may take place by way of improper agricultural land use, poor soil and water management practices, improper crop rotation, frequent use of heavy machinery, and poor irrigation practices. Natural disasters, including droughts, floods and landslides in hilly areas, may also contribute to land degradation.

Global warming is another environmental problem which has been predicted by scientists and recognized internationally by the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol (named after the convention held in Kyoto in Japan).

World-wide climate change or global warming is taking place due to the emission of green house gases (GHGs) – Carbon Dioxide (CO_2). Methane, Nitrous Oxide, Hydrofluorocarbon, Perfluorocarbon, and Sulphur Hexafluoride. Carbon dioxide is the

largest pollutant with 60% share and methane accounts for 15-20% share of the GHGs. These gases are responsible for altering the density of ozone layer in

the stratosphere which prevents ultra-violet rays of the sun to impact the earth temperature. With the gradual dilution of the ozone layer due to emission of GHGs, there is a slow but gradual warming of the global surface. It is apprehended that the present concentration of GHGs may lead to global warming, which may cause sea levels to rise, arctic glaciers and mountain snows to dissolve and coastal areas in different continents may be submerged. The Fourth Assessment Report of the Intergovernmental Panel on Climate Change (IPCC) in 2007 reported that the atmospheric concentration of CO₂ in 2005 exceeded by far the natural range over the last 6,50,000 years. At the UN Climatic Change Conference held at Bali, Indonesia, in December, 2007, commitments from both developed and developing countries were sought for pursuing CDM (Clean Development Mechanism) and registration of CDM projects, as per Kyoto Protocol.

2.4 Energy Issues

Economic development is inextricably bound up with inputs of energy, so much so that per capita consumption of energy is often taken to be an indicator of the development of a country. The energy policy of India is largely defined by the country's burgeoning energy deficit[3] and increased focus on developing alternative sources of energy, particularly nuclear, solar and wind energy.

About 70% of India's energy generation capacity is from fossil fuels, with coal accounting for 40% of India's total energy consumption followed by crude oil and natural gas at 24% and 6% respectively. India is largely dependent on fossil fuel imports to meet its energy demands — by 2030, India's dependence on energy imports is expected to exceed 53% of the country's total energy consumption. In 2009-10, the country imported 159.26 million tonnes of crude oil which amount to 80% of its domestic crude oil consumption and 31% of the country's total imports are oil imports. The growth of electricity generation in India has been hindered by domestic coal shortages and as a consequence, India's coal imports for electricity generation increased by 18% in 2010.

Due to rapid economic expansion, India has one of the world's fastest growing energy markets and is expected to be the second-largest contributor to the increase in global energy demand by 2035, accounting for 18% of the rise in global energy consumption. Given India's growing energy demands and limited domestic fossil fuel reserves, the country has ambitious plans to expand its renewable and nuclear power industries. India has the world's fifth largest wind power market and plans to add about 20GW of solar power capacity by 2022. India also envisages to increase the contribution of nuclear power to overall electricity generation capacity from 4.2% to 9% within 25 years. The country has five nuclear reactors under construction (third highest in the world) and plans to construct 18 additional nuclear reactors (second highest in the world) by 2025.

In India, the reserves of conventional sources of energy, i.e., coal, oil and natural gas – the fossil fuels, also known as non-renewable sources of energy, are limited and may not last for an indefinite period or more than 20-25 years at the present rate of consumption, while India's economic progress, changing life style and industrial practices continue to raise the need for energy. The generation and consumption needs of power or energy have increased 64 per cent during the past decade and the projected rate of increase is 8-10 per cent annually.

India's energy production is overwhelmingly dependent on coal. In 1995, coal accounted for 63.3 per cent of India's primary energy production, petroleum accounted for 18.6 per cent, hydro-electricity 8.9 per cent, natural gas 8.2 per cent, and nuclear power 1 per cent. In 2007-08, coal-fired thermal power units accounted for around 62.2 per cent of total power generation in the country. Of the total installed power generating capacity in India, about 10.5 per cent is based on gas or liquid fuel, excluding diesel. In addition, almost all captive power is generated from diesel, and goods transportation, whether by road or rail, is almost entirely fuelled by diesel, besides whatever mechanization is there in agriculture.

Fossil fuels, particularly coal, have been used all these years as primary resources for increasing generation of thermal power to meet the growing demand, and as a result brought about environmental pollution of a high order with fly ash and emission of hazardous gases, besides faster depletion of limited reserves.

2.4.1 Alternative sources of power

Among the alternative sources of energy, besides hydro-power and nuclear energy, there are some renewable sources – known as ‘Income’ energy – like solar energy and wind power that can be used and replenished.

India is endowed with an estimated potential of more than 1,50,000 MW of hydro-electric power. However, only 21.14 per cent had been developed till the end of 2007, and 9.53 per cent was being developed. Bulk of the potential which is in the Himalayan region – the hill States of Jammu and Kashmir, Himachal Pradesh, Uttarakhand, and the North-East, is yet to be tapped. The main reasons for the slow development of hydro-power include difficult and inaccessible potential sites, difficulties in land acquisition, rehabilitation, environmental and forest-related issues, inter-state issues, geographical surprises, and long gestation period. During April-December, 2007, generation of hydro-electric power (excluding power generated by plants below 2 MW but including imports of power from Bhutan) was reported to have been 100.7 billion KWh against 91.8 billion KWh during the corresponding period in 2006. Private sector participation in hydro-power projects was negligible until January 2006 when the Electricity Tariff Policy was notified which allowed a special dispensation for project development by PSUs and private sector on the basis of capital cost and norm based tariff as may be determined by the Electricity Regulatory Commission.

Nuclear power is another potential source of energy. However, nuclear power accounts for only around 2 per cent of the total power generation in India. Nuclear power generated during April-December 2007, was 12.8 billion KWh out of 525 billion KWh of total power generated during the same period. In order to develop nuclear energy, two important raw materials were needed: uranium and to a lesser extent thorium. While India has 24 per cent of the world’s known and available thorium, uranium reserves are meager. Availability of uranium, supply of equipments and access to the latest and most efficient technology are now a matter of international deals. Apart from the high cost of generating nuclear energy per KWh, release of radio-active elements in the process is also extremely hazardous not only to those who are directly exposed but also future generations. Disposal of radio-active wastes poses enormous problems and the nuclear reactors may constitute the most massive wastes after they become unserviceable, for the reactors can neither be dismantled nor shifted and thus may be continuously leaking radio-activity into air, water and soil.

Solar energy is an inexhaustible source of power. But years of research and efforts of scientists have shown that solar energy is not amenable to large-scale utilization for giant plants and concentrated uses. However, solar energy may be generated very well in small scale units due to its being low in intensity and wide-spread over large areas. Solar power may be used in many ways, such as water heaters, water pumps, furnaces, cookers, electrolysis of water, conversion into methanol, production of algae, etc.

Wind power is another source of renewable energy. The Ministry of Non-conventional Energy Sources (MNES) has assessed the gross potential of wind power to be 45,000 MW. By the end of 2002, wind power generation had an installed capacity of 1,702 MW, of which 1,639 MW had been achieved through commercial projects from private investment. The comprehensive wind power programme that was launched in India in the mid 1980s with the involvement of public utilities and industry led to the creation of an industrial base and infrastructure which contributed to large-scale commercial development. Another 1,500 MW of wind power was planned to be added during the Tenth Five Year Plan. Over 11 billion units of electricity are reported to have been fed to various State power grids from the wind power projects. A Centre for Wind Energy Technology (C-WET) has been setup, which acts as the technical focal point for wind power development in the country, and undertakes activities for motivating large private sector corporations, public sector units and power utilities to set up wind power projects.

Wind power has the highest production potential, after biogas, among all the non-conventional and renewable energy resources in India. Realizing this potential, Natural Energy Processing Company (NEPC) was set up in 1986, with water pumping wind mills and agro-generators. This private sector enterprise is reported to have a multi-crore turnover from diversified activities in the field of power generation from wind energy, as well as manufacturing and marketing of wind turbine generators. The company had installed over 2,000 wind turbine generators (WTGs), which accounted for about 400 MW of capacity – about 30% of the country's total installed capacity.

From the investors' point of view, the wind power sector offers several benefits. Apart from non-polluted free power from wind mills, there is a tax shield in the form of 80% depreciation in the year of installation. The electricity generated can be fed to the State electricity boards and can be drawn at the location of consumption. The extra power can be sold to third parties. No taxes or duties are charged on the power generated by WTGs. Since the fuel cost is nil, wind power is also saved from price fluctuations that the power

sector is otherwise prone to. To promote wind power generation, financial institutions and the Indian Renewable Energy Development Agency (IREDA) provide financial assistance at concessional rates of interest.

2.5 Women and Business Opportunities

Historically, women have been discriminated against in the male dominated society. Most girls were married when they were in their teens; widow remarriages were considered to be a social taboo; education beyond the primary or at the most school level was rare; girls, especially in rural and small towns, were deliberately undernourished and denied access to the outside world; and women were considered to be fit to cook food but not to work in business establishments. Even the Constitution has not been free from bias against the fair sex. Throughout the Constitution, women are referred to only six times, and in five of them, they are clubbed together with men and children. Equality of gender has not been explicitly expounded as a specific constitutional value, though Articles 14 and 15 guarantees the quality of status, opportunity and social, political and economic justice.

The report of the National Committee on the Status of Women has made startling revelations. Major findings in the report are: a decline in the sex ratio due to excessive mortality among women and female children; disparity in access to healthcare and widening gap between women and men in literacy, education and training for employment. Daily newspapers publish reports about rape, bride burnings, dowry deaths and wives beaten to death. Women are afraid of going out alone after dark and cannot go for shopping without male escorts.

Table 2.1 Gender Disparities

Women		Men
933.11 (per 1,000 males)	Sex ratio	1000
58.1 Yrs	Life expectancy at birth	57.7 Yrs.
6.3%	Population aged 60 + Yrs.	5.7%
35.9%	Population aged 0 – 14 Yrs	36.5%

75	Infant mortality rate (1993)	73
54.16%	Literacy (2001) School enrolment (1993-94)	75.85%
42.9%	Primary	47.1%
39.3%	Middle Drop-out rate (1993-94)	60.7%
39.1%	Primary	36.1%
10.2%	Women in polytechnics and ITIs	89.8%
22,27%	Work participation rate	51.61%
14.8%	Organised sector	85.2%
8.7%	All India services	91.3%
8%	Parliament	92%

Note: Data excerpted from Censuses 2001, unless otherwise stated.

Some statistics are worth recollecting in support of this assertion. Out of the 1.3 billion poor people in the world, 70 per cent are women, the majority of whom are illiterate with no access to basic amenities like safe drinking water. Two-thirds of the 130 million children worldwide who are not in school are girls. Between 75 and 80 per cent of the world's 27 million refugees are women and children. The majority of women earn an average about three-fourths of the pay of males for the same work. Worldwide 20 to 50 percent of women experience some degree of domestic violence during marriage. The primary victims today's armed conflicts are civilian women and children who are sexually abused by soldiers.

As we go into the future, discrimination against women will go and they will occupy equal status along with their male counterparts. Seeds for better tomorrow have already been sown. Today's girls are better educated, more assertive and more bold. Added to this is the women's liberation movement, to protect and improve the lot of women.

Business and other professional activities are multiplying, demanding the services of talented people, including women. The government is also keen on uplifting the status of women.

2.5.1 Women in Business

Participation of women in business as owners, managers and employees is less encouraging, considering the size of the population and the vast opportunities available. While women account for 48 per cent of the population, the 1991 Census put the female workforce at 20.85 per cent. Those that take up jobs are content with lower paid jobs. Women occupying top positions are few and far between. Reasons are not difficult to seek. The main reasons are:

1. Women are known to have lower attachment to work and are, therefore, content with lower positions;
2. They do not consider themselves as primary earners and withdraw from the labour force once family income reaches adequacy;
3. They lack education and training commensurate with men as marriages and home-making take precedence; and
4. They are less preferred to men in recruitment and selection of legal and other problems mentioned below.

2.5.2 Problems of Female Employment

Though there is no legislation which binds employers to hire women in preference to men, a substantial percentage of the fair sex is generally employed, partly because for certain jobs they are appropriate, and partly because suitable male candidates not available. On being employed, women pose additional problems to the employers. Provisions of the Factories Act and the Maternity Benefit Act should be complied with. Then there is the defiant attitude of a male worker to work under a woman manager or an unwanted chivalrous attitude if the farmer is a boss. Further, women should be paid equal wages as their male counterparts, though the former are less prepared to take up duties involving more physical strain. Payment of equal pay has been made mandatory.

There is also the cost of employing women. It is said that the cost of employing women is greater than the cost of employing men. Career interruptions, plateauing and turnover are more common with women employees and all these traits are expensive. The money companies invest in recruitment, training and development is less likely to produce top

executives among women than among men, and the invaluable company experience that developing executives acquire at every level as they move up through management ranks is more often lost.

Problems notwithstanding, owners of business establishments must encourage and prefer women while hiring people for different positions. Businessmen most

generously contribute to the education and nourishment of women. Whatever is done by businessmen is little considering the primary place occupied by women as mothers, wives, sisters and nurses to all of us.

This has been realized and more and more women are taking up jobs as table shows.

Table 2.2 Women Employees in IT Firms

Company	Employees	Percentage of Women
WIPRO	43,880	24
TCS	43,681	21
INFOSYS	31,000	22
HCL Technologies	20,249	22
Satyam	20,000	20
Cognizant	13,000	28
Accenture	11,000	25
Patni	5,980	19
Iflex	4,688	20

(Million tones, 2006)

2.6 Child Labour

The historic judgement delivered by a Division Bench of the Supreme Court on December 10, 1996 brought issue relating to the child labour to the centre stage. For a country, which has the shameful record of tolerating the exploitation of not less than 35

million children as workers in a wide range of industries and in the services sector, the judgement of the Supreme Court will go down as a triumph of human sensitivities over a mindset which is stuck to the myth that child labour is inevitable.

The Supreme Court has directed that in nine industries, already identified as 'hazardous' including the match industry in Sivakasi, the glass industry in Ferozabad and the carpet industry in Mirzapur, child workers are to be replaced by adult labour, while employers who have been engaging child labour in contravention of the Child Labour (Prohibition) and Regulation Act, 1986, would pay a compensation of Rs. 20,000 for each such child, which would enable them setting up a Child Labour Rehabilitation-cum-Welfare Fund. The fund will be augmented by a contribution of Rs. 5,000 by the State Government concerned, for each child, in case the State is unable to provide a job to an adult member of the family in question. The income accruing from the corpus would be used to ensure the child's education in a suitable institution with a view to making the child in due course a better citizen.

The Apex Court has prohibited the employment of children below 14 years of age in hazardous occupations connected with the transport of passengers, goods or mail by railways, cinder-picking, clearing of an ash pit or building operations in railway premises, catering establishments in railway stations, work relating to selling of fireworks or crackers and abattoirs and slaughter houses.

The judgement also bars the employment of children in beedi-making, carpet weaving, cement manufacture, cloth printing, dyeing and weaving, manufacture of fireworks, matches and explosives, mica-cutting and splitting, binding and construction industry, soldering, processes in electronic industry, tanning, soap manufacture, wool cleaning, slate pencils, building and the construction industry.

2.6.1 Why are children employed?

There are several economic and social reasons why children are put on jobs. The most obvious reason is the poverty of parents which compels them to send their children to jobs than to schools. Even where schooling is free, children are still sent to work as without their income, parents and other members in the family become even poorer.

Child labour exists because these are people willing to use children for a profit. A child is paid much less, is obedient, does not join unions and a child can be moulded to perform repetitive jobs. All these are advantageous to the employer.

There was a strong belief among certain societies that the members were forbidden from pursuing education. It was a sin and if any member disobeyed and went to school, he would be punished by the divine powers. This belief prevented parents from putting their children to school. Fortunately, this superstitious belief has faded out now.

2.6.2 Universal Phenomenon Child labour

Child labour is not peculiar to our country alone. All developing countries use child labour and so is the case with the developed countries. In fact, some of the most exploitative forms of labour like child prostitution exists in US, Germany and France.

However, our country holds the dubious distinction of having the largest percentage of child labour. That the country has 35 million children working on petty jobs has already been told. Some more data are worth quoting. In the decade from 1983-94, 33 per cent of its children were born in the presence of trained health workers, the average for all developing nations is 63 per cent. Whereas seven out of every 100 infants die after birth on an average in these nations, a little more than eight such deaths occur here; by the age of five, 9.7 out of every 100 die on an average; but if they are Indians, 12 will perish. Even if they live, illiteracy, disease and malnutrition kill around half of the nation's children.

2.6.3 The Remedies

It is good to know that there are four main approaches to child labour policy. The first stresses the need for eliminating poverty as that is the main cause for child labour. This approach does not address the child labour directly. The second approach emphasizes strategies to get more children to school, particularly incentives to induce parents to send their children to school, such as free text books, uniform and midday meal scheme implemented in Karnataka. The third approach considers child labour inevitable, at least in the short run, and stresses palliative measures such as regulating it to prevent abuse and to provide support services for working children. This approach is most commonly associated with UNICEF which has prepared a check list of regulatory and social

approaches that could meet the “best interest of the child”. Workplace schooling, stricter law enforcement against illegal child labour trafficking and providing support services for parents and for children working on the streets are some of the regulations contained in the UNICEF’s agenda. The fourth approach advocated by the ILO, favours banning child labour altogether. If this is not possible, at least child labour in its most abusive form should be banned. The most abusive practices include slavery, sale of trafficking of children, debt bondage and serfdom. This modified approach has received much attention and in 1999 the ILOs “Worst Forms of Child Labour Convention” was adopted.

How to end the exploitation of child labour? Compulsory schooling is one answer to the problem. As table shows, a large number of children are outside schools. Mandating schooling for all children must be the top priority for all countries in the 21st century.

Table 2.3 Children out of schools

Percentage of children of primary school age not attending school	
Sub-Sahara Africa	47%
Middle East and North Africa	16%
South Asia	34%
East Asia and Pacific	6%
Latin America and Caribbean	12%
Central and East Europe, Commonwealth of Independent states and Baltics	13%
World	20%
Of which developing countries	23%
Developed world	1%

Source: UNICEF, 2006

Stringent enforcement of labour laws is a must if the children were to be ensured of education, good food, clothing and health. In our country there is, as was stated earlier,

the Child Labour (Prohibition) Regulation Act, 1986. Article 24 of the Constitution prohibits employment of children in hazardous occupations. Factories Act, 1948, also contains provisions relating to the employment of children on dangerous machines. The Act makes the occupier of the factory liable for prosecution if he violates the provision. The Government has banned child labour in India since 2006.

Enactments and orders seem to have little impact on the abolition of child labour. With all the hoopla witnessed in the recent past, no restaurant owner has stopped using children for cleaning tables and utensils, nor the owner of a garage has told the kids not to clean engines and inflate tubes and tyres from tomorrow. Exploitation seems to continue. What is needed is that the conscience of the exploiters must be picked. All of us must realize that the tender age of children is not to be misused for a profit. Children must be fed well, clothed decently, schooled adequately so that they could grow into healthy citizens.

The UNICEF report recommends allocation of 20 per cent of government budgets to education and basic social services and exhorts donor governments to do the same with their official development assistance.

Countries like the US and Germany have begun to ban the import of the products of child labour. If such products are banned, it is believed, producers might stop producing and children would not be in the short-run, factories stop production, children lose their jobs and parents lose their additional incomes forcing them to abuse their children in a much more horrendous manner.

The most effective way of tackling the problem is realization on the part of parents, NGOs and all other sections of society that the innocent child should not be exploited for a profit.

2.7 Rural development

Majority of people in our country, as is well known, live in villages. The living conditions of villagers are far from satisfactory. Anything that is done in the direction of improving their living conditions is welcome. The Government of India is doing a yeoman service in this direction under its integrated Rural Development Programme (IRDP). The efforts of the government need to be supplemented by business establishments, because the task of making living decent and comfortable for villagers

is stupendous, considering the number of villages in our country and their geographical spread.

What specific activities can business undertake in the name of rural development? There are many urgent and important facilities to be provided such as good roads, drinking water, employment, medical aid, family planning, housing, schools and nutrition programmes.

Many progressive business houses have adopted certain villages for their all-round development. Particular mention may be made of the public sector giant Bharat Heavy Electricals Ltd. (BHEL) which has carved out a name for itself in this direction.

There are other instances also. An IMRB study conducted recently reveals that

83 per cent of the 150 sample companies are active in rural development. On top are the Tatas who had set up Tata Steel Rural Development Society, way back in 1979 itself. Mafatlals were also one of the first industrialists to set up a rural development organization, viz., Satguru Seva Sangh. Many companies are active in playing a facilitative role in implementing World Bank sponsored projects or the government's Integrated Rural Development projects. Mangalore Chemicals and Fertilizers (MCF), a UB group company, has been involved in socio-economic development work for several years now. In 1975, the United Kingdom, under what is known as the Colombo Plan, granted aid for the overall growth of villages in the developing countries. As part of the aid, 2,700 million tones of fertilizer was supplied to MCF by the UK government to undertake overall development activities in the underdeveloped regions of Karnataka. MCF sold this and with the proceeds, created a corpus of Rs. 40 lakh.

MCF surveyed several villages in the districts of Bellary and Raichur, keeping in view the irrigation potential, agricultural practices followed, adequate representation of small and medium land holding farmers as also rural artisans and selected Sangankal village of Bellary district and Herur village of Gangavathi taluk of Raichur district for implementation of the project. The project name is rather a mouthful: UK-MCF-TGB. Introduction of double cropping, use of balanced fertilizers, better water management etc. are a few of the achievements which have increased the income of farm families from Rs. 4,000 to Rs. 10,000 annually. From the interest accrual on the corpus fund of Rs. 40 lakh, the trust has so far spent Rs. 21.26 lakh towards various developmental activities.

Further down South, SPIC's agro-service centres (ASC) are yielding similar results. 10 ASCs were set up in Tamil Nadu. Today, there are 21 and extend to the neighbouring states of Andhra Pradesh, Karnataka and Pondicherry. Each ASC has 10 villages attached to it as satellite villages, located within a radius of 10-15 km from the main centre.

Apart from the ASCs, SPIC has rural development centres in Tamil Nadu and Andhra Pradesh for training in scientific farming and helping in integrated farming efforts, the agricultural and rural development programmes are conducted by technical assistants. Necessary tools like tractors with accessories, pre-fabricated buildings, agricultural implements and plant protection equipment are offered at subsidized rental rates.

2.8 Projects and People

Citing a project in a particular area is not always welcome. The project once completed will result in, among other things, displacement or even death of people who hitherto inhabited the area. It is the responsibility of the business to rehabilitate such displaced persons. Unfortunately, this responsibility is not realized by promoters-government or private. The Visakhapatnam Steel Plant provides a typical example. The project authorities had given an assurance that 5,000 displaced persons would be absorbed in the project subject to their suitability. So far, 1,339 of them have found jobs. Another 3,500 were to have been employed by the contractors. But it is not clear what happens to them once the contractor's job is over. Another example is the Yeluru reservoir project in Andhra Pradesh which will displace 10,121 persons, including 3,000 from the Scheduled Castes and Tribes.

It is heartening to note that the late Mrs Indira Gandhi took a firm stand on the conditions that should be fulfilled before a green field project can be considered for clearance...at least two schemes that the state governments must tie up before they can expect to secure approval for their industrial projects: one of them relates to afforestation and the other to rehabilitation of displaced persons. Both are aimed at safeguarding human interest.

2.9 Physically Handicapped

Yet another social action of business houses is the rehabilitation of physically handicapped people. We have 70 million disabled citizens in the country and the

response of the corporate sector towards these hapless citizens has been lukewarm. The Disability Act, 1995, which mandates that every enterprise in the organized sector should reserve three per cent of its workplace for the physically handicapped, has not made any difference. According to a study conducted by the National Centre for Promotion of Employment for Disabled People (NCPEDP), the overage percentage of physically handicapped in the total workforce of public sector enterprises is just 0.4 per cent. In the private sector, it is much less – 0.23 per cent.

2.10 Acquired Immune Deficiency Syndrome (AIDS)

The year 1983 goes down in history as the darkest year for it was in this year that scientists discovered a baffling disease called AIDS, also named ‘Gray Plague’, that has taken a heavy toll of human lives. Across the globe, 2.3 million people died in 1997 because of the dreadful disease. At the beginning of 1998, more than 30 million people, about 0.5% of the earth’s population, have been infected with HIV-the AIDS-causing virus.

The African continent is the worst hit. In Zimbabwe and Botswana, for example, a quarter of the adult population is infected. Unless there is an unforeseen breakthrough in treatment, all those infected will die from AIDS. As a result, the life expectancy of the average Zimbabwean, having risen steadily until 1990, when it was 56, is likely to fall to only 49 by the end of the century and that of a Batswana, will fall by a decade.

The virus is also spreading into areas that were previously AIDS free. In some of the former communist countries of Europe, rates of HIV infection have risen several hundred-fold over the past three years. In China, where HIV was until recently confined to the south-west and the coast, every province has now registered people affected with the virus.

India also has fallen into the vortex. Nearly five million people have already become victims and the scourge is spreading across the country.

AIDS is likely to cause considerable confusion and disruption in the workforce. When employees realize that they are working with an infected worker, they demand that the hapless employee should be dismissed. If the management discharges the employee, the law is violated, particularly in the US where individuals who have AIDS are protected by federal, state and local laws. The protection generally comes in the form of protection

against discrimination and is based on the fact the virus cannot be spread by casual contact.

Organisations are hard hit by additional costs-direct and indirect-when their employees contract the disease. Direct costs are in the form of increased medical burden. Indirect costs result from the loss of productivity when employees refuse to work with an AIDS-infected worker. Much of the problems relating to AIDS stems from the ignorance of people about the disease. They believe that the disease is highly infectious and there is no remedy for the victims. It is the responsibility of the government and business and non-governmental organizations to create better awareness about the disease in the minds of the people and extend appropriate medical help.

The government seems to be content with merely releasing advertisements, advising the public about the need to use AIDS preventive devices. An active government should go beyond this and take measures to control the epidemic.

Credit should go to the Central Government undertakings, particularly HMT and BHEL, for initiating measures to prevent AIDS. Teams of doctors from in-house Occupational Health Services visit plants and give lectures to employees on AIDS prevention. Lectures are held once or twice every year.

ASHA Foundation (Action Service Hope for AIDS) is a Bangalore-based voluntary organization which is rendering yeoman service in creating awareness of AIDS infection and counseling to HIV – positive persons, their families and the community. There are similar organizations in other cities too.

What are needed most for the employers is to educate workers about AIDS. The following guidelines need to be followed to make the educational programme effective.

1. Employees must be made to understand how AIDS is contracted. Understanding about the ways of contracting AIDS will ensure that the activities do not occur at the workplace.
2. Presentations to employees must be handled by professionals, preferably from experts. This is necessary as the message presented is going to include sexual references which, if not handled properly, are likely to have a negative impact on employees.
3. All employees must attend the sessions.

2.11 Social Audit

Social audit as a term was used as far back as the 1950s. There has been a flurry of activity and interest in the last seven to eight years in India and neighboring countries. Voluntary development organizations are also actively concerned. Social audit is based on the principle that democratic local governance should be carried out, as far as possible, with the consent and understanding of all concerned. It is thus a process and not an event. A social audit is a way of measuring, understanding, reporting and ultimately improving an organization's social and ethical performance. A social audit helps to narrow gaps between vision/goal and reality, between efficiency and effectiveness. It is a technique to understand, measure, verify, report on and to improve the social performance of the organization. Social auditing creates an impact upon governance. It values the voice of stakeholders, including marginalized/poor groups whose voices are rarely heard. Social auditing is taken up for the purpose of enhancing local governance, particularly for strengthening accountability and transparency in local bodies. The key difference between development and social audit is that a social audit focuses on the neglected issue of social impacts, while a development audit has a broader focus including environment and economic issues, such as the efficiency of a project or programme.

2.11.1 Meaning

One important issue related to social responsibility of business is how to evaluate the social performance.

Bauer and Fenn Jr. define social audit as “a commitment to systematic assessment of and activities on some meaningful, definable domain of the company's activities that have social impact.” According to Ahmed Belkaoui, “social audit much like the financial audit – is an identification and examination of the activities of the firm in order to assess, evaluate, measure and report their impact on the immediate social environment.” In other words, social audit involves:

1. Identification of the firm's activities having potential social impact;
2. Assessment and evaluation of the social costs and social benefits of such activities;
3. Measurement of the social costs and benefits; and

4. Reporting, that is presenting in a proper format and manner, the social performance of the firm.

Dr Clark C. Abt, in his book *Audit for Management*, suggests that a social audit should, as far as possible, be approximated to an ordinary commercial audit; that this should be based on a social balance sheet with a “credit” side and “debit” side. He calls them “inputs” and “outputs” or “costs” and “benefits” so far as the social balance sheet is concerned. After suggesting that every “input” and “output” must be measured in monetary terms, he points out that the basic purpose of a business corporation is to maximize the financial return, earned on its financial investment plus the amount of social return on its social costs and if we are to assess them by the same measures as of financial investment, this must be expressed in dollar terms. He further asserts that, sooner or later, the social balance sheet must become a mandatory part of the normal commercial balance sheet of the company.

2.11.2 Objectives and Benefits of Social Audit

The basic objective of social audit is to evaluate the social dimensions of the performance of the company.

1. Another principal objective which follows the objective mentioned above is to take measures to improve the social performance of the company on the basis of the feedback provided by the social audit.
2. Social audit increases the public visibility of the organisation.
3. If the social audit reveals a socially commendable performance of the company, it will help boost the public image of the company.

2.11.3 Methods of Social Audit

Some of the important methods of social audit developed by different people or organization are given below:

1. **Social Process Audit:** The aim of the social process audit, also known as Programme management audit, is to develop an internal management information system that will allow management to create and administer the social programmes in a better way. This involves the determination of the objectives of the social programmes and a social cost benefit analysis of the programmes with a view to determining whether these objectives have been met.

2. **Financial Statement Format Audit:** Under the financial statement format audit, the social information is presented in the conventional financial statement format, i.e., balance sheet and / or income statement.

3. **Macro-Micro Social Indicator Audit:** The macro-micro social indicator audit attempts to evaluate the micro indicators (i.e., the company's performance) against a set of macro indicators such as national policies.

4. **Constituency Group Audit:** Under this audit, the preference and attitudes of various constituencies (like employees, creditors, suppliers and customers) are identified and measured and the firm's performance is evaluated against the criteria developed for each group.

5. **Partial Social Audit:** Partial social audit evaluates any particular aspects of social performance like energy conservation or ecological preservation.

6. **Comprehensive Audit:** Comprehensive audit attempts to evaluate the total performance of the organization including social performance.

7. **Corporate Rating Approach:** In contradistinction to the audits mentioned above, this is an external evaluation of the company's performance by public groups like consumer organisations, social welfare organizations or media.

2.11.4 Obstacles to Social Audit

Social audit encounters a number of problems. The important obstacles are:

1. Being a relatively new concept, social audit is yet to gain wide appreciation and acceptance.
2. Being a relatively new concept, a clear and generally well accepted methodology for conducting the social audits is not available.
3. There is no agreement as to the items to be included for social audit.
4. It is very difficult, and in several cases even impossible, to quantify the social costs and benefits of different activities or items.
5. There may be resistance within the company to social audit because of the time, effort, and difficulty involved in the task.
6. There may also be resistance because of the fear of a dismal or unsatisfactory picture that may be presented by the social audit.

As the Committee set up by the Tata Iron and Steel Company Limited (TISCO) to conduct the Social Audit of the TISCO points out, though social audits have been undertaken in a number of countries, principally in the U.S.A. (to which the practice

owes its origin), Japan, the U.K. and one or two other Western countries, the subject has not yet attained the status of a science. There is no agreement, much less unanimity, among its most ardent proponents, particularly as to its basic principles or its true objectives. It is only a child of the last decade, during which there has been a growing concern about the environment and the problems of pollution, consumer protection, worker safety and equal employment opportunities. Melvin Anshen, Professor of Public Policy and Business Responsibility at the Graduate School of Business, Columbia University, and an eminent authority on the subject, remarks that “the social audit has been described as an idea whose time has come but which isn’t ready to be taken off the drawing board and put to work”.

2.11.5 Social Audit in India

Although the idea of social audit originated in the United States about half a century ago, it is only recently that it received serious attention of corporations even in the advance countries.

The first comprehensive social audit in India was conducted by the TISCO in 1980. It was conducted by the Social Audit Committee appointed by the Board of Directors of the company “to examine and report whether, and the extent to which, the company has fulfilled the objectives contained in Clause 3A of its Articles of Association regarding its social and moral responsibilities to the consumers, employees, shareholders, society and the local community.” The report of the Committee was a glowing tribute to the endeavours of the company in the discharge of its social and moral obligations to the various segments of the society. Some companies like the Cement Corporation of India have been making some social reporting in their annual reports.

The High Powered Expert Committee on Companies and MRTP Acts (Sachar Committee) observes that the acceptance of the concept of social responsibility must be reflected in the information and disclosures that the company makes available for the benefit of its various constituents – shareholders, creditors, workers and the community – and has suggested that a provision may be made in the Companies Act that every company shall give a social report which will indicate and quantify, in as precise and clear terms as possible, the various activities relating to social responsibility which have been carried out by the company in the previous year. The Committee has further suggested that it is possible that a company may be required to alter its Memorandum

with respect to the objects of the company so as to carry out its activities as an obligation to

the concept of social responsibility. It should be pointed out here that the TISCO had, in 1970, voluntarily incorporated in its Articles of Association its social and moral responsibilities to the consumers, employees, shareholders, society and the local people.

2.12 Summary

Traditionally, the term business commonly referred to commercial activities aimed at making a profit or to organizations formed to make a profit. The old concept of business, confining it to commerce and private profit, has undergone a radical change. Today, business is regarded as a social institution forming an integral part of the social system. Primarily, environmental issues may be said to hinge on the inter-related factors connected with industrialization and growth of population. The establishment of diversified industries and the growing urban and rural population in India have produced pressures on the air, water, and land resources, which are largely reflected in the degradation of environment. Participation of women in business as owners, managers and employees is less encouraging, considering the size of the population and the vast opportunities available. Child labour in business is not peculiar to our country alone. All developing countries use child labour and so is the case with the developed countries. In fact, some of the most exploitative forms of labour like child prostitution exists in US, Germany and France. Social audit much like the financial audit – is an identification and examination of the activities of the firm in order to assess, evaluate, measure and report their impact on the immediate social environment.

2.13 Keywords

Business: A business also known as enterprise or firm is an organization engaged in the trade of goods, services, or both to consumers.

Value: A personal or cultural value is an absolute or relative ethical value, the assumption of which can be the basis for ethical action.

Social Audit: It is a way of measuring, understanding, reporting and ultimately improving an organization's social and ethical performance

2.14 Check Your Progress

1. According to the 1991 census, 48% of the total population is women, out of which only% women are employed.
2. is a network of human relations that includes ideas, institutions and material objects.
3. The term social audit has been in use since the year
4. Social process audit is also known as programme
5. Under external evaluation of the performance of the company is done by public groups like consumer organisations, social welfare organisations, media etc.

2.15 Answers to Check your Progress

1. 20.85 2. Society 3. 1950 4. Management Audit 5. Corporate Rating Concept

2.16 Terminal Question

1. Define business and state its objectives
2. Discuss the ecological view of business in a systems relationship with society as suggested by Davis and Blomstorm.
3. Discuss in detail the environmental issues arising out of business activities.
4. Discuss the issues related to power and electrical requirements of the business.
5. Discuss the role and importance of women in business management at present.
6. Describe the problems of women employment.
7. Describe the issues related to child labour and the remedies for such problems.
8. Describe the importance of rural development and discuss the role of business in rural development.
9. Discuss the role of business in tackling serious diseases in India.

10. Define social audit and discuss its objectives in detail.
11. Describe the various methods of social audit.
12. Discuss the changing role of women in the society and state its implication on business and employment.
13. Business is one of the key factors for Rural Development in India. Do you agree. Give reasons to support your answer.
14. Business have a significant in fighting social evils. Discuss
15. Social Audit is an important activity for business today. Elucidate

2.17 References

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UNIT 3 SOCIAL RESPONSIBILITY OF BUSINESS

Structure:

- 3.1 Introduction
- 3.2 Definition and Classifications
- 3.3 The Evolving Idea of Social Responsibility
 - 3.3.1 Business Social Responsibility in Classical Economic Theory
 - 3.3.2 The Eighteenth and Nineteenth Centuries
 - 3.3.3 Changing Views of Social Responsibility in the Late Nineteenth and Early Twentieth Centuries
 - 3.3.4 The Contemporary View of Social Responsibility
- 3.4 Indian Scenario
- 3.5 Four Phases of Modern Philanthropy
- 3.6 Social Responsibility Models
- 3.7 Forces Pressuring Social Responsiveness
- 3.8 Responsibilities towards different stakeholders
 - 3.8.1 Responsibilities towards Shareholders
 - 3.8.2 Responsibilities towards Employees
 - 3.8.3 Responsibilities towards Consumer
 - 3.8.4 Responsibilities towards Community
- 3.9 Major Social Responsibilities of Business
- 3.10 Argument against Corporate Social Responsibility
- 3.11 Argument for Corporate Social Responsibility
- 3.12 Limits of Social Responsibility
- 3.13 Summary
- 3.14 Keywords
- 3.15 Check Your Progress
- 3.16 Answers to Check Your Progress
- 3.17 Terminal Questions
- 3.18 References

Objectives:

After studying this unit, you should be able to:

- Define Social Responsibility of Business
 - Explain the evolution of the concept of Social Responsibility of Business
 - Review the Social Responsibility Models
 - Describe the Forces Pressuring Social Responsiveness
 - List out the Social Responsibilities of Business
 - Review the Arguments For / Against Corporate Social Responsibility
-

3.1 Introduction

Milton Friedman claims that the ethical mandate of business is to increase the shareholders' profit. It is a general belief that business is accountable to its shareholders because it is running on their resources.

But this is a misconception. If business is accountable to shareholders because it uses their resources, then a business should primarily be responsible to society because in real terms, it uses society's resources. The money that business borrow from banks is that of the society. Business directly or indirectly uses natural resources of the nation which belong to the society. Business uses human resources of society, and above all, exists because of society. It is the society that gives business an opportunity to earn. So business is primarily accountable to society.

Corporate social responsibility is about seriously considering the impact of the company's decisions and actions upon the environment and the society. The dependence of any business on its social and ecological environment is so comprehensive that the very existence, survival and growth of any enterprise depend upon its acceptance by the society and the environment. If any business outlives its utility to the society and the environment, it has no place and reason to exist.

Now, you will study the social responsibility and business in this unit.

3.2 Definition and Classifications

Social responsibility of business refers to what the business does, over and above the statutory requirement, for the benefit of the society. The word responsibility connotes that the business has some moral obligations to the society.

The term corporate citizenship is also commonly used to refer to the moral obligations of business to the society. This implies that, just as individuals, corporates are also integral part of the society and that their behaviour shall be guided by certain social norms.

The operations of business enterprises affect a wide spectrum. The resources they make use of are not limited to those of the proprietors and the impact of their operations is felt also by many of people who are in no way connected with the enterprises. The shareholders, the suppliers of resources, the consumers, the local community and society at large are affected by the way an enterprise functions. Hence, a business enterprise has to be socially very responsive so that a social balance may be struck between the opposing interests of these groups. Goyder argues: “Industry in the twentieth century can no longer be regarded as a private arrangement for enriching shareholders. It has become a joint enterprise in which workers, management, consumers, the locality, Government and trade union officials all play a part. If the system which we know by the name private enterprise is to continue, some way must be found to embrace many interests which go to make up industry in a common purpose.” Later, in 1978, while delivering the C.C. Desai Memorial Lecture, he reiterated his plea that if the corporation has to function effectively, it has to be accountable to the public at large; and he sought to equate the suggestion of a responsible company with the trusteeship concept advocated by Gandhiji, the aim of which was to ensure that private property was used for the common good. The declaration issued by the international seminar on the social responsibility of business held in India in 1965 also co-related the Gandhian concept of trusteeship with the social responsibility of business as “responsibility to customers, workers, shareholders and the community.”

H.S. Singhanian classifies the nature of the social responsibility of business into two categories.

1. The manner in which a business carries out its own business activity.
2. The welfare activity that it takes upon itself as an additional function.

The first involves the acceptance of the fact that business is not merely a profit-making occupation but a social function which involves certain duties, and requires that appropriate ethics are followed. For example, a business must obey all the laws, even when they are disagreeable; it should produce the maximum goods of good quality, ensure smooth supplies at competitive prices, pay taxes, shun malpractices, pay a fair wage to employees and a reasonable dividend to shareholders. It is also the duty of a business to undertake new investment and promote the dispersal of economic activity through ancillarisation and the setting up of industries in backward areas so as to spread enterprise and take employment to the doorsteps of labour. In addition to its commercial activity, business also plays a role in promoting social welfare activity, even directly.

3.3 The Evolving Idea of Social Responsibility

The social responsibility idea evolved over a period of time. Some major stages in the long history are outlined here.

3.3.1 Business Social Responsibility in Classical Economic Theory

Through history, classical economic theory has been the fundamental inspiration of people in business. In the classical economic view, a business is acting in a socially responsible fashion if it utilizes resources as efficiently as possible to produce goods and services that society wants at prices consumers are willing to pay. The sole objective of business is to maximize profits while operating, of course, within the law. If this is done, say classical theories, firms carry out their major responsibility.

This easily understood goal, derived from Adam Smith's *Wealth of Nations*, was never sought in business practice without reservations. Even Adam Smith voiced a surprising number of exceptions to his principles for social reasons. Throughout our history, business and business people have modified the strict profit maximization principle to address social concerns-not much at first, but more and more over time. Nevertheless, today, this fundamental classical ideology remains entrenched.

3.3.2 The Eighteenth and Nineteenth Centuries

In the colonial era, business were very small. Merchants practiced thrift and frugality, which were dominant virtues then. But charity was to co-existing virtue and the owners

of these small enterprises made contributions to schools, churches and the poor. In the early nineteenth century, companies were not effusive in their social concerns. Charitable contributions continued and grew over time as great fortunes in business were made. In most cases, wealthy entrepreneurs who gave their fortunes to benefit society did so without any reference to the interests of the companies that were the fountainheads of their wealth.

For instance, John D. Rockefeller, who accumulated a fortune in the second half of the nineteenth century, gave in his lifetime, more than \$ 550 million and endowed the Rockefeller Foundation, “to promote the well-being of mankind throughout the world.” Andrew Carnegie gave away \$ 350 million during his lifetime to social causes, built 2,811 public libraries and gave 7,689 organs to American churches.

3.3.3 Changing Views of Social Responsibility in the Late Nineteenth and Early Twentieth Centuries

During the latter part of the nineteenth century and into the twentieth, a number of forces converged to lead business leaders, especially of the larger corporations, to address social problems out of self-interest. Vigorous industrial growth had many negative social impacts. Business feared new government regulations and sought to blunt their urgency. Business leaders, many of whom by this time were not the original entrepreneurs, but owned only a small part of the stock of the companies they managed, felt freer to use corporate assets for social action. Business sought and found arguments to circumvent the ultra vires doctrine.

By the 1920s, three inter-related themes had emerged to justify broader business social responsibility. First, managers were trustees, that is, agents whose corporate roles put them in positions of power where they could enhance the welfare of not only stockholders, but others such as customers, employees and communities. Secondly, managers believed they had an obligation to balance the interests of these groups. They were, in effect, coordinators who reconciled the competing claims of multiple stakeholders on their enterprises.

And thirdly, many managers subscribed to the service principle, a principle with two distinct definitions. One definition was a near-spiritual belief that business, simply by operating for profit, had the power to redeem society by creating a broad general welfare. If individual managers served society by making a business economically

successful, the aggregate business system would then work to eradicate social injustice, poverty and other ills. A second understanding of the service principle, however, was that although the capitalist system elevated humanity, individual companies and managers were still obligated to undertake social programmes to benefit or serve the public.

These three inter-related ideas-trusteeship, balancing of interests and service – were accepted by more and more business and opinion leaders. Although uplifting, they did not foster lavish contributions for social programmes, nor did they divert most individual managers from their laissez-faire attitudes and dominant emphasis on profits.

3.3.4 The Contemporary View of Social Responsibility

In the last forty years, the concept of business social responsibility has continued to evolve and expand. Today, the efficient use of resources to make a profit is still seen as the primary social responsibility of business. But added to economic performance are the ideas of previous eras about the meaning of social responsibility. The view that total social responsibilities are broader than simple economic responsibilities, has become more compelling, more accepted by managers and more widely put into practice than ever before.

The range of social programs assumed by business has continuously expanded since the early years of the century. Today, corporations carry out a wide array of social actions. The span includes programmes for education, public health, employee welfare, housing, urban renewal, environmental protection, resource conservation, day-care centres for working parents and many others. In each of these areas, the programmes that different corporations have implemented run into thousands.

The fundamental reason why the concept and range of social responsibilities have expanded is that accelerating industrial activity continuously changes society. In this situation, social responsibilities arise from the impacts of corporate actions on society. And we know more today about adverse consequences of some business activities. For example, early in this century, carcinogens in industrial effluents were unknown.

Corporate social programmes also arise from a second source-intractable social problems in the corporation's environment. "A healthy business and a sick society are hardly compatible," notes Peter Drucker. Racism, wars, violent crime, epidemics such

as AIDS and falling schools are societal pathologies a corporation has not caused but may benefit from mitigating.

3.4 Indian Scenario

The idea of social responsibility is very old in our country. The concept of parting with a portion of one's surplus wealth for the good of society is neither modern nor a Western import into India. The business community occupied a significant place in ancient Indian society. Merchants were treated with respect and civility and regarded as an instrument of social good, not least because of their philanthropy. Nourished by a social and religious ethic which put charitable giving high on its list of virtues, charity was an ingrained part of the life of most hereditary merchant communities that form the backbone of the modern business class. Merchants provided relief in times of famine or epidemics by throwing open godowns of food and treasure chests to look after the needy; built and supported temples, dharmshalas (pilgrim rest houses), night shelters, bathing ghats, water tanks, wells and panrapoles (animal refuges) and provided drinking water facilities. They donated for education in traditional schools and even for dowries for poor girls.

The problem with corporate social responsibility (CSR) is that nobody is very clear about what exactly it encompasses. The Indian government has been trying to make it mandatory for companies to spend at least 2% of net profits on CSR. Facing strong criticism, it gave up the effort in mid-July and made the spending voluntary. But the debate continues.

If the proposed rule had come into play, the government would have had to spell out what constitutes CSR. That would have gone some way in removing the vagueness that exists about the term. Today, CSR to some companies means providing lunch to employees. To others, it's about tackling global warming and environmental issues. Instead of defining CSR, the Indian government recast it as "responsible business" in a set of voluntary guidelines for firms released July 8 by then Union minister of corporate affairs Murli Deora.

The recent unsuccessful effort isn't expected to be the last word on mandatory CSR spending, however. In meetings with industry, Deora has repeatedly expressed the personal view that CSR should be compulsory. In the latest round of recommendations,

the government asks that companies keep tabs on CSR spending and disclose it to their principal stakeholders.

The CSR measures are actually part of a new Companies Bill that has been in the works for several years. The Companies Act of 1956, which is currently the rule of law, has several clauses inappropriate to the current business and economic environment. A revision process was started in October 2003 and a Companies Bill 2008 was tabled in Parliament. That legislation lapsed with the dissolution of the Lok Sabha (the lower house of Parliament) in 2009. A new bill -- the Companies Bill 2009 -- has been tabled. It is wending its way slowly through various committees.

While the Companies Bill contains many provisions that are of great importance to industry, it's the CSR piece that has created the most debate. Deora's predecessor, Salman Khurshid (now Union minister for law), at one time supported making the spending mandatory. Later, he veered around to the view that if CSR spending figures are made public, it will put adequate peer pressure on the corporate laggards.

Industry has been almost totally against a mandatory clause. The Federation of Indian Chambers of Commerce & Industry (FICCI) has suggested tax breaks instead for those who meet the voluntary targets. Rival chamber the Confederation of Indian Industry (CII) says that compulsory corporate responsibility would be counterproductive. "Companies may resort to camouflaging activities to meet such regulations, particularly during recessionary periods and economic downturns," argues the lobbying group.

India's philanthropic community is also against compulsory CSR. "It is a crazy idea," says Dhaval Udani, CEO of non-governmental organization (NGO) GiveIndia. "Once you make it mandatory, people will find ways and means to get out of it. The rules will be so vague that the reporting will be even vaguer." Deval Sanghavi, co-founder & CEO of Dasra, a strategic philanthropy foundation, agrees. "I am not in favor of mandatory CSR. When you make things mandatory, the chances of their not being done are greater," he notes.

Industrialist Adi Godrej adds, "It's good to say that [CSR] is desirable. Then people should decide [what to do] on their own." Philanthropist Rohini Nilekani is more critical. "I just don't get it," she says. "This is outsourcing of governance. This is taking the failure of the state and the corporates and trying to create a model out of it. If you want, you tax the corporates and put the money into social programs. But you can't dictate

CSR." The world over, very few countries have a CSR requirement; Saudi Arabia is possibly the only exception. "The laws in developed countries do not stipulate mandatory CSR contributions," according to KPMG partner (development sector practice) Sudhir Singh Dungarpur. "In the recent past, many European countries have specified that companies must include CSR information in their annual reports."

India has a tradition of corporate philanthropy. The trouble is that somewhere along the way, the lines between giving and CSR have grown hazier. "Corporate philanthropy and CSR are really two different things, but get blurred, particularly in India," Dungarpur notes. "CSR should actually relate to the way you conduct your business, whereas it gets confused with giving to the local communities in which you operate." He, too, is against a government mandate. "Generally the carrot approach -- where corporates understand the value in focusing on philanthropy and act upon it in that regard -- is better than the stick approach. It is not necessarily the quantum of funds spent that matters, it is how you spend it." Adds Parul Soni, executive director and practice leader at Ernst & Young (India): "CSR is a journey and not a destination."

"I don't think there is a clear distinction," between philanthropy and CSR, says Arpan Sheth, Mumbai-based partner with Bain & Company and the author of Bain's recently-released "India Philanthropy Report 2011". "It's like a Venn diagram where there's overlap between the two. I think in many ways, in India in particular, CSR is almost a 100% overlap with whatever the promoter family's passions are."

Recently, the government also sought to include vocational training for employees as part of CSR. But that term, too, is difficult to define. Would Infosys, which runs a huge university of sorts for entry-level employees, qualify? Or is would the vocational training umbrella only include those who are taught manual skills? The first government paper on CSR -- released by the ministry of corporate affairs in 2009 -- also talks of health, cultural and social welfare, and education coming under the CSR head.

Indeed, just about everyone sees CSR through a different lens. When Bill Gates and Warren Buffett came to India earlier this year to popularize their Giving Pledge, which asks the wealthy to commit to giving the majority of their fortunes to philanthropy, they told Indian companies that the effort was not CSR but CSC -- corporate social compulsion. An Ernst & Young white paper titled, "The Emerging Role of Business -- Not Just for Profit," offers other options: "CSR could be and is used synonymously with

terms like corporate responsibility, corporate citizenship, sustainable responsible business, corporate social performance and corporate sustainability."

Stepping into the breach is the Institute of Chartered Accountants of India (ICAI). The accounting regulator has set up a subcommittee to identify what should come under the CSR umbrella and what shouldn't. But that effort has spawned its own debate with some others questioning ICAI's right to be heard.

The arguments will likely continue because, as a white paper by KPMG and the Associated Chambers of Commerce and Industry of India (ASSOCHAM) presented at the first International Summit on CSR held in New Delhi in 2008 put it: "CSR is comprehended differently by different people." The report -- titled, "CSR: Towards a Sustainable Future" -- noted that until the 1990s, CSR was dominated by the idea of philanthropy and that business efforts were often limited to one-time financial grants. "Moreover, businesses never kept the stakeholder in mind while planning such initiatives, thereby reducing the efficacy and efficiency of CSR initiatives," according to the report. "However, over the past few years, the concept of CSR has been changing. There has been an apparent transition from giving as an obligation or charity to giving as a strategy or responsibility."

3.5 Four Phases of Modern Philanthropy

First phase:- Pure philanthropy and aid during industrialization.

Second phase:- Social responsibility during freedom struggle.

Third phase:- Social responsibility of business under mixed economy model.

Fourth stage:- Social responsibility of business in an unclear state in the global world.

1850 – 1914

The first shift was from a more or less purely ameliorative charity for religious reasons and causes during the pre-industrial era (pre – 1850), towards the more Western form of philanthropy in the period 1850-1914. The period saw the beginnings of industrialization in India and like their counterparts in the West, the new rich business families began to set up trusts and endow a host of modern institutions such as schools, colleges, hospitals, orphanages and windows homes, art galleries and museums for the welfare of society and the preservation and propagation of Indian culture. At the same time, they continued to contribute to older forms of charity such as building and

maintenance of temples, dharmshalas and water tanks so that there were elements of both charity and philanthropy in business giving. The Gujarati Dinshaw Petit and Premchand Roychand, spearheaded the new trend. The early pioneers of industry were leaders not only in the economic but also the social fields and took active interest and part in the religious and social reforms and in public life.

1914 – 1960

In the second phase (1914-1960), which was the golden period of both Indian capitalism and business philanthropy, there was a maturing of philanthropic practice. Apart from making political donations for the freedom struggle, business also contributed to many of the social and cultural causes associated with the movement such as revival of Indian art and culture, nationalist education and so on. Many of India's leading businessmen – GD Birla, Jamnalal Bajaj, Lala Shri Ram, Ambalal Sarabhai and others come under the spell of Mahatma Gandhi of untouchability, women's emancipation and rural reconstruction, even as the earlier preoccupation with creating a physical and social institutional infrastructure continued, further honed by the vision of a free, progressive and modern India.

When India became free, the independent state looked to the business

community to propel the country to a prosperous future and on the euphoria of Independence, the business class, confident of the capabilities, responded both by creating more wealth and utilizing it for non-business purposes. Several business leaders like GD Birla, JRD Tata, Lala Shri Ram, Kasturbhai Lalbhai and others, endowed institutes of scientific and technical research as well as art academies and institutes for the study of Indian history and culture. Many of the best Indian institutions in several fields, such as the Tata Institute of Fundamental Research, the Birla Institute of Technology of Pilani and Ranchi, the Calico Textile Museum, Ahmedabad to name but a few, owe their existence to private business munificence of the time.

1960-1980

The next shift came in the 1960s which ushered in an era of economic and political troubles and saw the business community operating under several constraints. The state also took on many of the obligations that were traditionally the responsibility of the society as a whole, such as education, care of the sick, relief in the wake of natural

calamities and care of the destitute. It led to a corresponding decrease of interest in private philanthropy. Mistrust of business consequent to sharp and unethical practices by some, coupled with high taxes to finance state-led development, further contributed to the disinclination to part with private wealth for public benefit. Ironically, the high tax regime aided by a deterioration in business morality led to a large expansion in the establishment of charitable trusts for purposes of tax planning.

The disillusionment consequent to the failure of the government to remove poverty and bring about social change at the pace required to remove the ever widening gap between the rich and the poor and to provide a richer quality of life, led to a renewal interest in private initiative to spearhead change. It made individuals look to voluntarism as a solution and an alternative to official action, and made business more conscious of the need to contribute to approved national development goals.

The 1970s thus saw a renewal corporate interest in social concerns and a new element emerged on the philanthropic scene – corporate philanthropy, as distinct from family business philanthropy. Spurred partly by the realization that supporting community development through philanthropic giving is in their own best business interests and partly by the use of the carrot and stick method by the government, several business leaders began to advocate more social responsibility on the part of business. Of this, philanthropic giving was only one aspect, the others being more ethical business practices and concern for the physical environment in which business operated. There was a diversification in the courses supported, such as afforestation, science education for the people, preservation of monuments, women's rights and consumer education.

1980 onwards

The post – 1980 period saw an upswing in business fortunes due to economic reforms and other factors and with it, a re-emergence of self-confidence. It increased both business willingness and ability to give, as well as public and government expectations of business. This contemporary phase, characterized by corporate citizenship, has seen a further swing away from charity and traditional philanthropy towards more direct engagement in mainstream development concerns and in helping disadvantaged groups in the society.

In sum, the development of business and industry in India has been accompanied by a clear change in the attitude of society and the business community itself about its

obligations to society and how they need to be expressed. It may be stated that the shift from merchant charity to corporate citizenship is not complete and it is not unusual to find all the three-charity, philanthropy and corporate citizenship – being practiced by the some business family or corporation. India's economic reforms and its rise as a major market and major player in the world (country/number) have not brought about any substantial (satisfactory) change in its attitude towards CSR (social responsibility).

Contrary to many expectations, India's approach to global CSR still has its own peculiarities and incorporates only a few provisions (aspects/facets) of CSR incorporated in the global mainstream. Studies show that Indian CSR is still in an unclear state, the following statements are enough to prove this. India's approach to CR seems to be shifting from traditional altruism to sustainable business, yet altruism remains widespread across many Indian companies. Community development still plays a crucial role in India's CSR programme.

3.6 Social Responsibility Models

There are some models which endeavour to describe the evolution and extent of social orientation of companies. Notables ones include Carroll's model, Halal's model and Ackerman's model.

Archie B. Carroll, who defines corporate social responsibility as the entire range of obligations business has to society, has proposed a three-dimensional conceptual model of corporate performance. According to Carroll, a firm has the following four categories of obligations of corporate performance.

1. Economic
2. Legal
3. Ethical
4. Discretionary

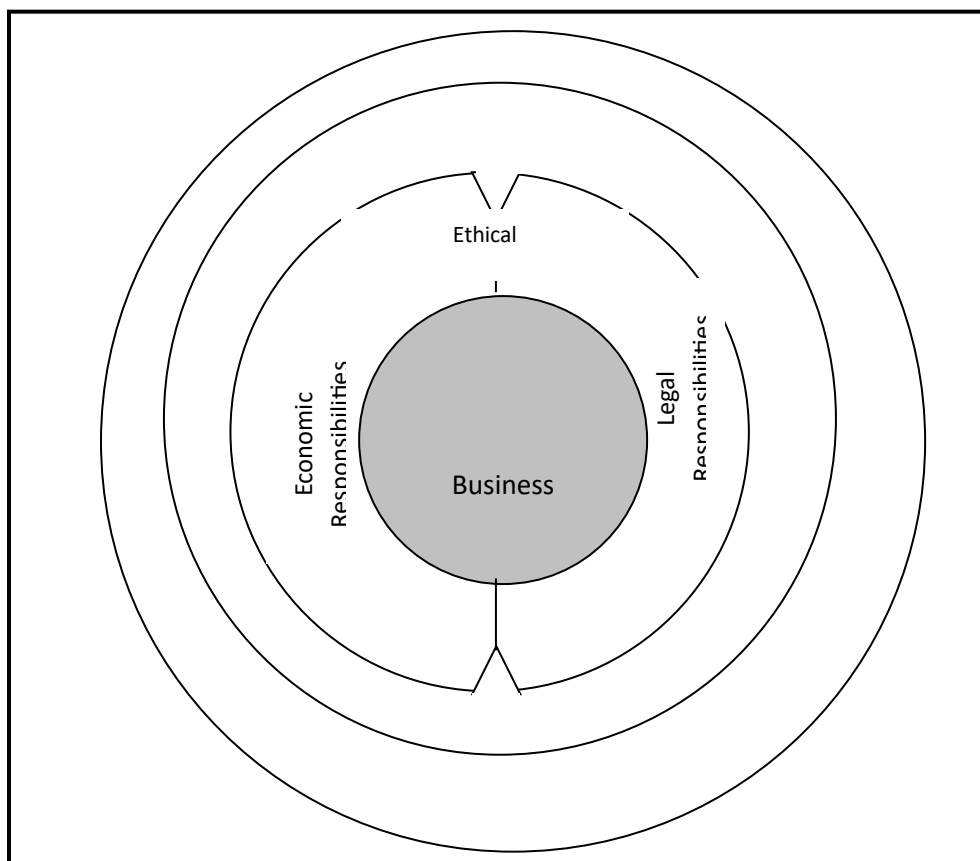
The firm being an economic entity, its primary responsibility is economic, i.e., efficient operations to satisfy economic needs of the society and generation of surplus for rewarding the investors and further development. Legal responsibilities are also fundamental in nature because a company is bound to obey the law of the land.

Ethical responsibilities are certain norms which the society expects the business to observe though they are not mandated by law. For example, a company shall not resort to bribing or unethical practices, unfair competitive practices etc.

Discretionary responsibilities refer to the voluntary contribution of the business to the social cause, like involvement in community development or other social programmes. Carroll points out that these four categories are not mutually exclusive, and the boundaries between them are difficult, if not impossible, to define. Further, these terms are not value-free and they may be interpreted differently by different people.

Carroll later presented the different categories of responsibilities as a pyramid of corporate social responsibility. Economic responsibilities are at the base of the pyramid, succeeded by legal responsibilities, ethical responsibilities and, finally, philanthropic responsibilities.

According to Carroll's pyramid, legal responsibilities come only at the second stage. This is not a right view. A company must inevitably obey the laws, even if it is unable to discharge some of the economic objectives, as long as it exists. Figure below presents the right perspective.



Discretionary
Responsibilities

Figure 3.1: Responsibilities of Business

William E. Hallal's return-on-resources model of corporate performance recognizes the fact that no corporate social posture will be value-free, and this makes corporate social responsiveness a tremendously difficult task. He point out that a firm can only attempt to unite the diverse interests of various social groups to form a workable coalition engaged in creating value for distribution among members of the coalition. Beyond a certain level of economic activity, the social issues at stake may become conflicting. For example, large spending for social cause may affect the profitability of the firm which could have implications for the stake holders and the future of the firm. This calls for tradeoffs which involve both economic and ethical decisions that will not necessarily satisfy the needs of every stakeholder. According to Ackeman's model, there are three phases in the development of the social responsiveness of a company.

The first phase is one when the top management recognizes the existence of a social problem which deserves the company's attention and acknowledges the company's policy towards it by making an oral or written statement.

The second phase is characterized by the company appointing staff specialists or external consultants to study the problem and suggest ways of dealing with it. The third phase involves the implementation of the social responsibility programmes.

3.7 Forces Pressuring Social Responsiveness

Not all firms are vulnerable to social group pressures and social regulations. Only some firms are pressured to undertake social responsibility actions. The forces that make firms become socially responsive are: government, community interests and demands, environmental concerns, competitive pressures, shareholder / investor pressures, philanthropic requests and initiatives and crises.

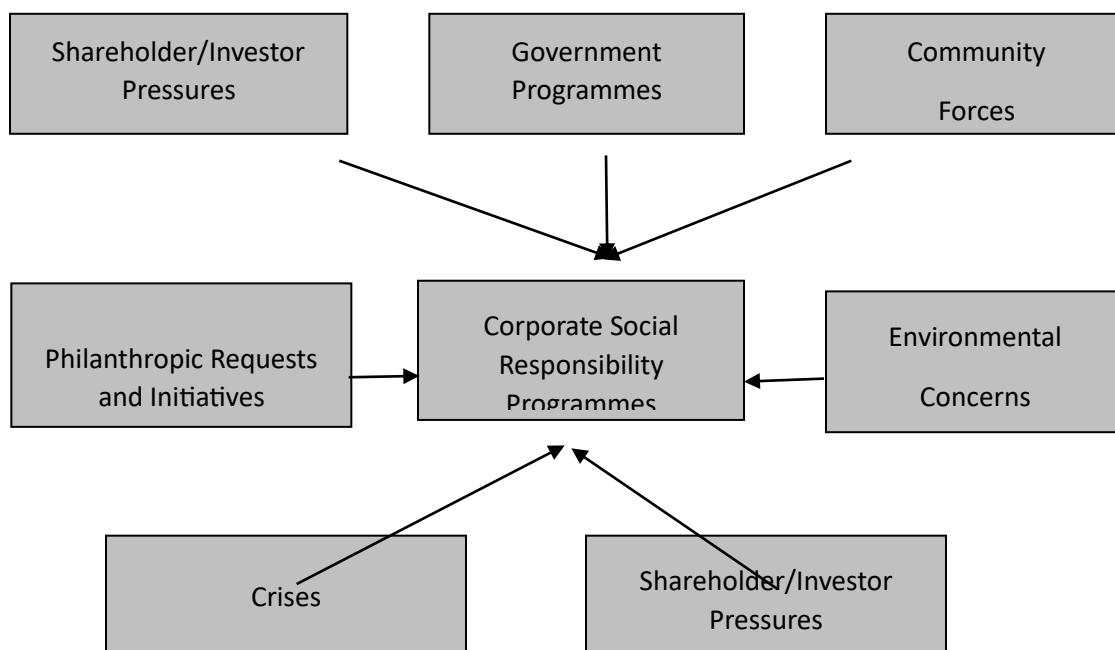


Figure 3.2: Pressures Leading to Social Responsibility

Government Programmes: Government (foreign and domestic) are the most significant forces pressuring firms for social actions. Most government pressures

concern compliance with existing regulations. But governments are also major sources of potential rules, a fact which businesses need to take note of. Governments ask businesses to volunteer to help them solve their problems.

Governments mandating social actions are not new. In the 1300s, for example, Londoners who violated the city's smoke pollution ordinances were beheaded. In the US, laws that regulated the purity or quality of certain goods date from colonial times and state and federal efforts to control water pollution began in the late 1800s.

Foreign governments exert pressures on international businesses to abide by codes of conduct that they and international organizations have drafted. These codes expect businesses to respect human rights and social justice, pay fair wages, protect the environment, ensure safety and health of workers, improve worker living conditions, and behave ethically.

Community Interest and Demands: Firms undertake many programmes that benefit society in general, not necessarily favouring stakeholders. Programmes can range widely, from helping rebuild disadvantaged sections to providing executive talents to run government undertakings.

MNCs from the US undertake a wide range of programmes in foreign countries, for example, creating scholarships for poor but deserving students from India, Malaysia, and Mexico, to pursue higher studies.

Environmental Concerns: Environmental programmes of firms mainly result from standards established by government agencies. The Government of India, for example, enacted the Environment Protection Act 1986. The main objective of the Act is to protect and improve the environment and the prevention of hazards to human beings, other living creatures, plant and property. Pollution Control Boards set up under the provisions of the Act, have laid down norms that firms are expected to comply with.

Shareholders/Investors Pressures: Large shareholders such as pension funds have long-range interests in the financial success of their investments. Some of them, obviously, exert pressures on firms to respond appropriately to community social interests. For example, shareholders of Pepsi Co. launched a campaign to force the company to pull out of Myanmar because of the human rights violation of the military regime in that country. Pepsi Co. did oblige the shareholders.

3.8 Responsibilities Towards Different Stakeholders

The multi-stakeholder principle was put in the agenda as a result of the defects in self-regulation of the profession and the weaknesses of legal regulation. It is a tool for NGOs,

It was necessary for the CSR and multilateral institutions to work together in a creative and collaborative manner to achieve the complementary goals and diverse expectations of the CSR process.

In the case of India, the full potential of the multistakeholder concept has not yet been realized, for two main reasons. First, only a few civil society organizations are cooperating in the field of CSR. Any multi-stakeholder process initiated has therefore not been able to sustain itself. Secondly, Indian companies are reluctant to adopt a multi-stakeholder approach on the grounds that CSR should be driven by business rather than NGOs.

In general Indian CSR policy is not directly linked to the idea of multi-stakeholder approach. On the other hand, the responsiveness of NGOs on this issue paints a different picture. The general perception is that companies cannot rely on NGOs for successful implementation of community development projects. Despite the above consequences, a positive view on multi-stakeholder approach is popular in India. However, CSR in India is still based on self-discipline (self-regulation) of business. The accountability to various stakeholders is described as follows.

3.8.1 Responsibilities towards Shareholders

People invest in money to make money. Milton Friedman claims that the ethical mandate of business is to increase shareholders' profit. The primary responsibility of business is to increase shareholders' wealth, to give good returns on investment, to give dividends at the proper time, to protect the interests of even small shareholders, to listen to and respect shareholders, to regularly invite shareholders to participate in decision making.

So the basic responsibility of a business towards shareholders is to create wealth for them. Economic Value Added analysis is an effective tool to measure the increment in shareholder wealth. Economic values added are increments in the shareholder's wealth beyond its expected return. Debt has its cost in terms of interest, but in financial terms equity does not have any cost. So in EVA, Equity costs are the risk-adjusted rate of return that investors should expect from this type of investment.

Could be met and above this it is EVA and if it is below this then company may be in profit but in terms of EVA it is decreasing shareholders wealth. These expected returns

should be met and if returns are above that, EVA is positive and if it is lesser then EVA is negative. That is, the firm may be in profit but it is not meeting expectations.

3.8.2 Responsibilities towards Employees

The Success of an organization is dependent on its employees. Gone are the days when employees were the most neglected resource of the organization. Today, HRM is the Critical Success Factor for the success of all industries, be it Old Economy industries like steel, cement or FMCG or New Economy ones like BPOs and software services. Organisations have many responsibilities, towards their employees:

1. Fair treatment
2. No discrimination on the basis of sex, caste or creed
3. Fair wages
4. Fair appraisal system
5. Healthy and safe working environment
6. Establishment of fair work standards and norms
7. The provision of labour welfare facilities
8. Fair opportunity for accomplishment and promotion
9. Proper recognition, appreciation and encouragement of special skills and capabilities of the workers
10. Installation of an efficient grievances handling system
11. An opportunity for participating in managerial decisions to the extent desirable
12. Proper training and development programmes so that workers can develop themselves according to a changing environment
13. Family Welfare: That is, if workers have lesser problems in their family life, their productivity will be higher. It is for this reason that Tatas have invested a lot in family welfare of its employees. JRD Tata has also won UNESCO's
14. world population award. JRD invested a lot in making his employees understand about family planning, which ultimately resulted in happier families among the employees.

Most of India's work force is employed in the private sector. Imagine, if every private sector pays attention on family planning, it would be a great boon to the organization, apart from benefiting the country.

However, there are two aspects of a business's employee policies that need to be examined more closely.

1. Child Labor

When it comes to CSR in the supply chain, companies emphasize on the effective elimination of child labor among their suppliers. While child labor is restricted/prohibited by the Indian Constitution. But this law is not being implemented in its true form. Companies operating in India are responsible for the elimination of child labour through CSR and contractors. Which does not go beyond the requirements of written law, but goes beyond the law generally prevalent in India. According to Article 24 of the Indian Constitution, 'No child below the age of 14 years shall be employed in any factory or in any hazardous employment' However, India has not ratified the International Labour Organisation's Core Convention No. 182, which deals with the 'worst forms of child labour'.

2. Contract labour

Contract labour is seen as an escape route from responsible business conduct. Contract labour is a widespread concept in India. Due to the stringent labour laws prescribed by the International Labour Act, Indian companies were facing difficulty in dismissing their employees during the recession period. In response to the high demands of their orders, companies outsourced their production process to domestic contract workers. Contract workers in the informal economy do not receive the protection and benefits mentioned in labour laws and labour contracts, except minimum wages. Thus contract labour is a loophole. Which empowers exploitative industries, and increases violation of labour rights and pollution.

3.8.3 Responsibilities towards Consumer

1. Providing products of proven quality
2. Regular R and D to augment the producer and to innovate
3. To ensure that product reaches the customer and to check any sort of black marketing or profiteering by middlemen and anti social elements
4. To supply goods at reasonable prices
5. To provide required after-sale services, and to ensure that spare parts should be available in the market

6. To fulfill its commitments impartially and courteously, in accordance with sound and straight forward business principles
7. To provide sufficient information about the product, including its adverse effects, risks and the care to be taken while using the product
8. To ensure that the product supplied does not have any adverse effect on the customer
9. To hear and redress the genuine grievances of customers
10. To avoid any type of cartel formation that attempts to reap monopoly profits.

3.8.4 Responsibilities towards Community

1. To prevent environment pollution and to prevent ecological imbalance
2. Improve the efficiency of business operations
3. Contributing to research and development
4. Development of backward areas
5. Promotion of small scale industry
6. Development of region in which they are operating. This includes working on development of schools, social awareness programmes, adult education, health, medical facilities, helping NGOs and the government for social causes such as the Pulse Polio Mission, etc.
7. Taking steps to conserve scarce resources and developing alternatives, wherever possible.

3.9 Major Social Responsibilities of Business

1. Optimum Utilization of Scarce national Resources: All corporations must use resources judiciously and not waste, damage or cause to deteriorate the resources at its disposal. It is essential in an energy/power scarce country like India. Not only this, business should develop alternative sources of energy and power. For instance, ITC uses wind power for some of its projects, while Mahindra and Mahindra spends on research on alternative fuels.

Reliance is a classical example of efficient utilization of resources as it uses by-products and waste of one project in another. Its petrochemical plants and refineries are so integrated that they use each other's products.

2. Responsibility Not to Make Losses: A loss-making unit is a burden on society. It should not only conserve resources of the society but perform its duty towards the customer by providing better products, towards the shareholder by creating wealth,

towards the society by utilizing its resources well, and towards its employees by not meeting better HR standards.

Most PSUs that make losses but are kept alive in the name of socialism and employment, are basically a burden on society. Their losses are met by taxing the society. One can say that society pays higher taxes to subsidise the inefficiencies of PSUs. The question arises, why should they?

3. Improved Quality of Life: An organization should help improve the society's standard of living, which is based on financial power and material growth.

4. Responsibility of Employment and Income: Every business should make provisions for the payment of fair wages, satisfactory working conditions, steady employment and job security, prospectus for promotion, growth and development of workers, and also take adequate measures for employee welfare.

5. Offering Quality Products at Fair Prices: Business is all about creating customers, and the customer can only be created when customers are satisfied. Customers can be satisfied when they are provided with value – added products at fair prices, after sales services, timely information, and when the product reaches the right customer, etc.

6. Environment Protection: Industrialization is doing much irreparable harm to the environment. It is therefore an obligation on them to not only morally, but also legally undo the damage by taking serious and responsible steps to protect the environment and to keep it healthy condition.

They should adopt modern technology to ensure that their operations do not harm the environment. Businesses should also take actions to educate their employee and people about the environment in general.

7. Fair Trade Practice: Fair trade practices of business include:

- i. Avoidance of formation of cartels or following monopolistic practices.
- ii. By creating shortages for the purpose of black marketing and speculation.
- iii. By exaggerating and making false statements regarding claims.
- iv. Not buying political favours to sway decisions it is favour.
- v. Following healthy competition with competition by not indulging in industrial espionage or other unethical means.
- vi. Not deliberately making the organizations sick to avoid obligations or to escape from responsibilities.

- vii. Not to involve in insider trading or to take undue advantage of inside information.
- viii. Not bribing public servants and corrupting the democratic structure of the country.
- ix. Paying taxes, duties and other dues honestly and on time.
- x. To provide required information to shareholders and all other stakeholders.
- xi. Making timely payment of borrowings and interest.
- xii. While dealing with suppliers, instead of using their bargaining power, corporations should invest in good relations with them. This will help suppliers maintain quality and develop new products for the organization. This may appear to be costly initially but it ultimately pays. The Japanese usually believe in establishing a good rapport with their suppliers.
- xiii. Not adopting a communication strategy that is not compliant with social norms.
- xiv. Business should abide by the laws of the land.

8. Local development: Businesses use resources of the society are therefore responsible for the development of their surroundings areas. A business can perform various functions to develop its local area. In fact, if every business house takes responsibility of some villages, miracles can happen in India.

Business houses like Tata Chemicals, ITC and HLL are doing so. Cooperatives like IFFCO are also following this concept. These business houses adopt

some village and construct roads, spread literacy, ensure health programmes, promote family planning and other social reform programmes, help farmers in agriculture and marketing of their products, and promote the handicraft and cottage industry of the villages. HLL is giving employment and empowerment to the women of villages through its operation Shakti and ITC is revolutionizing the village distribution system through its e-choupal system.

3.10 Argument Against Corporate Social Responsibility

The major arguments against assumption of broad social responsibilities include:

1. Loss of Profit Maximization: Diverting resources away from the firm to socially responsible programmes undermines the principles of the competitive market and deprives shareholders of rightful economic gain.

2. **Cost:** Social obligations can be very expensive and may render firm unable in going for attractive business investment; or it may even have to go out of business.
3. **Lack of Skills:** Most of businessmen do not have the requisite skills and training to work effectively on social issues.
4. **Dilution of Purpose:** The pursuit of social goals may dilute the economic productivity of the firm.
5. **Too Much Power:** Business can be said to already possess much power without encouraging it to increase its social influence.
6. **Lack of broad support:** There is lack of public support for corporate social responsibility and this condemns it to failure.
7. **Lack of accountability:** There is no way to hold a business accountable for the outcomes of its social programmes, once instituted.

3.11 Argument for Corporate Social Responsibility

The major arguments supporting a role for the social responsibility of business are as follows:

1. **Public Expenditure:** There is a deep conviction within sections of the public that business has a clear and the power that goes with it.
2. **Long Run Viability:** If a business fails to meet this need, other groups will assume the responsibility and the power that goes with it.
3. **Public Image:** Socially responsible behaviour creates a positive public image for business. Tata and Birla enjoy a very good image among people because of their social welfare programmes.
4. **Better Environment:** Businesses can create a better environment which will be more conducive to future business success.
5. **Avoidance of government regulation:** If business is perceived as meeting its social obligations, costly and restrictive government regulations can be avoided.
6. **Balance of Responsibility and Power:** Since a business already has a great deal of social power, its social responsibility should be of equal importance.
7. **Let Business Try:** Since other social institutions have failed to resolve many social problems, it's time to give business a try.
8. **Business has the resources:** Business has a reservoir of capital and expertise that has great potential for public service.

9. Problems can become profit: If the innovative skills of businesses can be applied to social problems, some efforts might lead to profits in the traditional business sense.

10.Prevention is better than cure: If there are any further delays in resolving social problems they are only going to become worse.

11.Shareholder Interest: Businesses will prosper from an improved social environment.

3.12 Limits of Social Responsibility

The social responsibility actions of businesses are limited by cost, efficiency, relevance and scope. As a result of these constraints, actions fall short of public expectations.

Cost

Social responsibility costs money. Whether a company desires to adapt a village, donate to a college or school, build a hospital, maintain parks or undertake relief operations in times of calamity, it costs money.

Efficiency

Social responsibility affects efficiency adversely. Being obliged to the employees, say a company runs its plant, even if it is incurring losses every year.

Its efficiency goes down and its ability to compete is lost.

Relevance

According to several critics, business has no obligation to society. The only obligation is to run the business successfully. Social responsibility is irrelevant. According to Friedman, for example, “There is one and only one social responsibility of business: to use its resources and energy in activities designed to increase its profits so long as it stays within the rules of the game....(and) engages in open and free competition, without deception and trend...”. Friedman contends that corporate officials are in no position to determine the relative urgency of social problems or the amount of organizational resources that should be committed to a given problem. He also insists that managers who devote corporate resources to pursue personnel, and perhaps misguided notions of the social good, unfairly tax their own shareholders, employees and customers. In short, business should produce goods and services efficiently and leave the solution of social problems to the concerned individuals and government agencies.

Often, social responsibility action is undertaken for wrong reasons rendering the exercise to irrelevance and ineffectiveness. Consider what has happened to Brij Mohan Khaitan, the tea giant. In the beginning of 1990s, Khaitan was under tremendous pressure from the Bado Security Force (BSF). One of his executives was kidnapped and another was gunned down by the militants. BSF demanded hefty sums as a pre-condition for peace. It was this time that Khaitan reflected and set up a school at a cost of Rs. 22 crore. The school could not help Khaitan buy peace from the BSF.

Scope and Complexity

Society's problems are too massive, too complex, and too deep seated to be solved by even the most socially conscientious company or even by all companies acting together.

The problems such as environmental pollution-acid rain, ozone depletion, destruction of rain forests; health problems-AIDS, drug and tobacco use; racial discrimination; sex discrimination, ethnic and religious animosities and the like defy solutions however conscientious one might be.

Business has its own limitations. It should deliver quality goods at reasonable prices, earn profits for shareholders, pay taxes to the government and plan strategies to survive in the competitive world. Amidst such varied problems, how can business solve yet another complex problem, viz., social responsibility.

3.13 Summary

Business is not merely an economic but also a social function. It is the only activity, that influences every aspect of the society and nation. Firstly, business should be responsible to society because in real terms, it uses society's resources. The money that business borrow from banks belongs to society's. Businesses directly or indirectly a country's national resources, its human resources, and above all, exist because of society. Thus there can be no denying that business enterprise are accountable to society. The socio-economic obligations of business refer to its obligation to prevent economic consequences of business activity from adversely affecting public welfare business have a duty to recognize and honour the new social responsibilities. The pressure of organized labour is growing, public awareness about quality of life is increasing, and the need to remove all types of pollution exists. Public opinion lays on business morality and

integrity to be observed by all organisations. The development of consumerism in many countries demand and insists upon on consumer protection in the marketplace.

Major social responsibilities of business the use the resources in a judicious manner, to shun waste, misuse, damage or resources at its disposal. A loss-making unit is a burden on society. A business should offer quality products at fair prices to society and should follow fair trade practices of business. Business can perform various functions to develop its environment areas. Investment in employees increases their productivity. If employees are happy and contented, their children receive good education and enjoy good health, this enhances their productivity. Industrial peace can also reduction in cost. Social responsibility has a direct impact on brand loyalty, sales and profit, can be used to gain strategic advantage and to increase market share. ITC launched its e-choupal and HLL leads to its project Shakti in this endeavour. Many firms also carry out social audit. It is a balance sheet that shows what a business has taken from society and what it has given back to society at large.

3.14 Keywords

Social responsibility: It is an ethical ideology or theory that an entity, be it an organization or individual, has an obligation to act to benefit society at large.

Philanthropy: In modern practical terms, it is private initiatives for public good.

Stakeholders: It can be a person, group, organization, member or system who affects or can be affected by an organization's actions.

NGO:- Non-governmental organizations (which cooperate directly and indirectly in social work).

Consumerism:- Consumer is the axis of the market and all business activities revolve around him.

Social responsiveness:- Sensitive attitude towards social problems.

3.15 Check Your Progress

A. Fill in the blanks

1. Modern philanthropy has phases.

2. According to Carroll there are classes of responsibility for professional performance.

3. There are three stages of response (reaction) depending on the company's social response to the

B. True/False :-

4. Government is the most important force to compel companies to do social work.

5. The success of an organization does not depend on its employees.

6. Cost, efficiency, relevance can be mentioned as limitations of social responsibility.

3.16 Answers to Check Your Progress

1. Four 2. Four 3. Ekman model

4. True 5. False 6. True

3.17 Terminal Questions

1. Define Social Responsibility.

2. Explain the various stages in the evolution of Social Responsibility.

3. Explain in detail the various phases in modern philanthropy.

4. Analyze the various the social responsibility models.

5. Elucidate the forces pressuring social responsiveness.

6. State the various responsibilities towards different stakeholders by an organisation.

7. Explain in detail the major social responsibilities of business.

8. State the arguments for Corporate Social Responsibility

9. State the arguments against Corporate Social Responsibility

10. Explain the limits of Social Responsibility

Social Responsibility is a luxury which few business organisations can afford? Do you agree? Give arguments in support of your answer?

11.Does Social Responsibility conflict with the economic objectives of a business organisation? How can social responsibility be used as tool to achieve the mission of the organisation?

12. Expenditure in social responsibility is not expenditure, but rather an investment. Discuss the statement?

13.Social Responsibility is not a recent phenomenon but has long years of history. Elucidate

14.Analyze the modern philanthropy and its impact on corporate social responsibility.

3.18 References

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UNIT- 4 CONSUMERISM AND BUSINESS

Structure:

- 4.1 Introduction
- 4.2 Definition of Consumerism
 - 4.2.1 Utility of Consumerism
- 4.3 Exploitation of Consumers
- 4.4 Consumer Rights
- 4.5 Consumer Protection
- 4.6 The Need for Consumer Protection
- 4.7 Steps Required for Consumer Protection
- 4.8 Methods for Consumer Protection
 - 4.8.1 Imposition of Self-Regulation and Discipline
 - 4.8.2 Voluntary Organisations of Consumers
 - 4.8.2.1 Consumer Associations or Councils
 - 4.8.2.2 Consumer Cooperatives
 - 4.8.3 Spreading Information and Awareness
 - 4.8.4 Government Legislation
 - 4.8.5 Other Methods
- 4.9 Consumer Protection Act, 1986 (With Amendments)
 - 4.9.1 Objectives of the Act and Rights of Consumers
 - 4.9.2 Consumer Protection Councils
 - 4.9.3 Consumer Disputes Redressal Agencies
 - 4.9.4 Remedial Action
 - 4.9.5 Appeal
 - 4.9.6 Penalties
 - 4.9.7 Implementation of the Act
- 4.10 Green Consumerism
 - 4.10.1 The Roots of Green Consumerism
 - 4.10.2 Green Consumers
 - 4.10.3 Business as Usual
- 4.11 Summary
- 4.12 Keywords
- 4.13 Check Your Progress

4.14 Answers to Check Your Progress

4.15 Terminal Questions

4.16 References

Objectives:

After studying this unit, you should be able to:

- Define Consumerism
 - Understand the importance of Consumer Rights
 - Analyze different methods for Consumer Protection
 - Review the Consumer Protection Act, 1986
 - Describe the concepts of Green Consumerism and Ethical Consumption
-

4.1 Introduction

An important socio-political environment confronting the business is the growth of consumerism and the legislative measures to protect the consumers. Consumer movement had its conspicuous beginning and development in the United States. There has been a growth of consumer awareness in most countries leading to growth of consumerism and growing demand for consumer protection.

Though consumerism is not well developed in India, there are several consumer organizations in India like the Consumer Guidance Society of India (CGSI), Mumbai, and the Consumer Education and Research Centre (CERC), Ahmedabad, which are doing commendable work. Some of these organizations are very active in conducting product testing and exposing substandard quality and adulteration. The demand for regulatory measures or effective implementation of available measures for consumer protection have been substantiated by the results of such tests. ISI certification of food colours, demanded by the C.G.S.I., is now mandatory. Consumer organizations also play an important role in redressing consumer grievances.

Since 1993, the Consumer Education and Research Society (CERS), sponsored by the CERC, has been performing a very bold-and commendable task of comparative testing of consumer goods at their in-house laboratory, and since 1998 its publication INSIGHT – The Consumer Magazine has been carrying our test results far and near. The media have been publishing the test findings. These test results enable the consumers to

evaluate and compare product of different companies. The manufacturers can, therefore, no longer be complacent.

Consumer movement is growing, albeit slowly, in India. It may gather momentum from the growing consumer awareness and the growing feeling that the consumer is ruthlessly exploited and taken for a ride. Many products fail to satisfy the quality requirements and many sellers do not favourably respond to the genuine grievances of consumers.

As you know that many products tests conducted by some consumer are necessarily a problem for the business. Consumerism is, in fact, regarded as an opportunity by consumer oriented businessmen, as described later in this unit.

4.2 Definition of Consumerism

Different authorities define the term consumerism differently. Let us consider some of the important definitions of consumerism.

Cravens and Hills define the term ‘Consumerism’ as follows:

“Consumerism is a social force within the environment designed to aid and protects the consumers by exerting legal, moral and economic pressures on business.”

Mrs Virginia K. Knauer says consumerism may simply be expressed as “Let the seller beware” in comparison to the age-old caveat emptor or “Let the buyer beware.”

Consumerism is a battle against exploitation. It is the collective endeavour of the consumers to protect their interests. It is a means of ascertaining their rights against the sellers. It is a social force to make businesses more honest, efficient and responsible. It also pressurizes the Government to adopt necessary legal measures to protect the interests of the consumers. It is basically a protest movement. It is generally a non-official movement initiated by the public and voluntary consumer organizations.

Philip Kotler defines consumerism as “a social movement seeking to augment the rights and powers of the buyers in relation to sellers”. Boyd and Allen state that although often abused as a term, consumerism may be best defined as the dedication of those activities of both public and private organizations which are designed to protect individuals from practices the impinge upon their rights as consumers.”

In his speech delivered at the 44th Annual General Meeting of Hindustan Level Ltd. in 1977, the Chairman, Mr T. Thomas, rightly pointed out: “While the producer has the power or the right to design the product, distribute, advertise and price it, the consumer has only the power of not buying it. One may argue that the producer runs the greater risk in spite of having several rights because the veto power remains with the consumer. However, the consumer often feels that while he has the power of veto, he is not always fully equipped to exercise that power in his best interests. This situation may be the effect of lack of information, too much indigestible information or even misinformation from one or several competing producers. This problem facing the consumer has led to ‘consumerism’. It is worthwhile to note that consumerism, like several other social movements, e.g., independence movement Civil Rights movement, etc., has been the result of a social conflict and cannot, therefore, be wished away. It will be with us till the conflict facing the consumer is resolved.”

Consumerism, interpreted as a collective endeavour of the consumers to protect their interests, it is manifestation of the failure of the business, including that of the public sector, and the government to guarantee and ensure the legitimate rights of the consumers.

4.2.1 Utility of Consumerism

It would be better to summarise the factors responsible for laws to protect consumer rights. These factors are as follows:

- The rapidly increasing variety of goods and services that modern technology provides;
- The growing size and complexity of production and distribution systems;
- A high level of sophistication in marketing and sales practices, including in advertising and other forms of production;
- The removal of the personal relationship between buyer and seller as a result of mass marketing methods; and
- the increased mobility of consumers.

Well-organised and dynamic consumerism may be expected to produce the following results:

1. Producers and sellers will not take the consumer for granted. When consumers are strong enough to protect their rights, the business will be compelled to shun unfair trade practices.
2. Consumerism will provide feedback for the business. It will enable the producers to understand consumer grievances, needs and wants. This will assist in the more effective implementation of the marketing concept or the societal marketing concept, depending upon the nature of consumerism.
3. Producers will be able to enlist the support of consumers to minimize the imperfections on the distribution front. Several times the supply position is made worse by hoarding and black-marketing by traders. Further, many sellers have a tendency to charge a price which is higher than the actual by giving one or other reason. There is no reason why the consumer and producer should not co-operate to get rid of the unscrupulous traders.
4. The above points indicate that consumerism is an opportunity for honest and dynamic firms. In fact, quite a few leading businessmen view it so.
5. Consumerism will make the government more responsive to consumer interests, prompt it to take necessary, statutory measures, and make the required institutional arrangements to safeguard consumer rights.

4.3 Exploitation of Consumers

Consumers are, however, by and large, practically denied most of these rights. They are exploited by a large number of restrictive and unfair trade practices. A situation has developed in which the public have become victims of false claims for products blatantly advertised. Behavioural science is extensively applied to marketing to ruthlessly, exploit the consumers by stimulating the weak points and soft corners of their mind. Misleading, false or deceptive advertisements are quite common. Many a time the advertisements deliberately give only half truths so as to give a different impression than is the actual fact. Thus, advertisements may, be misleading because things that should be said have not been said, or because advertisements are composed or purposefully presented in such a way as to mislead. The situation is such that misrepresentations about the quality of a product or the potency of a drug or medicine can be projected without much risk.

As the High-Powered Expert Committee on Companies and MRTP Acts, popularly known as the Sanchar Committee, points out, fictitious bargains are another common

form of deception. Many devices are used to lure buyers into believing that they are getting something for nothing or at a nominal value for their money. Prices may be advertised as generally reduced and cut when in reality the goods may be sold at sellers' regular prices.

Thus, apart from the monopolistic and restrictive trade practices that have the effect of restricting competition and increasing the market imperfections to the common detriment, consumer exploitation through unfair trade practices that mislead or dupe the customers has become widespread. And it is this situation that has largely led to the growth of consumerism.

4.4 Consumer Rights

Consumers in the advanced countries, obviously, are much more conscious of their rights than in countries like India. In 1962 President John F. Kennedy, and in 1965 President Johnson emphasized the consumer rights and gave an impetus to consumerism in the U.S.A. and other countries.

Important consumer rights include:

1. Right against exploitation by unfair trade practices.
2. Right to protection of health and safety from the goods and services the consumers buy or are offered free.
3. Right to be informed of the quality and performance standards, ingredients of the product, operational requirements, freshness of the product, possible adverse side effects and other relevant facts concerning the product or service.
4. Right to be heard if there is any grievance or suggestions.
5. Right to get the genuine grievances redressed.
6. Right to choose the best from a variety of offers.
7. Right to a physical environment that will protect and enhance the quality of life.

The Consumer Protection Act 1986 mentions the following rights:

1. Right to Safety:

Right to be protected against the marketing of goods and services which are hazardous to life and property.

2. Right to Information:

Right to be informed about the quality, quantity, potency, purity, standard and price of goods and services, as the case may be, so as to protect the consumer against unfair trade practices.

3. Right to choose:

The right to be assured, wherever possible, of access to a variety of goods and services at competitive prices.

4. Right to be heard:

The right to be heard and to be assured that the consumer's interests will receive fair consideration at the appropriate forum.

5. Right to Redressal:

Right to be prevented from unfair trade practice or restrictive trade practice or unfair exploitation of consumers.

6. Consumer Education Right: The right to acquire the knowledge and skills necessary to take action to influence the factors that affect consumer decisions.

7. Right to a Healthy Environment:

The right to a physical environment that will enhance the quality of life. It includes protection from environmental hazards over which the individual has no control. It acknowledges the need to protect and improve the environment for present and future generations.

8. Right to Basic Needs:

The right to basic needs ensures access to basic goods and services that guarantee survival. It includes adequate food, clothing, shelter, health care, education and sanitation to lead a decent life.

4.5 Consumer Protection

For effective consumer protection, a practical response on the part of three parties, the business, the government and the consumers, is essential.

Firstly, the business, comprising the producers and all the elements of the distribution channels, has to pay due regard to consumer rights. The producer has an inescapable

responsibility to ensure efficiency in production and the quality of output. He should also resist the temptation to charge exorbitant prices in a seller's market. Many a time, the imperfections on the supply side, like hoarding and black-marketing, mercilessly gouge the consumer. Hence, a socially responsible producer should see to it that whatever is produced reaches the ultimate consumer in time and at reasonable prices.

As T. Thomas observes, "Restraint is best exercised voluntarily than through legislation which will otherwise become inevitable. Advertising agencies and marketing management have a very important role to play in this respect. By overplaying the claims, they will be cutting the very branch on which they are perched."

Secondly, the Government has to come to the rescue of the helpless consumer to prevent him from being misled, duped, cheated and exploited. It should also take special care of the vulnerable sections.

The UN Guidelines for Consumer Protection points out that "the governmental role in consumer protection is vital and finds expression through policy-making, legislation and the development of institutional capacity for its enforcement. To provide a legal basis for enforcing basic consumer rights, every country needs to have an irreducible minimum of consumer protection legislation, covering physical safety, promotion and protection of consumers' economic interests, standards for the safety and quality of goods and services, distribution facilities, redress, and education and information programmes. Governments also require the necessary machinery to enforce such legislation." The Guidelines encourage Governments to develop, strengthen or maintain a strong consumer protection policy. In so doing, each Government must set its own priorities for the protection of consumers in accordance with its economic and social circumstances and the needs of its population.

The UN Guidelines also calls upon the Government to establish distribution facilities for essential consumer goods and services. It is suggested that Governments should, where appropriate, consider:

(a) Adopting or maintaining policies to ensure the efficient distribution of goods and services to consumers; where appropriate, specific policies should be considered to ensure the distribution of essential goods and services where this distribution is endangered, as could be the case particularly in rural areas. Such policies could include assistance for the creation of adequate storage and retain facilities in rural centres,

incentives for consumer self-help and better control of the conditions under which essential goods and services are provided in rural areas; and (b) encouraging the establishment of consumer cooperatives and related trading activities, as well as information about them especially in rural areas.

Further, according to the Guidelines, Governments should establish or maintain legal and / or administrative measures to enable consumers or, as appropriate, relevant organizations to obtain redress through formal or informal procedures that are expeditious, fair, inexpensive and accessible. Such procedures should take particular account of the needs of low-income consumers. Governments should also encourage all enterprises to resolve consumer disputes in a fair, expeditious and informal manner, and to establish voluntary mechanisms, including advisory services and informal complaints procedures, which can provide assistance to consumers. Information on available redress and other dispute-resolving procedures should be made available to consumers.

The motive of private gain tempts business to maximize income by socially undesirable trade practices; and this calls for government intervention. Statutory action to protect the interests of consumers has become quite common. In the United Kingdom, for instance, the Trade Description Act, 1968, prohibits the use of misleading descriptions of goods or services or misleading representation of price reductions. In a number of countries, pro-consumer legislation contains provisions that enable an affected party to seek remedy for compensation for the loss or damage suffered by it at the hands of a person who has indulged in prohibited practices. This is true of the Sherman Act and the Clayton Act of the U.S.A.; the Federal Act of Switzerland, the Act Against Restraint of Competition of Spain, the Act concerning Prohibition of Private Monopoly and Maintenance of Fair Trade of Japan, the Trade Practices Act of Australia, the Combines Investigation Act of Canada, etc.

In some countries, statutory bodies are empowered to require the advertiser to substantiate the claims made in the advertisements. For instance, the Federal Trade Commission (FTC) of the United States can seek affirmative disclosures. That is, if information in an advertisement is considered insufficient by the FTC, the Commission may require a company to disclose in its advertising some of the deficiencies or limitations of its product or service so that the consumer can judge its negative, as well as, positive attributes. The FTC can also require the advertisers to submit on demand by the Commission data to back-up advertising claims for a product's safety, performance,

quality or price comparability. The intent of this substantiation is to help consumers make more reasoned choices by having information made available to them. Members of many industry groups, including automobiles, appliances, soaps and detergents, television sets, dentists, hearing aids, and all over-the-counter drugs have been ordered to provide the Commission with documentation in support of their designated advertising claims. Corrective advertising requirements have increasingly been a part of many FTC consent orders. Corrective advertising doctrines are based upon the idea that inaccurate information has already been communicated by advertisers, and that corrective advertising is needed to eliminate the lingering effects of such information.

Thirdly, consumers should accept consumerism as a means of asserting and enjoying their rights. Consumerism should succeed in making the business and the government more responsive to the rights of the consumers.

Peter Drucker has remarked that “consumerism is the shame of the total marketing concept,” implying that the concept is not widely implemented. Consumerism reflects not only the failure of the business to widely implement the marketing concept but also the need to give the business policies a social orientation so as to enhance long-run social welfare. As Philip Kotler observes, “consumerism is a clarion call for a revised marketing concept,” Hence, the original marketing concept has to be broadened to include the societal marketing concept.

“The societal marketing concept calls for customer orientation backed by integrated marketing aimed at generating customer satisfaction and long-run consumer welfare, as the key to attaining long-run profitable volume”.

As Kotler points out, “the addition of long-run consumer welfare asks the businessman to include social and ecological consideration in his product and market planning. He is asked to do it not only to meet his social responsibilities but also because failure to do this may hurt his long-run interests as producer.” Thus, the message of consumerism is not a setback for marketing but rather

points to the next stage in the evolution of enlightened marketing. Just as the sales concept said that sales were all important, and the original marketing concept said that consumer satisfaction was also important, the societal marketing concept has emerged to say that long-run consumer welfare is also important.” Hence, he feels that consumerism will be enduring, beneficial, pro-marketing and ultimately profitable.

“Consumerism mobilizes the energies of consumers, businessmen and government leaders to seek solutions to several complex problems in a technologically advanced society. One of these is the difference between serving consumer desires efficiently and serving their long-run interests. To marketers, it says that products and marketing practices must be found which combine short-run and long-run values for the consumer. It says that a social marketing is an advance over the original marketing concept and a basis for earning increased consumer goodwill and profits. The enlightened marketer attempts to satisfy the consumer and hence his total well-being on the theory that what is good in the long-run for consumer is good for business.”

Non-governmental Organisations (NGOs) or voluntary organizations have a very important role in consumer protection. It may be noted that one of the stated objectives of the U.N. Guidelines for Consumer Protection is to facilitate the development of independent consumer groups which should have the freedom to present their views in decision-making processes affecting them. The Guidelines state that consumer organizations should be encouraged to monitor adverse practices, such as the adulteration of foods, false or misleading claims in marketing and service frauds. Business and consumer groups should also be encouraged by Governments to formulate codes of marketing and other business practices to ensure adequate consumer protection. Consumer groups have a role to play as well in undertaking education and information programmes, particularly for low income populations. Promoting the growth of a strong consumer movement and increasing protection for people in their role as consumers are central aims of Consumers International’s work. To this end, it assists newly formed consumer groups in developing countries. Consumers International’s independence is guaranteed by strict membership rules – organizations that join must be non-profit-making and non-commercial and must operate exclusively in the consumer’s interest.

4.6 The Need for Consumer Protection

In India consumers spread over the entire length and breadth of the country are unorganized. Many of them are also illiterate, poor and backward. As against this, the producers are relatively much more organised. They have huge resources at their disposal and can deceive and exploit consumers in a number of ways. In a bid to beat competition, increase their market share and maximize their profits, they, at times, adopt dubious means to push up the sales of their products.

What are the ways in which producers and traders can deceive consumers? The following are the most popular:

1. Prices may be fixed at levels much higher than those dictated by the costs of production.
2. The sellers may first hike prices and then offer discounts to attract consumers.
3. The consumers may not be given the correct weight or quantity of goods.
4. Advertisement might make false claims about the quality of the goods.
5. Advertisement may provide incomplete information not disclosing the risks associated with the use of the products.
6. The goods supplied to the consumers may be highly adulterated.

Prices in India have been increasing by leaps and bounds over the last three-four decades. Naturally they have affected the consumers, particularly those belonging to the poor classes or the lower middle income groups very adversely. A number of causes are responsible for pushing up the prices and it is not possible to single out any particular cause. However, it has been observed that in a number of cases the producers intentionally restrict output to raise prices by forming cartels amongst themselves and adopting restrictive trade practices. In some cases the price that a consumer is asked to pay has no relation to the cost of production. This often happens in the case of drugs whose prices are generally kept much higher than their cost of production. Another practice that is becoming increasingly popular to deceive consumers is the offer of heavy discounts on prices. The traders often raise the prices arbitrarily and then offer discounts. As a result, the unsuspecting consumer may actually be shelling out even a higher price than the actual price of the product.

Often advertising is another means used by producers to deceive consumers. The actual purpose of advertising is informing the consumer about different products. To this extent, it is useful. However, it has a number of ill effects, the two most important being the following:

1. the cost of advertising is added to the selling cost and this increases the prices
2. it can be deceptive and can misguide the consumers.

Companies can claim qualities with no scientific basis and they can keep the consumers in dark by not disclosing the risks associated with the use of their products. World wise, advertising is now a \$ 435 billion business. But that's a conservative estimate of annual global expenditures. If all forms of marketing are included, the figure rises to nearer \$

1 trillion. In fact, global advertising has increased by seven times since 1950, growing a third faster than the world economy. The growth in advertising expenditure has been particularly rapid in the countries of Asia and Latin America especially since the mid - 1980s and the early 1990s. over the past 10 years individual countries in this region have shown spectacular advertising growth – for China more than 1,000 per cent, for Indonesia 600 per cent, for Malaysia and Thailand more than 300 per cent, and for India, the Republic of Korea and the Philippines more than 200 per cent. Compared with GDP levels, the advertising expenditures in developing countries are particularly high.

The worst hazard that has appeared in India in recent times is the widespread practice of adulteration. Adulteration is practiced by private trade at several points in the supply chain – right from the producer to the ultimate consumer. In agricultural commodities adulteration is widespread. Small pebbles are mixed in wheat, jowar, bajra and maza. Leaves and bark of some trees are mixed with tea and sold as tea. Butter is mixed with coloured vanaspati, chilli powder with dust, spices with sand, yellow mud, saw dust, etc. Adulteration in milk is also quite common. The worst criminals are the manufacturers and dealers of spurious drugs as they play havoc with the lives of people.

4.7 Steps Required for Consumer Protection

On account of the above factors, a strong public opinion has built up over the years demanding protection to consumers. Protection to consumers requires the recognition of the following rights of the consumers by the business and the government.

1. **The right to safety.** Consumers should have right to protection of health and life against goods which are hazardous to health and life.
2. **The right to be informed.** Consumers should be given proper information about the goods that they intend purchasing. They should be protected against wrong and misleading advertisement.
3. **The right to choose.** Consumers should be given the right to choose from a variety of goods. This will give them an opportunity to select goods of their choice. In addition, because of competition, the prices charged would be reasonable.
4. **The right to be heard.** Consumers should be given a ‘sympathetic ear’ by the government. Their complaints and grievances should be properly looked into.

5. The right to get redress. It is not enough to hear the complaints of the consumers. It is also necessary to take action on these complaints as early as possible. For this purpose an appropriate redressal machinery must be in place.

According to Human Development Report, 1998, consumer rights must be defended through:

1. Strict standards for consumer health and safety.
2. Product labeling about the content and proper use of products and their environmental and social impact.
3. Information and awareness campaigns about potential health hazard, such as smoking and the improper use of feeding formula for infants.

4.8 Methods for Consumer Protection

The most important methods for consumer protection are as follows:

1. Imposition of self-regulation and discipline on themselves by the manufacturing and trading community.
2. Voluntary organization of consumers to safeguard their interests.
3. Spreading information and awareness regarding different products.
4. Government legislation to stop the malpractices resorted to by the traders and manufacturers.

4.8.1 Imposition of Self-Regulation and Discipline

The imposition of self-regulation and discipline by the manufacturers and traders on themselves is a very desirable but least feasible method of consumer protection. Only a handful of producers and traders will agree to impose self-discipline on themselves. Most others will not participate in this self-regulation at all while many will only support it verbally without doing anything concrete. The fact is that there are many unscrupulous traders operating with the sole intention of earning profits without caring for the means they adopt to achieve this purpose. How can they be expected to agree to self-regulation? A new approach that has been adopted with considerable success in this regard in recent years is 'publicizing' certain vital information and then requiring businesses to report their 'level' of adherence to this information. For instance, in some countries, the governments publicize information on industrial polluters. This encourages the production of information about pollution generation, both as a source of incentive for behavioural change and as a benchmark for subsequent regulation. A

well known example is the US Toxic Release Inventory, which requires businesses to report the amounts of toxic materials that they put into the environment. Many companies respond by reducing pollution to preserve their reputation.

4.8.2 Voluntary Organisations of Consumers

Consumer organizations are organizations formed by consumers to fight for their rights and are prepared by consumers to create awareness among them about their responsibilities to enhance consumer welfare through proper coordination with governments and institutions. They may be operating under different names. They are very united, aggressive and effective in protecting the interests of consumers.

The responsibilities of a consumer organisation are many :

1. To provide consumer education including awareness on rights and duties of consumers.
2. To share and exchange consumer related information.
3. To promote cooperation and collaboration in all activities relating to consumer protection and interests.
4. To carry out research and product testing.
5. To ensure basic needs like food, housing, health care and clean environment to every consumer.
6. To develop a sense of confidence among consumers to represent their complaints.
7. To educate consumers, to make their own decisions, to think critically and to gain strength to resist dangerous trends and practices.
8. To work with communities to help them solve their problems.
9. To provide counselling and guidance in cases of grievances.
10. To organise programmes of public interest.

In many countries, even developed and advanced ones, consumers have grouped themselves together on a social basis. Organization is often achieved by setting up consumer associations or councils, or by organizing cooperative organizations. India has

a rich history of the development of consumer organisations. Following are some of the consumer groups and organisations that have been established over the years:

1. Passengers and Traffic Relief Association (1915)
2. Indian Women's Association (1917)
3. Indian Association of Consumers (1956)
4. Gayatri Charitable Trust (1960)
5. Jyoti Sangh Consumer Protection Department (1962)
6. Bombay Civil Trust (1963)
7. Consumer Guidance Society of India (1966)
8. Karnataka Consumer Service Society (1970)
9. Visaka Consumer Council (1973)
10. All India Gram Panchayat (1974)
11. Consumer Education and Research Centre (1978)
12. Gram Panchayat (1979)
13. Consumer Forum (1980)
14. Consumer Unity and Trust Society (1984)
15. American Action Group (1985)
16. SMN Consumer Protection Council (1986)
17. Bombay Communication Electronics Association (1989)
18. Consumer Organization of India (1991)
19. Consumer Cooperation Council (1992)

4.8.2.1 Consumer Associations or Councils

Consumer associations or Consumer councils have been formed in most of the developed countries and some developing countries with an eye on protecting the rights of consumers. In India, a nucleus consumer organization named National Consumer Services (NCS) was set up in 1963. Its main object was to collect market intelligence, publish bulletins for information of consumers, study the trends of rising prices, and organize activities against the malpractices of the trade. Some councils and consumer associations affiliated to NCS were set up in Delhi. Another consumer organization named Price Rise Resistance Movement (PRRM) was set up in Delhi in 1964. It organized meetings to protect against rising prices. Open air shops were also formed for the sale of vegetables, fruits, eggs, etc. In 1996 a Consumer Guidance Society was set up in Mumbai. It was a voluntary organization set up to promote and protect the rights

and interests of consumers. It provides information and guidance to consumers, campaigns against adulteration of goods by traders and publishes test results of consumer goods. A consumer organization 'Common Cause' set up by H.D. Shourie and based at Delhi, is also doing yeoman's service in the field of educating consumers and protecting their rights. A National Consumer Council of India was formed in Delhi in 1968.

4.8.2.2 Consumer Cooperatives

A consumer cooperative is a voluntary association of individuals formed for the achievement of the common good. In India, any ten or more persons belonging to a particular place, class or occupation can come together to form a cooperative society. They can apply to the Registrar of Cooperative Societies for registration. Some of the advantages of consumer cooperatives are as follows:

1. Since a number of individuals come together to form a consumer cooperative, their bargaining power increases.
2. Since purchases are made in bulk, they are generally at lower prices.
3. Consumers are assured of unadulterated and standard quality goods.
4. Correct weights and measures are used by the society therefore the consumer is saved from 'deceit' on this account also.
5. Goods are sold at market prices to avoid unhealthy competition with other retailers. The profits earned on this account are usually spent on various social programmes for the benefit of members.
6. In our country consumer cooperatives have performed the function of distributing essential commodities at reasonable prices.

As a policy, Government of India have been emphasizing the need for strengthening cooperatives, so as to enable these organisations to play a dominant role in the Public Distribution System both in the urban and in the rural areas. The consumer cooperative structure in the country has four tiers, with the National Cooperative Consumers Federation of India Limited (NCCF) at the national level. State Cooperative Consumers Organisations are affiliated to the NCCF. At the central/wholesale level, there are 800 consumer cooperative stores. At the primary level, there are 21,903 primary stores. In the rural areas, there are about 44,418 village level Primary Agricultural Credit Societies and Marketing Societies undertaking the distribution of consumer goods along with their normal business. In the urban and semi-urban areas the consumer cooperative societies

are operating about 37,226 retail outlets to meet the requirements of the consumers. The NCCF besides undertaking distribution of consumer articles, also has a consultancy and promotional cell for strengthening consumer cooperative societies engaged in the retailing activities. NCCF with its Head Office at New Delhi has 34 branches/sub-branches located in various parts of the country. The government with the help of NCCF, launched a scheme called Sarvpriya in July 2000. The scheme envisages distribution of 11 selected commodities of daily use to the consumers through the fair shops and consumer cooperatives. The sales turnover of NCCF during 2006-07 was Rs.411 crore.

4.8.3 Spreading Information and Awareness

Globalisation – the integration of trade, investment and financial markets – has also integrated the consumer market. Globalisation is bringing a constant stream of new products, produced far away in unknown conditions. In such circumstances, information and awareness regarding different products becomes essential. Unfortunately, the predominant source of product information available today in most of the countries across the globe is commercial advertising. If unchecked, commercial advertising can be deceptive as its main objective is to ‘lure’ consumers to use a certain product and not to inform or educate them regarding the risks or hazards associated with the use of that product. Thus, while marketing and advertising campaigns have intensified, information campaigns lag far behind (particularly in the developing countries). This is due to the fact that while massive expenditures are being incurred on commercial advertisements, resources for information campaigns are always seriously limited.

4.8.4 Government Legislation

Governments of most of the countries have adopted various legislations for the protection of consumer rights. For example, the British and US governments have enacted a number of laws which have served as a guide for other countries. The important British laws in this respect are: (i) The Sale of Goods Act, 1893,

(ii) The Food and Drugs Act, 1955,

(iii) The Weights and Measures Act, 1963,

(iv) The Trading Stamps Act, 1964,

(v) The Fair Trading Act, 1973 etc.

The Government of India have also passed a number of Acts to protect the rights of consumers. These include Agricultural Produce (Grading and Marketing) Act, 1937; the Essential Commodities Act, 1955; the Weights and Measures Act, 1958; Prevention of Food Adulteration Act, 1954; the Drugs and Cosmetics Act, 1940; Fruit Products Order 1955; the Prevention of Black Marketing and Maintenance of Supplies of Essential Commodities Act; Drugs and Magic Mark) Act; the Indian Sale of Goods Act; the Dangerous Drugs Act; the Emblems and Names (Preventing of Improper Use) Act; Packaged Commodities (Regulation) Order, 1975; the Trade and Merchandise Mark Act; Monopolies and Restrictive Trade Practices Act, 1969 etc. The most important legislation in the field of consumer protection is the Consumer Protection act, 1986, to which we turn in the next section.

4.8.5 Other Methods

Under ‘other steps’ we shall consider (i) Conferment of National Awards, (ii) Publicity measures, (iii) Consumer Welfare Fund, and (iv) Bureau of Indian Standards.

(i) National Awards

To encourage the participation of consumer organizations, women and youth in the field of consumer protection, the Ministry of Civil Supplies, Consumer Affairs and Public Distribution of the Government of India has instituted three National Awards namely National Award on Consumer Protection, National Women Award and National Youth Award on Consumer Protection which are given every year.

(ii) Publicity Measures

The fifteenth of March is celebrated as “World Consumer Rights Day” all over the world. This day is used to spread consumer awareness through various means like display of hoardings, banners, bus panels, etc. In India, Doordarshan and AIR also regularly broadcast programmes on consumer protection and brochures and booklets (like ‘Salient Features of Consumer Protection Act, 1986’, ‘Rights of Consumers’, ‘The Consumer Protection Act and You’, ‘Help Prevent Adulteration’, ‘Consumer Protection and Weights and Measures’, ‘Directory of Consumer Organisations’, etc.) are published. In addition, 24 December has been declared as ‘National Consumer Day’.

(iii) Consumer Welfare Fund

The Government of India created the Consumer Welfare Fund (CWF) in 1992 with the objective to provide financial assistance to protect and promote the welfare of the

consumers, develop consumer awareness and strengthen the consumer movement in the country particularly in the rural areas. The Fund, set up by the Department of Revenue under the Central Excise and Salt Act, 1994, is operated by the Ministry of Consumer Affairs, Food and Public Distribution.

Schemes under CWF included: (i) Jagriti Shivir Yojana (launched in June 2001); (ii) setting up of District Consumer Information Centre in a phased manner;

(iii) setting up of consumer clubs in schools and colleges; and (iv) promoting involvement of research institutions/universities/colleges etc. in consumer protection and welfare. With the closure of funding of Jagriti Shivir Yojana and District Consumer Information Centre by the Department of Consumer Affairs, the State Governments are now being impressed upon to create their own Consumer Welfare Fund.

(iv) Bureau of Indian Standards

The Bureau of Indian Standards (BIS) is the national standards body of India. The main function of BIS include preparation and implementation of standards, operation of certification schemes – both for different items ranging from food products to electronics. The scheme is basically voluntary in nature. However, keeping in view the safety and mass consumption of certain products, it has been made mandatory for 68 items like LPG cylinders, food colours, packaged drinking water, etc.

Consumer Awareness Scheme in the Eleventh Plan

The Consumer Awareness Scheme for the Eleventh Plan amounting to a total of Rs. 4,009 crore has been approved by the government on January 24, 2008. the scheme has been formulated to give an increased thrust o a multi-media publicity campaign to make consumers aware of their rights. The slogan ‘Jago Grahak Jago’ has now become a household name as a result of publicity campaign undertaken in the last three years. Through the increased thrust on consumer awareness in the Eleventh Plan, the government has endeavoured to inform the common man of his rights as a consumer. As part of the Consumer Awareness Scheme, the rural and remote areas have been given top priority.

4.9 Consumer Protection Act, 1986 (with amendments)

Enactment of Consumer Protection Act, 1986 was one of the most important steps taken to protect the interest of the consumers. It was formulated after studying intensively the

consumer protection Acts of a number of countries, and after thorough consultations with the representatives of consumers, traders and industrialists. All the provisions of the Act came into force with effect from July 1, 1987. The Act was thoroughly amended in 1991 and 1993. To make the Consumer Protection Act more functional and purposeful, a comprehensive amendment was carried out in December 2002 and brought into force from March 15, 2003. As a sequel, the Consumer Protection Rules, 1987 were also amended and Consumer Protection Regulations, 2005 framed to give effect to the provisions of the Act.

4.9.1 Objectives of the Act and Rights of Consumers

The objective of the Consumer Protection Act is “to provide for the better protection of the interest of consumers and for that purpose to make provisions for the establishment of consumer councils and other authorities for the settlement of consumers’ disputes and for matters connected therewith.” The Act applies to all goods and services especially exempted by the Central Government. It covers all the sectors whether private, public or co-operative. The provisions of the Act are compensatory in nature. Section 6 (Chapter II) of the Act enshrines the following rights of consumers:

- (a) the right to be protected against the marketing of goods and services which are hazardous to life and property;
- (b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods or services so as to protect the consumer against unfair trade practices;
- (c) the right to be assured, wherever possible, access to a variety of goods and services at competitive prices;
- (d) the right to be heard and to be assured that consumers’ interests will receive due consideration at the appropriate fora;
- (e) the right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; and
- (f) the right to consumer education.

4.9.2 Consumer Protection Councils

The Act provides for the establishment of a Central Consumer Protection Council by the Central Government and State Consumer Protection Councils by the respective State governments. The Central Council shall consist of the following members, namely (a) the Minister incharge of consumer affairs in the Central Government, who shall be the

chairman and (b) such number of other official or non-official members representing such interests as may be prescribed. The Central Council shall meet as and when necessary, but at least one meeting of council shall be held every year. The objects of the Central Council are to promote and protect the rights of consumers noted above (clauses (a) to (f) of Section 6.)

The State Council shall be established by the State Government in question and shall consist of the following members: (a) the Minister incharge of consumer affairs in the State Government who shall be the chairman, and (b) such number of other official or non-official members representing such interests as may be prescribed by the State government. The State Council shall meet as and when necessary but not less than two meetings shall be held every year. The objects of every State Council shall be to promote and protect within the State rights of the consumers laid down in clauses (a) to (f) of Section 6.

4.9.3 Consumer Disputes Redressal Agencies

4.9.4 Section 9 of the Consumer Protection Act provides for the establishment of a three-tier consumer disputes redressal system at the District, State and National level. The three redressal agencies are as follows:

1. A Consumer Disputes Redressal Forum at the District level known as the ‘District Forum’.
2. A Consumer Disputes Redressal Commission at the State level known as the ‘State Commission.’
3. A National Consumer Disputes Redressal Commission established by the Central Government.

Section 10 of the Act is concerned with the composition of the District Forum, Section 16 with the composition of the State Commission and Section 20 with the composition of the National Commission.

Section 11 relates to the jurisdiction of the District Forum. According to this Section, subject to the other provisions of this Act, the District Forum shall have jurisdiction to entertain complaints where the value of the goods or services and the compensation, if any, claimed does not exceed rupees twenty lakhs. According to Section 12, a complaint in relation to any goods or services sold may be filed with a District Forum by:

1. the consumer to whom such goods or services are sold;

2. any recognised consumer association (whether the consumer in question is a member of that association or not);
3. one or more consumers, where there are numerous consumers having the same interest; or
4. the Central government or the State government either in its individual capacity or as a representative of the interests of consumers in general.

Section 17 relates to the jurisdiction of the State Commission. According to this Section, subject to the other provisions of the Act, the State Commission shall have jurisdiction to entertain complaints where the value of the goods or services and the compensation, if any, claimed exceeds Rs. 20 lakh but not Rs. 1 crore. Section 21 relates to the jurisdiction of the National Commission. According to this Section, subject to other provisions of the Act, the National Commission shall have jurisdiction to entertain complaints where the value of goods or services and the compensation, if any, claimed exceeds Rs. 1 crore.

4.9.4 Remedial Action

If any of the consumer redressal agencies is satisfied that the goods complained against suffer from any of the defects specified in the complaint or that any of the allegations contained in the complaint about the services are proved, it shall issue an order to the opposite party to do one or more of the following things namely –

1. to remove the defect pointed out by the appropriate laboratory from the goods in question;
2. to replace the goods with new goods of similar description which shall be free from any defects;
3. to return to the complainant the price of, as the case may be, the charges paid by the complainant;
4. to pay such amount as may be awarded by it as compensation to the consumer for any loss or injury suffered by the consumer, due to the negligence of the opposite party;
5. to remove the defects in goods or deficiencies in the services in question;
6. to discontinue the unfair trade practice or the restrictive trade practices or not to repeat them;
7. not to offer the hazardous goods for sale;
8. to withdraw the hazardous goods from being offered for sale;
9. to provide for adequate costs to parties.

4.9.5 Appeal

According to Section 15, any person aggrieved by an order made by the District Forum may prefer an appeal against such order to the State Commission within a period of 30 days from the date of the order, in such form and manner as may be prescribed. Any person aggrieved by an order of the State Commission may prefer an appeal against such order to the National Commission within a period of 30 days (Section 19). In case a person is aggrieved by the order made by the National Commission, he may prefer an appeal against such order to the Supreme Court within a period of 30 days from the date of the order (Section 23). (In all cases, the appeal can be entertained even after the expiry of 30 days provided that the authority (redressal agency) to whom such appeal is being made is satisfied that there was sufficient cause for not filing it within that period.)

4.9.6 Penalties

Section 27 pertains to the issue of penalties. According to this section, where a trader or a person against whom a complaint is made or the complainant fails or omits to comply with any order made by the redressal agency, he shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to three years, or with fine which shall not be less than Rs. 2,000 but may extend to Rs. 10,000 or with both.

Dismissal of Frivolous or Vexatious Complaints. Where a complaint instituted before any redressal agency is found to be frivolous or vexatious, the redressal agency shall dismiss the complaint and make an order that the complainant shall pay to the opposite party such cost, not exceeding Rs. 10,000 as may be specified in order.

4.9.7 Implementation of the Act

In terms of the Consumer Protection Act, Consumer Disputes Redressal Agencies have been set up at the district level (600), State level (35) and National level to provide simple, inexpensive and time bound justice to the consumer complaints against defective goods, deficient services including the unfair/trade practices adopted by the traders or any person. States have been empowered to establish additional District For a in the same District. States can also establish additional benches of the State Commission and also notify places to hold circuit benches. The Central government set up the National Commission in 1988 at New Delhi. The Act empowers appointment of additional

members of the National for creation of additional benches as also for heading of circuit benches by the National Commission to bring justice to the doorstep of the consumers. At present, 3 benches are functioning in the National Commission.

The Government of India also created a separate Department of Consumer Affairs in the year 1997 to act as the nodal department to exclusively focus on protecting the rights of consumers including redressal of consumer grievances as well as to promote standards of goods and services, etc. On the request of the Central government, some State governments have created separate Departments/Directorates of Consumer Affairs and, wherever it has not been feasible to do this, at least the names of the Departments have been changed to include Consumer Affairs/Consumer Protection for the knowledge of the general public. The Central government has recently requested all the State/Union Territories to establish a separate Department with full fledged Secretary so that the consumer protection programme gets exclusive attention for protecting and promoting the welfare of consumers.

4.10 Green Consumerism

Green consumerism refers to all forms of consumer behaviour and models that are good for people's health and protection of the environment. Green consumption involves saving of resources, less pollution, purchase of environment friendly products, reusable goods, categorized collection and recycling of waste materials, and having an eco-friendly lifestyle in order to protect and maintain ecological balance.

Green consumerism can be described as either a highly democratic strategy to save the planet or exploitative marketing, depending on who you are talking to. As a strategy to save the planet it confronts the mass of consumers in industrialised countries. Consumer demand has got us into the current mess, now it has to get us out again. Consumers must inform themselves about major environmental problems and then, by being cross-informed through product labelling, they should only select environmentally benign products -- and green life-styles to match their new consumption tastes.

The idea is that when awareness of environmental problems penetrates deeply enough into the community consciousness the purchasing power of the mass market will force all manufacturers to green both their products and their manufacturing processes -- on pain of being rejected in the market-place by green-leaning consumers. If all goes

according to plan only those companies which adapt to the demand for greenness will survive. This approach to environmentalism is seen as being consistent with our existing mainstream culture. It allows the majority of people participation in the decision-making process by way of voting with their credit cards.

The other point of view on green consumerism sees the mass of consumers as being victimised and exploited by misleading advertising which appeals to highly moral, but ill-informed, instincts on environmental matters. It sees manufacturers, together with the high-priests of over-consumption, the advertising industry, adapting to environmental concerns as if they were merely a new fashion to squeeze the juice out of, before moving on.

The first point of view sees the environmental crisis as being the result of the quality of past mass consumption whereas the second view sees it as being caused by, not only the quality, but the volume of consumption as well. For the sceptic, green consumerism might even increase environmental damage by encouraging the consumption of new types of products under the misconception that they are environmentally benign.

4.10.1 The Roots of Green Consumerism

Green buyers, of course, have been around for a long time, but until recently they were only a discriminating few. The birth of the modern green consumer movement is usually dated at around the time the newly-released Brundtland Report was generating heightened awareness of the global ecological crisis. In 1987 a British company called The Body Shop won the UK "Company of the Year" Business Enterprise Awards. The Body Shop was then "riding high on a wave of green consumerism" as an outlet for "cruelty-free, minimally packaged, natural ingredient soaps". It was expanding at the rate of 20 new outlets a year and its extraordinary success helped to inspire several authors to quickly assemble popular guides to both green economics and green consuming. Green discrimination by consumers was thereafter quickly established as an essential ingredient of the business culture's plan to save the planet.

4.10.2 Green Consumers

It wasn't long, however, before the green sceptics began responding to all this market enthusiasm with articles of their own. Some of them concentrated on the environmental

problem that would ensue from any increase in consumption, whether the increase was green or not.

The dilemma is that of consumption, the question of being: can we continue to consume goods at the present rate, even if we move to more environmentally acceptable products, and expect to stave off the impending environmental crisis. For it is runaway industrial growth that is poisoning the planet and consumption is its driving force.

Following closely behind this "nice try but it won't work" kind of scepticism was the more critical school of, 'Beware the green con', which was a journalistic response to the green shopping guide articles of 1989. These counter-argument articles often presented a mirror image of the green-shopping enthusiasm of the year before. But this time they were listing consumer products which were falsely promoted as being green.

One influential article listed four pitfalls for the consumer trying to buy green. The first pitfall was the 'Bit-Less-Trap'. This is best illustrated by the CFC-free aerosol, which is marketed as environmentally-friendly, but which may contain other gases which threaten health or continue to damage the ozone layer. It is a bit less harmful than its predecessor, but still not sound. Unleaded petrol is another example. It lessens the problem of lead pollution in the atmosphere but then aromatic hydrocarbons are added to the unleaded petrol to keep up the octane level and, if the car doesn't have a catalytic converter attached to the exhaust, benzene is emitted, which is a known carcinogen.

The second pitfall was identified as the 'Green Image Game'. A statement directed at marketing executives was cited which advised "By making products sound as if they are good for the environment, manufacturers can attract extra sales from around a third of the population".

The third pitfall was 'Niche-marketing'. This is evident when a manufacturer produces one line of products specifically directed towards environmentally-aware consumers but at the same time produces comparable products in the old environmentally-unfriendly mode for the mainstream market.

The fourth pitfall was the 'Cradle-to-Grave Trap' which was identified as a concern for the history of the whole product: the resources that are refined to make it, the pollution caused in manufacturing, the energy consumption, both in manufacturing and operation,

and the product's life-span and disposal problems. This pitfall is the impossibility for the consumer to find all this out before every purchase.

4.10.3 Business as Usual

By 1991 the green consumer revolution seemed to be over. In September of that year an article in the Good Weekend was introduced with, "In just one year the great green ground swell has gone out with the tide. The shops still hold 'green' products but many are only superficial, as is customer support.

Graphs were shown of polling results which proved the string-bag lifestyle was tough and short. Between November 1989 and September 1990 affirmation to questions like, "Would you pay more for biodegradable plastics" and "Would you purchase products marked environmentally friendly", had approximately halved. It seems that the waning of green fashion, combined with a recession, had driven business back to normal. It was time to rewrite the scenario in which punctilious green consumers were going to dictate environmental terms to the manufacturers. It was now the turn of the advertisers to use their craft to segment the market and ruthlessly exploit residual consumer concerns about environmental matters.

Some recent advertisements for cars are good examples of the way some car manufacturers now like to identify their brands with environmental issues. The strategy is to confront new-car buyer resistance, that might be rooted in consumer guilt, with an appeal to environmental responsibility. A SAAB advertisement has a picture of an exhaust pipe with the caption, "A BREATH OF FRESH AIR". The text of the advertisement claims that "Our cars actually clean the air". It goes on to say that tests have shown that a SAAB's exhaust gases actually contain less hydrocarbon and nitrogen oxide than the surrounding air in London traffic.

The peak of mass enthusiasm for green consumerism has clearly passed. The market now seems to be segmented into the majority who tend to resist green marketing and a minority who tend to respond to it. If this is the case then there is little prospect for green consumerism succeeding as a method for solving the environmental crisis. The plan originally called for the mass consumer market to demand a complete restructuring of manufacturing along environmentally sound lines. A minority of consumers can never be expected to achieve this.

4.11 Summary

Consumerism is a movement to inform consumers and protect them from business malpractices. The movement focuses on inferior and dangerous merchandise, unfair business practices and false or misleading advertisements. Unfair practices by businessmen abound. Artificial scarcities are created; prices are unreasonably hiked; adulteration is unabashedly practiced; under-measurement and under-weighing are rampant; money is accepted in advance, promising delivery of product in question within a specified time but seldom honoured and other – sales services are mostly an unkept promise. Ads and labels are misused and are full of sex, false claims and half truths. Businessmen should realize their moral responsibility and avoid indulging in practices that are harmful to consumers. Such enlightened self-realisation is unfortunately lacking. Government regulation becomes necessary to protect consumer interest. The government has appropriately passed several legislations and issued notifications and orders to restrain businessmen from indulging in felonies. Consequently, we have around fifty laws which have been enacted to protect their interest. The Consumer Protection Act, 1986, is the latest to be enacted by the Central Government. This is the most powerful piece of legislation which provides effective protection against unfair trade practices, unsatisfactory services and defective goods. The Act provides for setting up of special forums of district, state and Central levels to deal exclusively with consumer complaints and issues. It provides for awarding compensation to the aggrieved consumer. The Act brings in its fold even public undertakings which were excluded by previous legislations. Besides enacting legislations, the government has taken other measurement to protect consumer interest. The government has included consumer protection as an item of the 20 Point Programme. A Consumer Advisory Council has been set up by agencies, including state governments, the Textile Committee and the Department of Science and Technology. The media is giving coverage to the subject and AIR and Doordarshan have been organizing programmes like Lok Samasyani Sansad and Janavani. Apart from what the government does, the consumer should himself assert his rights and protect himself against business malpractices. This is the genesis of consumerism. Various consumer movements have come up in different parts of the country and as of today, there are 237 and odd consumer organizations working towards consumer protection. The consumer movement is still in its nascent stage. It is sure to grow and become more powerful as

we go into the future with new concepts like Green Consumerism and Ethical Consumption.

4.12 Keywords

Consumer: A consumer is defined as someone who acquires goods or services for direct use or ownership rather than for resale or use in production and manufacturing

Consumerism: It is a social and economic order that encourages the purchase of goods and services in ever-greater amounts.

Exploitation: It means using something in an unjust or cruel manner.

Consumer protection: It consists of laws and organizations designed to ensure the rights of consumers as well as fair trade competition and the free flow of truthful information in the marketplace.

Green consumerism: It is a type of consumer activism practiced through 'positive buying' in that ethical products are favoured, or 'moral boycott', that is negative purchasing and company-based purchasing.

4.13 Check Your Progress

Fill in the blanks

1. The term does not include a person who acquires goods or services for resale or for any business purpose.
2.,Consumers should be given proper information about the goods they wish to purchase.
3. The most important law in the field of consumer protection is the Consumer Protection Act, ...
4., refers to all forms of consumer behaviour and models that take into account the health of people and the environment.

4.14 Answer to Check Your Progress

1. Consumer 2. Right to Information 3. 1986 4. Green Consumerism

4.15 Terminal Questions

1. Define consumerism.
2. Explain the various utilities of consumerism.
3. Give details on how the consumer is exploited in different ways.
4. Enlist the important consumer rights.
5. Give details of the government bodies, international bodies and voluntary helping in strengthening the Consumer Rights movement.
6. Explain the need for Consumer Protection.
7. Explain the important methods for Consumer Protection.
8. Briefly explain the various features of Consumer Protection Act, 1986.
9. Explain the concept of Green Consumerism.
10. Describe the constitution and working of three tier Consumer Dispute Redressal Forums?
11. How does the Consumer Protection Act, 1986 protect the interest of the Consumers?
12. Why has consumer protection become necessary in modern times?
13. The role of government with respect to consumer protection may be viewed from different angles. Elucidate
14. How do producers and sellers often exploit the consumers? Explain the main measures for the protection of consumers in the country.

4.16 References

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UNIT-5: Macro Economic Environment and Modern Theories of Economic Growth

Structure:

- 5.1 Introduction
- 5.2 Nature of Macro-Economic Environment
- 5.3 Features of macroeconomics
- 5.4 Macroeconomic variables
- 5.5 Macro as a Static or Dynamic Analysis
- 5.6 The concept of Equilibrium in Macro Economics
- 5.7 Methodological Concerns
- 5.8 Scope of Macro Economics
 - 5.8.1 Transformation from Micro to Macro Economics
- 5.9 Contemporary Macro Economics
 - 5.9.1 Monetarism
 - 5.9.2 Neo-Classical Approach
 - 5.9.3 Supply Side Economics(SSE)
- 5.10 Modern Theories of Economic Growth
- 5.11 Harrod-Domar Model
- 5.12 Domar Model
- 5.13 Harrod Model
- 5.14 Kaldor's Model of Growth
- 5.15 Neo-Classical Model of Growth
- 5.16 Solow's Model
- 5.17 Summary
- 5.18 Keywords
- 5.19 Check Your Progress
- 5.20 Answers to Check Your Progress
- 5.21 Terminal Questions
- 5.22 References

Objectives

After studying this unit, students would be able to understand:

1. The nature of macro-economic environment
2. The scope of macro economics
3. Variables which affect macro-economic environment
4. Contemporary Macro-economic world
5. Modern theories of economic growth

5.1 Introduction

Classical economists like J. B. Say and Pigou used to believe that supply creates its own demand; hence there is no possibility of general over production and general unemployment. They also maintain that there is a tendency of full employment equilibrium in the economy and if there is temporary disequilibrium it may be automatically shifted to equilibrium position through automatic adjustment of demand and supply forces through flexibility of wages, price and interest rates. But during the great depression of 1930s world witnessed something it never imagined before. There was glut of commodities in the market, but there was deficiency in demand leading to closure of businesses, lockouts by industrialists, hence unemployment was a resultant consequence, no further production, no income leading to total chaos in the economy. Then came the Keynesian revolution who has propounded theory in 1936 in his book ‘General theory of Employment, Interest and Money’. His theory was based on the experiences of great depression and he concluded that unemployment may be found in every economy and the main cause of unemployment is deficiency in aggregate demand, so the problem of unemployment could only be tackled by increasing the aggregate demand. To stimulate aggregate demand, investment acts as a key component as per Keynes. Keynes also opines that government intervention is necessary to resolve the problem of large scale unemployment. Macro economy approach is based on whole economy and is also known as aggregative economics. In this context Kurihara remarked ‘There is much practical advantage in seeing through all the complex interrelationships of the economy as a whole and in concentrating on large aggregates which affect the whole economy.

5.2 Nature of Macro-economic Environment

Macro economics is concerned with aggregate quantities as total investment, consumption, general price level, national income, total output, total savings,

aggregate demand and aggregate supply. In the words of Shapiro, “Macro economics deals with the functioning of the economy as a whole.” According to Gardner Ackley “Macro economics concern with such variables as a aggregate volume of output of an economy, with the extent to which its resources are employed, with the size of the national income and with the general price level.” Hence, Macro economics is called as aggregative economics. The word ‘Macro’ originated from the Greek word ‘Makros’ which means large. So macro economics is concerned with the study of economy as a whole. Fellner also put it as “Macro economics or aggregative economics studies aggregates of individual making units particularly economy as a whole.” The term Macro economics was first coined by Prof. Ragnar Frisch in 1933 as he first segregated micro and macro economics into two parts. Although the origin of macro economics as a methodological approach to economic problems belong to Mercantilists I sixteenth and seventeenth century. They were concerned with the economic system as a whole. Malthus, Sismondi and Marx also approached problems in a macro-economic manner. Fisher, Walras and Wicksell have contributed to the development of macro economics, Walras gave the general equilibrium analysis approach, but the main credit goes to J M Keynes who has given macro economics as a solution to revive the total economies of the world from the depression they underwent. It is also called as depression economics. In the words of Ackley “Macro economics deals with the economic affairs in the large, it concerns with the overall dimensions of the economic life.” It studies the character of the forest independently of the trees which compose it. M H Spencer says that macro economics is concerned with the economy as a whole or large segment of it. In macro economics attention is focused on such problems such as level of unemployment, the rate of inflation, the nation’s total output and the other matters of the economy wide significance. Macro economics is also known as theory of income, output and employment.

5.3 Features of macroeconomics

The following are the important features of macroeconomics as a study in the field of economics, commerce and management:

1. Short run characteristics of macroeconomics: Short-term symptoms can be expressed in the following way:

(i) In the short run, the quantity and quality of labour, amount of capital, existing technology, extent of competition, degree of monopoly, tastes of people, broader social structure, etc., remain constant and do not undergo any significant change.

(ii) Although employment can be increased by increasing both

(iii) consumption and investment, in the microeconomics, more emphasis is given on increasing investment rather than increasing consumption expenditure to increase the level of employment.

(iv) In the short run, national product or aggregate supply is considered constant.

2. Study of the Economy as a Whole: Macroeconomic analysis is the study of the economy as a whole. It is mainly concerned with national income or national product, aggregate consumption, aggregate investment, effective demand, price level, employment level (of resources and labour force).

3. Macroeconomics is a systematic and detailed thinking: Macroeconomics is a detailed study of all conditions or situations. It studies all situations like inflation, deflation, boom or recession, full employment or underemployment etc.

4. Macroeconomics is conducive to capitalist or neoliberal reform: The aim of macroeconomics is to reform capitalism, not to destroy it. It states with certainty that capitalism, as it existed during the First World War, has no place in today's changed world. Various laws of macroeconomics are based on various characteristics of capitalism such as private property, freedom of choice, profit motive and price mechanism etc.

5. Macroeconomics is a form of monetary economics: Classical economists emphasized real rather than monetary factors in their analysis, since they saw money's main function as simply a medium of exchange.

6. Macroeconomics is primarily institutional: The second characteristic of macroeconomics is that it is institutional in nature and focuses on savings, investment, money supply and the psychology and institutional factors affecting the propensity to save.

7. Importance of State Intervention: Macroeconomics lays great emphasis on state intervention. When private investment falls short of raising public expenditure to the desired level, government expenditure is the main instrument to stimulate demand.

8. Crucial role of investment: In macroeconomics, investment has been given the main responsibility. Investment means increasing the stock of goods and new capital assets for income generation.

9. Role of Consumption: Consumption expenditure and psychological law of consumption are very important in macroeconomics. The role of consumption in determining employment is no less important than investment and production. More production leads to more employment generation.

10. Role of National Income: Macroeconomics gives great importance to the study of national income. It creates a favorable environment with the availability of necessary statistical data for the study of investment, employment, savings, consumption etc.

5.4 Macro Economic Variables

The main macro economic variables have been identified as consumption, investment, money supply, interest rate, price level, wage rate and so on. Although these variables appear to be self explanatory but a closer look to them reveal that they should be understood thoroughly. First of all we should know whether these variables are stock variables or flow variables. A stock variable is that variable which has meaning only at a specific point in time. An example of stock variable is population data. It has a meaning if you are enquiring at a particular time. Macro-economic variables are generally stock variables. Flow variables are those variables which cannot be meaningfully expressed except in terms of a time period. For example income per year, savings per quarter etc. Investment spending is a flow variable whereas capital stock is a stock variable.

5.5 Macro as a Static or Dynamic Analysis

Static analysis is concerned with the equilibrium in which variables don't change overtime. The static models enquire into the forces leading to, maintaining and reestablishing, if necessary the equilibrium condition. Then there is concept of comparative static i.e. comparison of two equilibrium states. In both the static analysis and comparative analysis used by Keynes, there is no exact accounting for how the new position was reached and how long it took to reach it. Static or comparative analysis can be illustrated in the figures 5.1a and 5.1b given below:

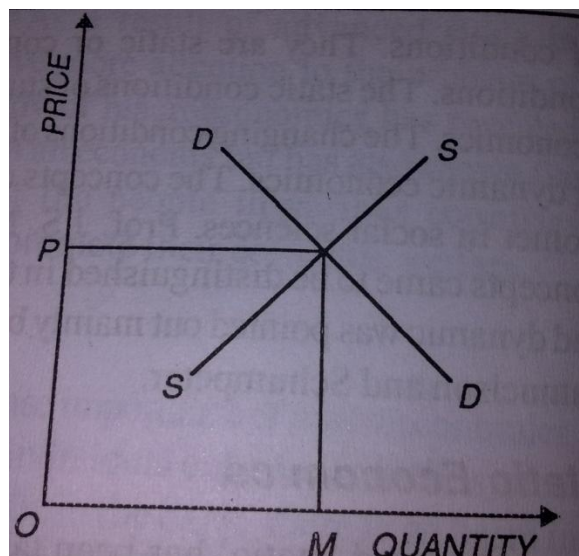


Figure 5.1a: Static Analysis

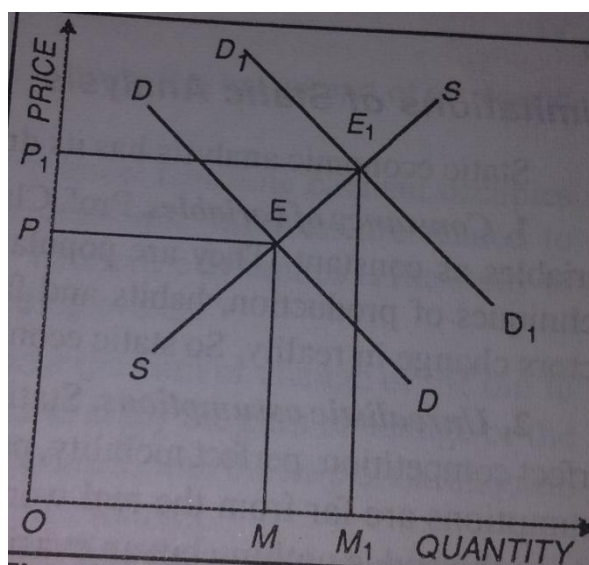


Figure 5.1b: Comparative Static

Point E in figure 5.1a reveals the equilibrium conditions pertaining to demand and supply interaction in the market. Point E to E' in figure 5.1b reveals that change in variable D will induce the model to react until the new equilibrium E' is reached. E to E' is comparing the two equilibrium conditions. When the economy is moving in equilibrium then the model static or comparative static can be applied, but the problem lies when the economy is not in stationary state, it is in disequilibrium phase then the role of dynamic model is emphasized. In macro economics use of dynamic model is

comprehensive; in dynamic model the role of time element is very important. It is called as period analysis or sequence analysis. It involves the time lags.

5.6 The concept of Equilibrium in Macro Economics

Equilibrium is a stabilizing force or the balancing of the opposing forces, it is a position of rest where there is no tendency to change unless the balance is disturbed. It is the most beneficial stage. To understand the concept of equilibrium, both the short and long run elements are required to be understood. Short run equilibrium demands that some elements are fixed and in long run equilibrium all variables are variables. Keynes has used short run equilibrium analysis in which he has explained the concept of underemployment equilibrium and over full employment equilibrium. So he has given the concept that economy may not be in full employment equilibrium as maintained by Classicals. There may be case of unemployment of resources leading to underemployment equilibrium and over full employment equilibrium which is over use of natural resources in the economy. He says there is short run case in the economy as in the long run we may be buried or dead.

5.7 Methodological Concerns

Macro-economic deals with the method type study. It is important to know which methods or techniques will be formulated or employed, theory can be created by anyone but there should be proper hypothesis framing, assumptions of the theory must be discussed, assumptions should be relevant. They should be unrealistic or too restrictive. They should be explicitly stated. Value judgments which are the main determinants of the theory should be clearly specified.

Positive economics, is an approach to economics that seeks to understand the functioning and behaviour of a system or mechanism without judgement. It explains what exists and how it works.

Normative economics, is an approach to economics that analyzes the consequences of economic behavior, evaluates whether it is good or bad, and describes possible actions to be taken. It is also called policy economics.

Method: Descriptive economics which collects data to describe phenomena and facts.

Economic theory is a statement or set of related statements about cause and effect, action and reaction.

Model is a formal statement of a theory, usually a mathematical statement, that describes the predicted relationship between two or more variables.

The variable can be called the measure of change that occurs from observation to observation over time.

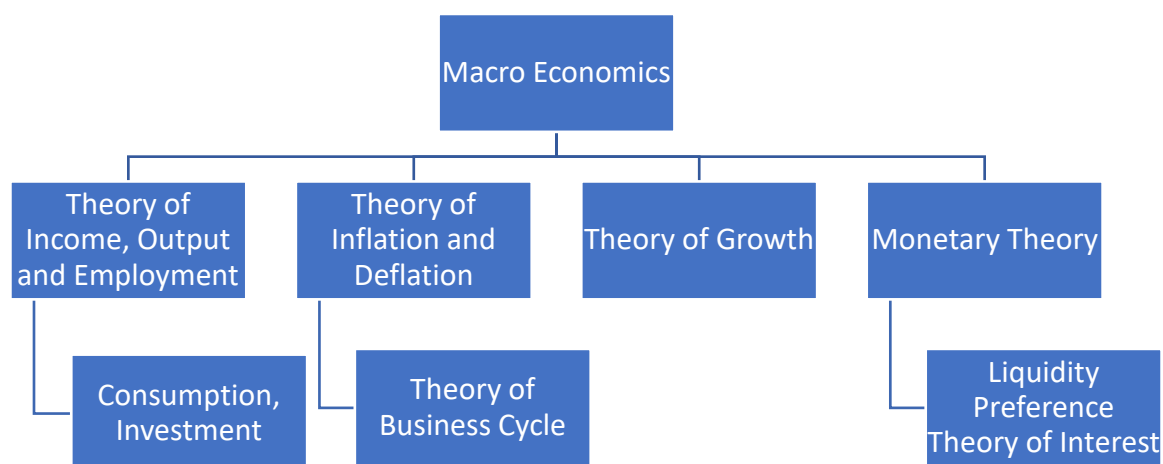
Other things being equal or all else equal is a tool used to analyze the relationship between two variables when there is no change in the value of the other variable. Its purpose is to simplify things. The use of *ceteris paribus* is part of the process of abstraction. In building economic theory, this concept makes it easier to concentrate the truth on the relationships of interest to us.

Model in words, graphs and equations: The most common way of expressing or representing the relationship between two or more quantitative variables is by means of a graph on a two dimensional plane.

5.8 Scope of Macro Economics

Macro economics is indispensable for understanding the working of the economy. As Tingbergen puts it “Macro-economic concepts help in making the elimination process understandable and transparent.” It is helpful in framing economic policies, in focusing on monetary terms of the economy, to analyze the economic growth, to study the business cycle, to study the affect of general unemployment and to understand the behavior of individual units.

Scope of macro economics is very broad but in general macro economics include the following topics shown in the chart below:



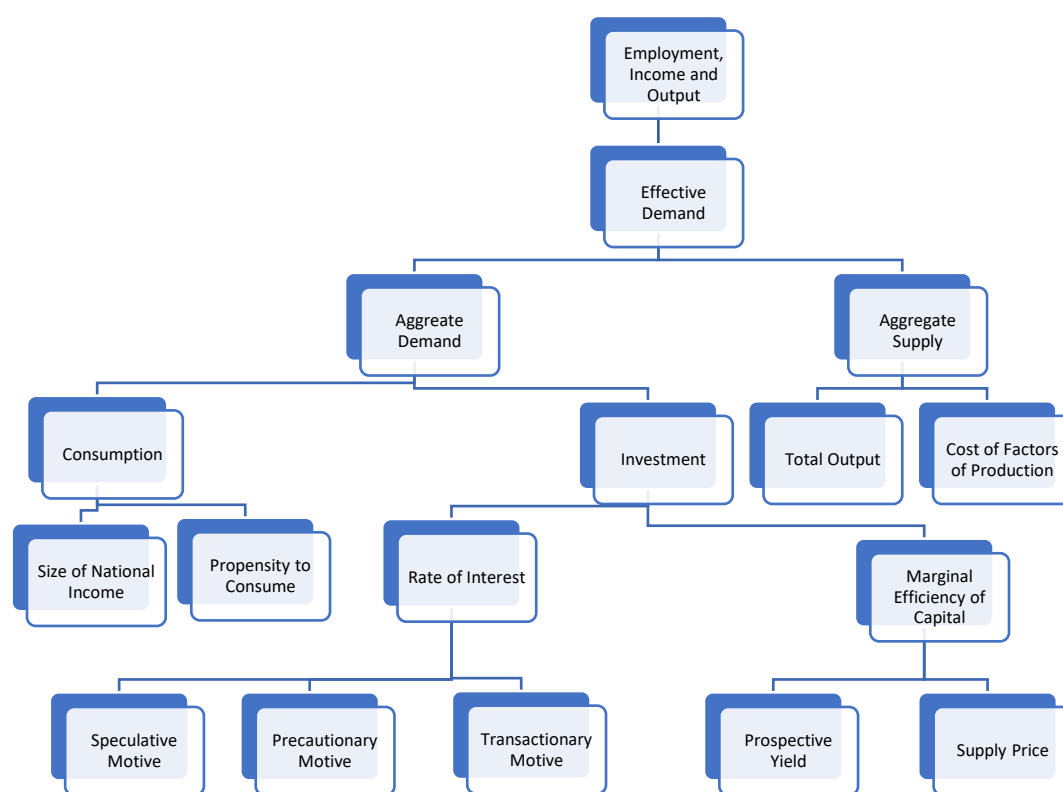
5.8.1 Transformation from Micro to Macro Economics

Mercantilists, Physiocrats and Classical economists like Adam Smith, Ricardo and Malthus were focused upon studying the total income of the community and how the economic system behaves over a period of time. With the aftermaths of great depression (1929-32) resulting in large scale unemployment which led to the aggregative thinking and birth of Keynesian's general theory. J M Keynes became the chief advocate of macro economics.

The urge of the underdeveloped economies after the Second World War was to develop quickly led economists like Walras, Wicksell, Fisher to contribute their might towards the development of new macro-economic ideas. There are certain branches of modern economics which can be purely classified as branches of macro economics such as public finance, banking, international trade etc.

1. In the 1920s and 30s, Simon, Kuznets Nobel Prize winner of 1971 developed the conceptual framework of national income accounts which provided the basis to determine savings, investments, consumption etc.
2. Keynesian General Theory has improved Magna Carta for macro economics. In his theory he showed how the equilibrium of the whole economy could be established.
3. Last but not the least, in the macro economics application of mathematical techniques gave birth to dynamic sequential models of growth and fluctuations.

4. Apparatus of the Keynesian General theory, effective demand is the logical starting point of Keynesian economic theory. According to Dillard the word effective here is used to designate the point where aggregate demand intersect aggregate supply curve. The effective demand essentially depends upon aggregate demand which in turn is composed of consumption demand and investment demand, so $AD = C + I$. Consumption further depends upon size of nation's income and propensity to consume. On the other hand investment depends upon rate of interest and marginal efficiency of capital (MEC), rate of interest further depends upon the liquidity preference and the MEC depends upon prospective yield and supply price.



Liquidity Preference

Keynesian Model

5.9 Contemporary Macro Economics

Macro-economic approach given by Keynes has led to three counter revolutions since 1965 as explained by James Tobin, these revolutions are explained below:

1. Monetarism Propounded By Milton Friedman

2. Neo-Classical Macro Economics founded by Robert, Lucas and Muth
3. Supply Side Economics

5.9.1 Monetarism

The most pertinent challenge to Keynesian economics came from Professor Milton Friedman and his associate from Chicago school of money, he stressed that money is the most strategic factor which determines the level of gross national product and income. Friedman's theory is based on two major factors which are listed below;

1. According to Friedman output and employment both are governed by money supply, hence he says there is no need to change them through taxes or government spending
2. Changes in money stock are chiefly responsible for economic fluctuations, hence it is the duty of central banks to check the growth of money supply and to maintain it at constant rate.

This neo-classical approach emerged because of inflation, vast expansion of state functions as a natural result of Keynesian theory based on comparative static equilibrium although theory was considered very important by economists like R.F. Haard, Domar, Hansen and Robinson. They introduced dynamic framework in the Keynesian analysis which became helpful in analyzing both the equilibrium and disequilibrium states of the economy.

According to David Ledsmar, monetarists can be classified into four components:

Two different meanings of the 'quantitative theory' approach in macroeconomic analysis:

- (A) It was used by Milton Friedman (1956) to describe the theory of demand for money, and
- (B) The most conservative view is that fluctuations in the quantity of money are primarily caused by fluctuations in people's monetary or money incomes.

2. The analysis of the division of monetary income fluctuations reveals an ex ante convergence Phillips curve between the price level and real income whose structure rejects the assumption of an inverse relationship between important long-run economic variables.

Monetary approach to balance of payments and exchange rate theory.

(a) Factors opposing stabilisation policy of monetary or fiscal, and wage and price controls and (b) Long-term monetary policy supports a “rule”, or at least a pre-determined “target”, rather than fixing some form of monetary behaviour for the interest rate.

Monetarist Review

The Great Depression was a result of the failure of central banks to control the quantity of money. The central bank itself allows excessive reduction in the quantity of money. Most of the macroeconomic problems can be solved by the use of the central bank's control of the quantity of money.

5.9.2 Neo-Classical Approach

Basically the failure of Keynesian model to deal with Inflation and stagflation has led to the Neo-Classicals. Neo-classical approach was first originated by Prof. Muth in 1961, in his article he gave the core idea of neo-classical economics:

- A. The theory of Rational Expectation
- B. The theory of Market Clearing

The rational expectation theory is based on the fact that people are rational and they rightly anticipate the action and then behave accordingly. The advocates of rational expectation hypothesis believe that there is no need for state intervention. The theory of market clearing is an important proposition of the Neo-classical economics. It is the combination of Walras general equilibrium ideas and recent theory of efficient markets. An efficient market possesses all the relevant information and in it market clearing price is established for every good traded in the market. Eventually all the trading takes place at equilibrium prices.

Neo classical Self-Adjustment Mechanism: Necessary and Sufficient Conditions and Conditions.

➤ When s (savings) increases, the interest rate falls, I (investment) will rise until:

$S = S@Yr$ (full employment level income)

Perfectly flexible wages, prices and interest rates are part of a self-adjusting mechanism and determine the tendency for full utilization of all resources, including labor.

➤ Perfectly flexible wages may be a necessary condition but it is not a sufficient condition for full employment. Interest rates must also be flexible.

➤ Another way of saying this: all markets, including factor markets, must be perfectly competitive.

5.9.3 Supply Side Economics(SSE)

The economists are resuming back to the classical approach and supply side economics has its foundation on says law of market. For them they blame Keynesian economy for inflation and stagflation. They meant that excessive government intervention had led to excessive growth of money supply resulting in shortage of supply of goods and services. They also blame transfer payments which are unproductive for the economy. Basically supply side economists believed that the generation of money should be accorded with the production of goods, so need to increase production is very important. SSE seems to view that both Keynesianism and Monetarism are the two sides of the same tarnish demand–management point. In their estimation demand side fiscal and monetary policy are responsible for the simultaneous occurrence of high unemployment and rapid inflation. Even president Regan of US in 1980s supported the supply side view of the economists which believe that there should be reduction in taxes because it cuts the incentive to produce more and finally depresses production.

Review of Presentation Side Economics

- It is a strange occurrence that Keynes's macroeconomic record could not control inflation and unemployment.
- By describing the production of record goods and services, the rate of economic growth has been reduced.
- Supply side advocates say that policies should be such that they encourage producers.
- Supply side advocates support monetarism for price stability.

Keynesian vs. Supply-side Economics

- **Demand Management Policies:** Fiscal and monetary policies seek to change aggregate expenditure – these are the main prescriptions of Keynesian economics.
- **Supply-side policies:** Fiscal, monetary and other policies and rule changes are designed with the primary goal of increasing real income - these are the prescriptions of supply-side economists.

Supply Side General Knowledge of Economics

- If the real income is increasing, then as per the definition economic growth will also be found.
- An increase in real income reduces unemployment as people in the economy demand work.
- Finally, the quantity equation for money shows that an increase in income curbs inflation.

Supply side: Two classes of tax policies

- Tax policy framework that increases real income.
- Skill policy framework that promotes free enterprise and private property rights and further improves and enhances government efficiency.

5.10 Modern Theories of Economic Growth

One of the most important objectives of macro-economic policy is the rapid growth in the economy. GM Meier defines economic growth “as the process whereby the real per capita income of a country increases over a long period of time.” So the economic growth is measured by the increase in volume of goods and services produced in the country. Generally there are four sources of economic growth which are given below:

1. Human Resources(Labour supply, motivation, education etc.)
2. Natural Resources(Land, fuels, minerals, environmental quality etc.)
3. Capital Formation(Roads, machines, factories etc)
4. Technology(Engineering, science, management, entrepreneurship)

Various models have been framed by the economists regarding economic growth. These models are analyzed below:

5.11 Harrod-Domar Model

R.F. Harrod and Evsey Domar published their essays in economic journals and became the pioneers in framing the growth models. Both were interested in discovering the rate of income growth necessary for the smooth functioning of the economy. They majorly focused on the key role of investment and its dual character in the process of economic growth. Firstly investment creates income and secondly it generates the productive capacity of the economy by increasing its capital stock. Former role is called as demand

effect and later is called supply effect. According to Harrod and Domar as long as investment is taking place real output and income will continue to expand.

Assumptions of the Model

1. No state intervention is possible
2. There is an initial full employment equilibrium level of income
3. Saving and Investment are related to the income of the current year
4. Marginal Propensity to save remain constant
5. There are no changes in interest rate
6. There is a closed economy and no international trade is taking place
7. The general price level remains the same i.e. Constant
8. Fixed and circulating capitals are lumped together under capital
9. Only one type of product exists
10. Ratio of capital stock is assumed to be fixed
11. There is no depreciation of capital goods
12. There are no lags and adjustments between investment and creation of productivity capacity

5.12 Domar Model

Domar framed a model around one pertinent question “At what rate investment should increase in order to make the increase in income equal to increase in productive capacity.” He himself answers this question by forging a link between aggregate demand and aggregate supply through investment.

Increase in Aggregate Supply and Productive Capacity

The supply side of the economy in the Domar’s model is explained with the help of relation : $Y_s = \sigma K$

This means that supply of output (Y_s) depends upon productive capacity of capital (σ) and the amount of real capital (K). If the productive capacity of capital increases it will lead to increase in economy supply.

Aggregate Demand

The demand side effect of investment is explained as below;

$$\bar{Y}_d = I/a. I$$

This equation signifies that level of effect demand (Y_d) is directly related to the level of investment through the process of multiplier whose value is given in equation as $1/a$ and secondly effective demand is inversely related to marginal propensity to save. For the long run equilibrium to be maintained Y_d and Y_s should be equal.

$$Y_d = Y_s$$

$$I/a = \sigma K$$

$$I = a \sigma K$$

This relation signifies that steady growth is possible when investment is equal to product of saving income ratio, capital stock and capital productivity. In the words of Kurihara, “It is an increase in productive capacity due to increment of real capital which must be matched by equal increase in effective demand due to an increment of an investment, if a growing economy with expanding stock of capital is to be maintained.”

Analysis of Disequilibrium

It prevails under following two conditions:

1. $\Delta I/I$ or $\Delta Y/Y > a\sigma$
2. $\Delta I/I$ or $\Delta Y/Y < a\sigma$

In the first case long term inflationary effect will appear because with the high growth rate of income peoples purchasing power will increase which will lead to inflation. In the second case investment is lagging behind the productive capacity which will result in over production and reduction in demand leading to secular stagnation.

5.13 Harrod Model

This model focuses on three major issues which are explained below:

1. How can steady growth be achieved for an economy with a fixed capital output ratio and fixed saving income ratio?
2. How can the steady growth rate be maintained?
3. How do natural factors put a limit on the growth rate of the economy?

To discuss these issues, he has given three different concepts of growth:

1. Actual Growth Rate(G)
2. Warranted Growth Rate(G_w)

3. Natural Growth Rate(G_n)

Actual growth rate is determined by the actual savings and investment in the economy. It can be defined as change in income to the total income i.e. $\Delta Y/Y = G$. According to Harrod to achieve the steady growth rate ex post savings must be ex-post investments. In that case actual growth rate is determined by saving income ratio and capital output ratio which is assumed to be fixed as $GC = S$. Where G is the actual growth rate and C is the capital output ratio and S refers to saving income ratio. Warranted growth rate is also known as full capacity growth rate. It is the rate of income growth required for full utilization of capital stock and is denoted by G_w . G_w is determined by capital output ratio and the relationship can be expressed as:

$$G_w C_r = S$$

Where C_r is the capital output ratio and S is the saving income ratio.

According to Harrod, to achieve the goal of steady growth, actual growth rate and warranted growth rate must be equal i.e. $G = G_w = C = C_r$.

Instability of Growth

Harrod has analyzed the conditions in which G_w and G are not equal i.e.

1. If $G > G_w$
 $C < C_r$
2. If $G < G_w$
 $C > C_r$

If G is greater than G_w , growth rate of income is higher than output, demand would exceed supply and result be inflation. On the other hand if $G < G_w$, growth rate of income will be less than growth rate of output, there would be deficiency in demand and economy would be in state of deflation.

G_n is the natural growth rate and is influenced by natural factors such as labour, capital equipment, technical knowledge etc. These factors impose ceiling on the expansion of output. This ceiling limit is called as full employment ceiling. So the natural growth rate is the maximum growth rate which an economy can achieve with its available natural resources. This relationship can be expressed as $G_n C_r =$ or not $\neq S$. It can be illustrated with the help of figures 5.2a and 5.2b given below:

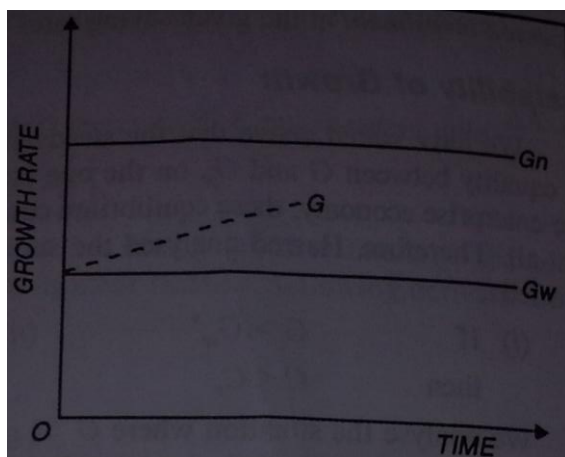


Figure 5.2a

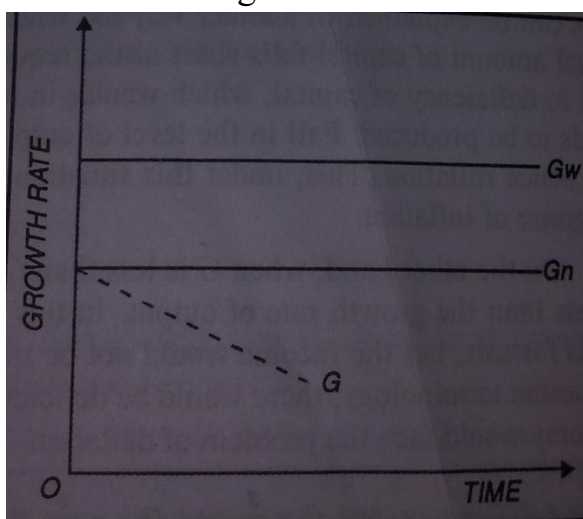


Figure 5.2b

Comparison of Domar's Model and Harrod Model

Domar's Model	Harrod's Model
$\sigma = \Delta Y/I$ or $\Delta I/I = a\sigma$	$G_c = S$ $G = \Delta Y/Y$
$a = \Delta S/\Delta Y$ or $\Delta I/I = \Delta Y/I$	$\Delta Y/Y \times I/\Delta Y = S/Y$ C
$\Delta I/I = \Delta S/I$	$= 1/\Delta Y$
$\Delta I = \Delta S$	$= 1/Y = S/Y$ $s =$
	S/Y

	$I = S$

Criticism of Harrod-Domar Model

This model has been criticized on the following grounds:

1. Capital Output Ratio and Propensity to save are assumed to be constant but in actual world they are likely to vary in the long run.
2. Interest rate cannot be stable and their changes do influence investments.
3. Harrod-Domar model ignore the role of government in investment.
4. It also ignores the effect of entrepreneurial ability which determines the warranted growth rate in the economy.

5.14 Kaldor's Model of Growth

Kaldor in his essay, 'A model of economic growth published in the economic journal attempts to provide a framework for relating the genesis of technical progress to capital accumulation.'

Assumptions of Kaldor's Model

1. It is based on the assumption that technical progress depends on the rate of capital accumulation
2. He based his model on Keynesian assumption of full employment in which under short period aggregate supply is inelastic.
3. Income consists of wages and profits
4. Share of profits is a function of investment
5. Monetary policy is passive in this model
6. Choice of technique is assumed to alter with the accumulation of capital

This model functions under two stages

- i) Constant working population
- ii) Expanding Population

Constant Working Population

Kaldor purposes three functions for the operation of his model:

- i) Savings Function
- ii) Investment Function
- iii) Technical Progress Function

- i) Savings Function

$$S_t = aP_t + \beta(Y_t - P_t) \quad (i)$$

$$1 > a > \beta \geq 0$$

In equation (i) S_t stands for saving which consists of profits out of P_t and out of wages also $(Y_t - P_t)$ in current period t . The a and β lies between 0 and 1.

- ii) Investment Function

$$K_t = aY_{t-1} + \beta(P_{t-1} / K_{t-1}) Y_{t-1} \quad (ii)$$

$$I_t = K_{t-1} - K_t$$

$$A > 0, \beta < 0$$

Equation (ii) holds that stock of capital (K_t) at time t is a coefficient a of the output of previous period (Y_{t-1}) and coefficient β of the rate of profit (P_{t-1} / K_{t-1}) multiplied by the output of the past period (Y_{t-1}).

- iii) Technical progress

$$Y_{t+1} - Y_t = a'' + \beta'' I_t / K_t \quad (iii)$$

$$a > 0 \text{ and } 1 > \beta'' > 0$$

It shows the rate of growth of income is an increasing function of the rate of net investment expressed as the proportion of stock of capital (I_t / K_t). In period t multiplied by capital per head β'' plus the coefficient of technical progress i.e. a .

These functions are presumed to be given according to the model, we now proceed from a point of time, $t = 1$ and the existing stock of capital is inherited from the past Y_0 and K_0 are the past income and past capital. Y_t is the given income which is yielded by the labour force and capital stock K_t .

The technical progress equation (iii) shows that growth of income and capital from period t onwards and economy moves from short period equilibrium to long period equilibrium of steady growth. Level of profits brings equality in S_t and I_t . To attain the stable equilibrium path the necessary condition must be fulfilled i.e.

$$a - \beta > \beta' Y_t/K_t \quad (\text{iv})$$

This means that growth rate of saving must be more than the growth rate of investment. To attain the stable equilibrium and sufficient condition for the stable equilibrium path is:

$$P_t \leq Y_t - w \quad (\text{v})$$

$$P_t/Y_t \geq m \quad (\text{vi})$$

Equation v tells us that the profits should not exceed income minus wages as this is actually a constraint and equation vi tells us that rate of profits P_t/Y_t should be more than minimum margin of profits. To attain the stable path, technical dynamism of the economy is must and can be attained through following equation:

$$G = a''/1-\beta'' \quad (\text{vii})$$

Growth rate is determined by the technical progress function as shown in equation vii. This can be illustrated in the figure 5.3 given below:

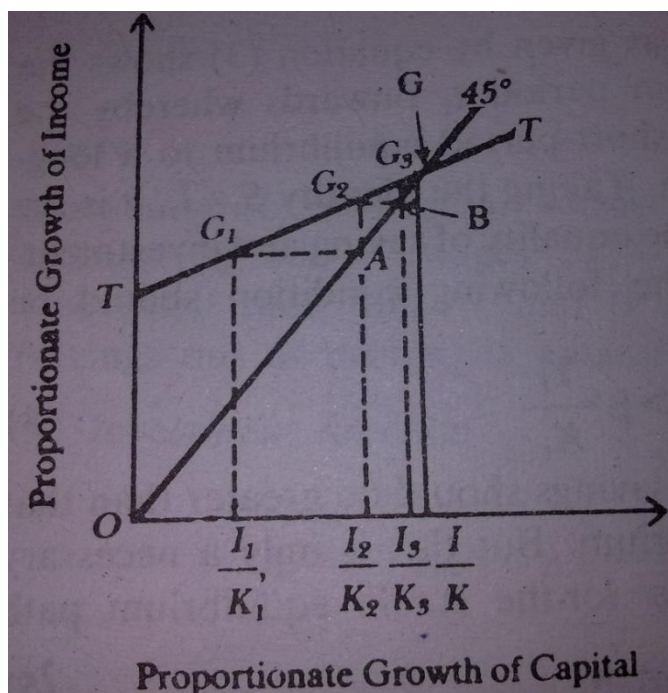


Figure 5.3: Technical Progress Function and Growth Rate

G is the outcome of technical progress function. TT' and 45 degree line shows the steady growth, where growth rate of income is proportionality equal to growth rate of capital. In the figure 5.3, $G_1 > I_1/K_1$ i.e. Growth of output is more than growth of capital, now there will be increase in investment to make $I_2/K_2 = G_1$ at A but it will lead to growth of output in period t2 at G2 and subsequently growth of output will rise till reaches G.

Expanding Population

Now Kaldor considers the case of growth in population and growth in income. Kaldor based his model Malthusian view of population growth, he assumes:

- For any given fertility rate – the percent rate of growth in population cannot exceed a certain minimum. However real income is rising.
- The rate of population growth will rise moderately as a function of the rate of growth of income over some interval of the later before that maximum is reached.

With the above assumptions Kaldor's relationship of population growth with income growth can be explained as follows:

$$I_t = g_t (g_t \geq \lambda)$$

$$I_t = \lambda \quad (g_t \geq \lambda)$$

Here I_t = growth rate of population, g_t = percentage rate of growth of income, λ = maximum rate of population growth. In g_t will be more than λ then I_t will also be less than λ , both income and population growth will tend to rise till the growth rate of population is equal to λ . The relationship can be expressed in the figure 5.4 given below:

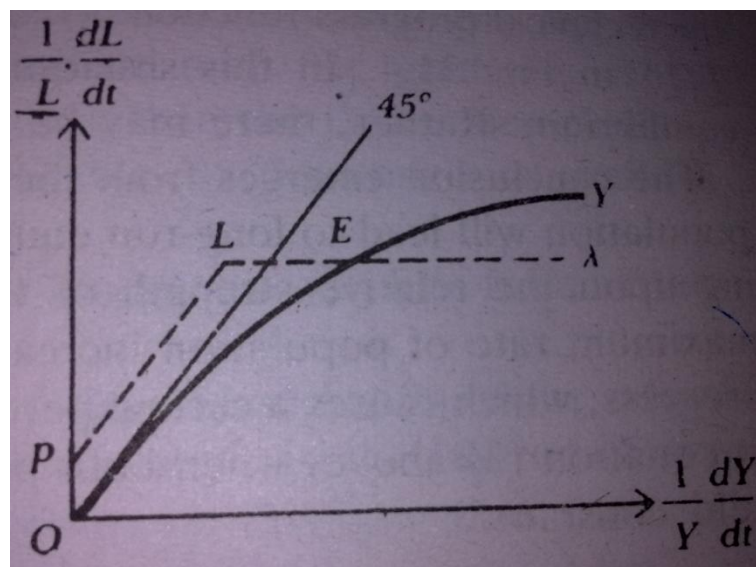


Figure 5.4: Technical Progress and Expanding Working Population

In the figure 5.4 on OY axis we have measured proportionate rate of growth of population and OX axis proportionate rate of growth of income is measured. OY in figure 5.4 is shown as the growth path of income and $P\lambda$ is depicted the curve of growth rate of population. It implies as the growth rate of income increase the growth rate of population too increases till the λ becomes horizontal. Here the rate of the growth of income is more than population growth rate as is shown at point E in the figure 5.4. Although in the long run, population would grow at its maximum rate indicating by the dotted portion of the figure 5.4.

In the long run population growth will lead to long run equilibrium growth in income also depending upon two main factors:

1. Maximum rate of population increase
2. Rate of technical progress

Criticism of the Model

1. It fails to explain the rate of growth of the economy
2. It does not cite any reasons or any explanation for stability or instability in the economic system.

5.15 Neo-Classical Model of Growth

Neo-Classical model challenged the basic assumption of constant capital output ratio and they tried to avert the knife edge equilibrium linked with divergent growth rates. Models of J E Meade, R M Solow, Swan, Tobin are considered as neo-classical model. Here basic model of Solow and Meade are discussed.

Meade's Model

J E Meade propounded a Neo-Classical model of economic growth in his book 'A Neo-Classical Theory of Economic Growth' he states that manpower supply or population growth rate is a major determinant of growth of an economy. So he tried to establish the relation between population growth and income growth. He cites three reasons for the growth of an economy which are:

- i) Stock of capital is growing because net savings are made out of current income
- ii) Working population is growing
- iii) Due to technical progress, more and more output is produced with the given amount of resources

Assumptions of the Meade's Model

1. No international trade takes place
2. Constant return to scale exists
3. No state intervention
4. There are two commodities produced in the economy i.e. consumption goods and capital goods
5. Machines are the only form of capital
6. Each year certain part of machinery depreciates
7. Ratio of labour to capital can be varied

Conditions of Growth

According to Meade output produced in the economy depends upon four factors of production i.e. land, labour, natural resources and technology. These can be expressed in the production function form as given below:

$$Q = f(K, L, N, T)$$

Where Q stands for output, K stands for stock of machines, L stands for labour and N is for natural resources and land, T is for technology. To increase the output stock of machines is required to be increased leading to accumulation of capital. The increase in capital stock is represented as ΔK and further it will increase the income or output by $V\Delta K$ where V is the marginal net physical product of a machine. Again Q may increase because L is growing. If population increase is shown as ΔL then total income will grow at $W\Delta L$ where W represents the marginal physical product of labour. Increase in technical progress is shown as $\Delta \bar{Y}$. If land or natural resources remain constant then increase in output is the summation of increase in L, K, T as shown in equation given below:

$$\Delta Q = V \Delta K + W \Delta L + \Delta \bar{Y}.$$

The proportionate rate of growth of output is shown as follows:

$$\Delta Q/Q = VK/Q \cdot \Delta K/K + WL/Q \cdot \Delta L/L + \Delta \bar{Y}/Q$$

Where $\Delta Q/Q$ is the annual growth rate of income, $\Delta K/K$ represents the annual proportionate growth rate of stock of machines, $\Delta L/L$ stands for annual proportionate growth rate of labour force and $\Delta \bar{Y}/Q$ is the growth rate of income followed by technical progress. VK/Q represents the share of net profits whereas WL/Q represents the share of wages etc.

Variations in the Rate of Economic Growth

Prof. Meade studied the factors responsible for the increase or decrease in economic growth. He says changes in income per head ($y-1$) will be dependent upon changes in V, S and Y where V is the marginal productivity of capital and S is savings. If I and r remains unchanged but S goes on increasing, capital per head ($Y-1$) will increase and V will fall. Thus VS will be falling. This fall may be slowed down if the substitution of Capital for other factors can be done. If the technology can be improved or changes in r can take place, it will raise the MPP of capital and will affect the growth rate of real

income per head and in turn increase the volume of savings. So we can follow from this that higher the rate of technical progress(r), higher will be the product of capital(V), lower will be the initial savings due to heavy investment in machinery, but as income increases savings will rise. The effect of technical progress on growth rate of income can be shown with the help of figure 5.5 given below:

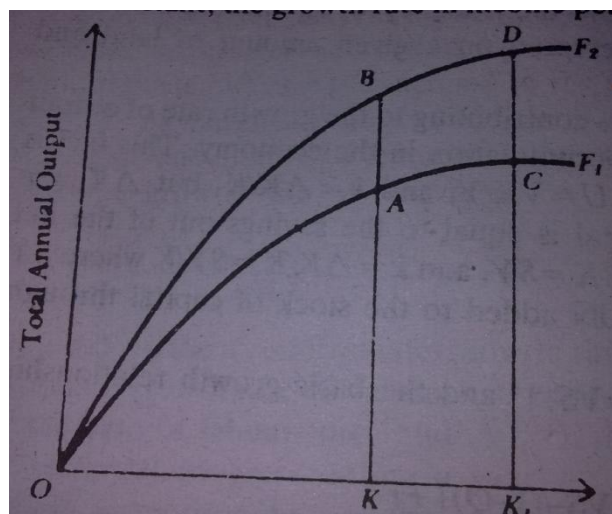


Figure 5.5: Effect of Technical Progress on Total National Income

On OX axis total stock of machinery is measured and on OY axis total annual output is measured. The curve Of_1 shows the amount of output produced in the first year with the help of given machinery and state of technical progress. OA is the capital in the first year and AB is the output. Now the amount of capital has increased to OH, then GH will be the new level of output produced, at this point slope of the curve G is less than B, MP of machinery will be lower. Now in the second year when the technical progress has taken place new curve Of_2 which will be above Of_1 shows that the higher level of output can be produced with higher level of technology.

Conditions of Steady Growth

Prof. Meade stated the conditions of the steady growth which are discussed below:

1. All elasticity of substitution between various factors of production are equal to unity.

2. There is neutrality in technical progress towards all the factors and proportions of profits, wages and rents saved from national income are all constant. So the total savings will be sum of savings out of profits(u), wages (w) and rent(Z).

$$S = S_u v + S_w Q + S_g Z$$

Prof. Meades says that the growth rate of output is given in basic equation:

$$Q = uK + Yl + r$$

Where u, Y, l and r are constant here. So Q depends upon K. K is the growth rate of capital stock which is determined by SY/K represents the amount annually added to the capital stock through savings. So equilibrium position ultimately depends upon the rate of accumulation of capital in the economy.

There is unique or critical growth rate of capital stock as explained by Meade which equalizes the growth rate of income and the growth rate of capital stock. In either of the two situations i.e. higher or lower capital stock than the critical stock it will not equalize output and capital stock. Critical growth rate of capital stock is equal to $Yl+r/I-u$, then the growth rate of income will also be $Ql+r/1-u$ then the equilibrium condition is fulfilled.

$$Q = uK + Yl + r$$

$$a = ua + Yl + r$$

$$a - ua = Yl + r$$

$$a(1-u) = Yl + r$$

$$a = Yl + r / 1 - u$$

This can be expressed in the figure 5.6 given below:

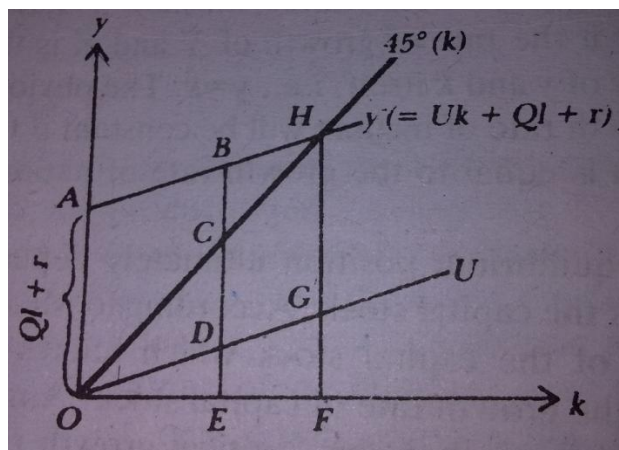


Figure 5.6 : Model Steady Economic Growth

Growth rate of capital stock is measured on OX axis and growth rate of national income is measured on OY axis. AY curve depicts the total growth of national income and 45 degree line shows the capital stock(K), u curve measures the MPP of capital. In the starting growth rate of capital is OE and national income is shown as BE but BE is equal to BD +DE. BD = $Ql+r$ and DE is MPP of capital. Here BE is greater than capital stock CE. So K will rise till point F where it will intersect AQ curve on point H. This is condition and stage of steady growth at which rate of growth of capital is equal to rate of growth of income.

5.16 Solow's Model

Solow gave his model in his book “A Contribution to the Theory of Economic Growth”. He regards labour and capital as substitutable inputs producing the output.

Assumptions of the Solow Model

1. Constant Return to scale exists
2. The factors of production i.e. Labour and capital are rewarded according to their marginal productivities
3. Both prices and wages are flexible
4. Saving Ratio is constant
5. Labour and capital are substitutable
6. Neutral technical progress exist
7. Only one commodity is produced

Solow says that there would be a tendency for capital–labour ratio to lead itself to the equilibrium ratio under the variable technical coefficient. So Solow's analysis is convergent to equilibrium path. Solow takes one commodity in the economy and output as a whole is depicted in it. Its annual rate of production is shown as $Y(t)$ also represents the real income, some part of the income is saved and other is invested. Rate of savings is shown as $sY(t)$. $K(t)$ is the stock of capital, so net investment is the rate of increase of capital stock i.e. dK/dt or K .

Main identities of the Solow's Model are :

$$K^* = sY \quad (i)$$

Capital stock is function of income

$$Y = F(K^*, L) \quad (ii)$$

Output is produced with labour and capital exhibiting constant return to scale.

Substituting equation (ii) in one we can derive

$$K^* = SF(K, L) \quad (iii)$$

L here is labour force, labour force increases at a relative rate n , since population is growing exogenously, so we can derive equation iv as:

$$L(t) = L_{oe}^{nt} \quad (iv)$$

L is the supply of labour, n is the natural rate of growth given by Solow. Equation (iv) can be regarded as supply of labour. Marginal product will determine the wage rate of labour. Right hand side of the equation shows the compound rate of growth of labour from period O to t .

Now substitute equation (iv) in (iii)

$$\text{Then } K = SF(K \cdot L_{oe}^{nt}) \quad (v)$$

Equation v is time path of capital accumulation which must be followed for full employment level.

Possible Growth Patterns

Prof. Solow introduced the fundamental equation to find output capital accumulation path consistent with any growth rate of labour force towards steady state as illustrated in equation vi.

$$\dot{r} = SF(r, 1) - nr \quad (vi)$$

n is the relative rate of change of labour force, r is the ratio of capital to labour. The function $SF(r, 1)$ represents output per worker as function of capital per worker. It states that rate of change of capital labour ratio ($\dot{r}$) is the difference of increment of capital $SF(r, 1)$ and the labour (nr) it can be expressed graphically as given in figure 5.7 below:

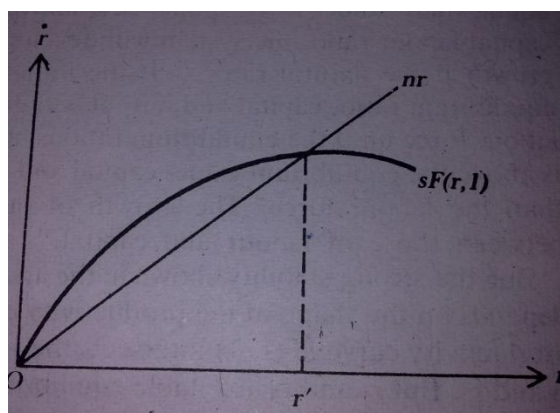


Figure 5.7: Possible Growth Pattern Based on Fundamental Equation given by Solow

Figure 5.7 ray through the origin is the function nr . The second curve represents the function $SF(r, 1)$ shows the diminishing marginal productivity of capital. The point of intersection shows $nr = SF(r, 1)$ and $\dot{r} = 0$ then $r = r'$. The capital labour ratio is constant at $r = r'$ and the capital stock must expand at the same rate as the labour force i.e. n . They assume constant return to scale and real will also grow at the same relative rate n and output per head of labour force will be constant at r' . There will be balanced growth equilibrium. If r lies to the right of r' then there is divergence and system will try to develop at state of balanced growth who maintains the stability of ' r '.

5.17 Summary

Macro economics deals with the functioning of the economy as a whole. It is very useful tool for the policy making especially to promote growth in the economy, to combat inflation, to correct the balance of payment. Macro economics policy has its own tools and instruments like monetary and fiscal policy. Many growth models have

been propounded by different economists to promote growth in the economy. Harrod - Domar model suggested the key role of investment to promote growth. Solow and Meade have also given their models which can help in designing policy for promotion of growth. But they have assumed variable capital output ratio rather than fixed capital output ratio as suggested by Harrod - Domar.

5.18 Keywords

Macro economics: It deals with aggregate quantities such as aggregate investment, aggregate consumption, general level of prices, national income, aggregate product, aggregate savings, aggregate demand and total output.

5.19 Check Your Progress

(A) Fill in the blanks

1. Walras has introduced the concept of.....equilibrium analysis.
2. Capital is.....variable.
3. Harrod and Do
4. mar introduced.....component in macroeconomics
5. Keynesian approach is called as.....static approach.
6. Macroeconomics is also called as.....economics

(B) True/False

1. There are four main sources of growth
 2. Harrod - Domar model deals with the capital factors as the crucial factor of economic growth.
 3. Actual growth rate is called as full capacity growth rate.
 4. Solow has introduced substitutability of capital for labour.
 5. Harrod - Domar model is also called knife edge equilibrium.
-

5.20 Answers to Check Your Progress

- (A) 1. General 2. Stock 3. Dynamic 4. Comparative 5. Aggregative
 (B) 1. True 2. True 3. False 4. True 5. True
-

5.21 Terminal Questions

1. Examine the consequences of a departure of the actual rate of growth from the warranted rate of growth and of the warranted rate of growth from the natural rate of growth.

2. Critically examine the Solow's model in detail.
3. Discuss the Meade's contribution towards Neo-classical growth model.

5.22 References

1. Ackley Gardner Macroeconomics
2. Glahe F R Macroeconomics

UNIT 6: AGGREGATE DEMAND AND SUPPLY

Structure:

- 6.1 Introduction
- 6.2 Concept of Aggregate Demand and Aggregate Supply Model
- 6.3 Concepts of Aggregate Demand and Aggregate Supply
- 6.4 Review of aggregate demand and aggregate supply model
- 6.5 Factors Effecting Aggregate Supply and Aggregate Demand
- 6.6 Business Cycle Analysis and Application of Aggregate Demand and Aggregate Supply Model
- 6.7 Uses of the AD/AS Model
- 6.8 Summary
- 6.9 Keywords
- 6.10 Check Your Progress
- 6.11 Answers to Check Your Progress
- 6.12 Terminal Questions
- 6.13 References

Objectives

After studying this unit, students would be able to understand:

1. Concept of Aggregate Demand and Aggregate Supply Model.
2. Constituents of Aggregate Demand and Aggregate Supply.
3. Factors Affecting Aggregate Demand and Aggregate Supply.
4. Application of AD/AS model to Business Cycles.
5. Role of AD/AS model to combat inflation and stagflation.

6.1 Introduction

Unemployment in the US rose from 3.2 percent in 1929 to 25.2 percent in 1933. GNP fell by around 30 percent. In United Kingdom (UK) also similar scenario was witnessed and level of unemployment was around 11 percent. Most of the Latin American countries and European countries suffered from the great depression which stirred the controversy among economists whether the classical approach is able to deal with the economies during the phase of depression. Answer was in negative clearly. Keynes was

also participating in the debate and he gave his theory to deal with the problem of depression. He emphasized the deficiency in the effective demand is the cause of unemployment and other resulting consequences. First formal approach was propounded by Keynes who has given aggregate demand and aggregate supply as major components of effective demand. Hence, they are called as Macro-economic determinants and the model is known as Aggregate supply and Aggregate Demand model (AD/AS).

6.2 Concept of Aggregate Demand and Aggregate Supply Model

The AD/AS model is useful for explaining the conditions which affect the level of Real Gross Domestic Product (GDP adjusted for inflation) and the level of inflation. Basically the model is based on micro-economic supply and demand model but in this model the concept of aggregation is important. So emphasis is on aggregate demand and aggregate supply curve which is the summation of all individual demand and supply curves in the market. Here we are using more than one parameter and two equilibrium conditions are compared with each other with the help of comparative static approach.

Introduction to Aggregate Supply/Aggregate Demand Model

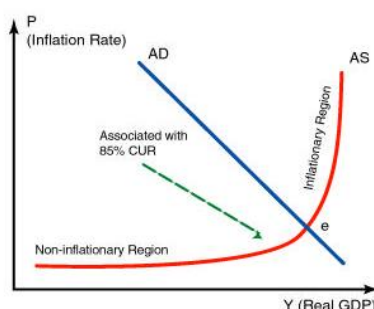


Figure 6.1: Aggregate Supply and Aggregate Demand Model

Aggregate Demand and Aggregate Supply model is basically concerned with the whole output of an entire economy. In this model micro-economic foundations have been applied and it is mere aggregation of the individual components of an economy. In figure 6.1 on x-axis real gross domestic product is measured and on y –axis level of price inflation is measured. Implicit price deflated value used to compute real GNP from nominal GNP as an economic statistical measure is applied. Real GDP is determined

by the interaction of AD/AS curve at the equilibrium level 'e'. At this equilibrium level, national rate of inflation is also determined. Aggregate demand is negative sloping which implies that purchasers will be able to buy more goods at lower prices. Aggregate demand is constituted of four components which are consumption, investment, government purchases and net exports. Aggregate supply curve is relatively flat for a long span of time as seen in figure 6.1. Then it turns sharply upwards, turning vertical past the equilibrium point. Flat region of the AS curve is non-inflationary region and vertical portion is inflationary region of the AS curve. Sharp bend in the curve can be called capacity utilization rate which is the measure of percent of capacity being used by nation's manufacturers. If an industry is running at 100% capacity, it means all available productive assets are being used. When the economy starts showing the symptoms of inflation then the capacity utilization rate is above 85% i.e. beyond the average figure. Industries are facing serious bottlenecks, shortage of labour, raw material and there costs are increasing and they sometime have to pay more to the labourer.

6.3 Concepts of Aggregate Demand and Aggregate Supply

Keynes has used the concept of effective demand to denote the total demand for goods and services at various levels of employment. In the words of Keynes, "The value of the D (aggregate demand) at the point of aggregate demand function, where it is intersected by aggregate supply function will be called the effective demand." So the level of employment is determined by effective demand which in turn is determined aggregate demand price and aggregate supply price. According to Keynes' analysis, equilibrium was below the level of full employment, it could be equivalent to it or even above it. The main points of this theory are as follows:

1. Consumption depends on consumption and not on interest rate.
2. Savings are done as per habit and also due to tradition and social values.
3. Investment depends on interest rate as well as entrepreneur's expectations about the future.
4. In modern economy, it can often be seen that prices and wages are not completely flexible in the establishments and institutions.
5. The overall result of this can be in the commodity and labor market which can be in the form of market imbalance, unemployment and excess of aggregate supply over aggregate demand.

6. A monetary economy is fundamentally different from a barter system.
7. The traditional dualism cannot be true. Aggregate demand = aggregate supply is not equilibrium, it is merely a state of existence.
8. There is a limit to the expansion of production profitably. If the principle of 'se' were applicable then there would be no obstacle to full employment, production would expand until the excess labour is eliminated. Thus, this is a refutation of the principle of 'se'.

The analysis of this theory was later expanded by Hicks-Hanson model (press-load model and aggregate supply and aggregate demand) and Samuelson (accelerator theory) and post-Keynesian (Sraffa, Robinson, Pasinetti etc.) and neo-Keynesian (Fisher, Taylor, Howitt etc.).

Aggregate Demand Price

In the words of Shapiro the aggregate demand price for the output of any given amount of employment is the total sum of money or proceeds, which is expected from the sale of output produced when the amount of labour is employed. It means expected revenue from the sale of output produced at a particular level of employment.

The aggregate demand function according to Keynes “Relates any given level of employment to the expected proceeds from that level of employment”. Table 6A shows the aggregate demand schedule given below:

Table 6A: Aggregate Demand Schedule

Level of Employment(N) (Lacs)	Aggregate Demand Price(D) (Rs. Crores)
20	230
30	240
40	250
50	260
60	270
70	280
80	290

Aggregate Demand Curve can be drawn on the basis of this schedule.

Aggregate Supply Price

Aggregate supply price involves at each level of employment certain money cost of production including normal profits which the entrepreneur must cover. Aggregate supply price refers to the proceeds necessary from the sale of output at a particular level of employment. A schedule which shows the aggregate supply prices at various levels of employment is called as aggregate price schedule or aggregate supply function. In the words of Prof. Dillard, “The aggregate supply function is a schedule of the minimum amounts of proceeds required to induce varying quantities of employment. Table 6B given below shows the aggregate supply schedule:

Table 6B: Aggregate Supply Schedule

Level of Employment(N) (Lacs)	Aggregate Supply Price(D) (Rs. Crores)
20	215
30	230
40	245
50	260
60	275
70	290
80	305

The table 6B shows that the aggregate supply price rises with the increase in level of employment. Keynes says that aggregate supply function is an increasing function of the level of employment. The aggregate supply curve slopes upward from left to right because as the expected proceeds rises, level of employment also rises.

Determination of Effective Demand

Effective demand is the point where the entrepreneurs expect to receive equal to what they must receive and their profits are maximized. It is the intersection of aggregate demand and supply curve. Table 6C given below shows the schedule of aggregate demand and aggregate supply and the determination of effective demand.

Table 6C: Schedule of Aggregate Demand and Aggregate Supply Showing Determination Effective Demand

Level of Employment(N) (Lacs)	Aggregate Demand Price(D) (Rs. Crores)	Aggregate Supply Price(D) (Rs. Crores)
20	230	215
30	240	230
40	250	245
50	260	260 (effective demand)
60	270	275
70	280	290
80	290	305

Table 6C highlights the determination of effective demand. The two curves intersect at the 50 lacs level of employment. It is the point of effective demand and equilibrium.

This can also be illustrated in the figure 6.2 given below:

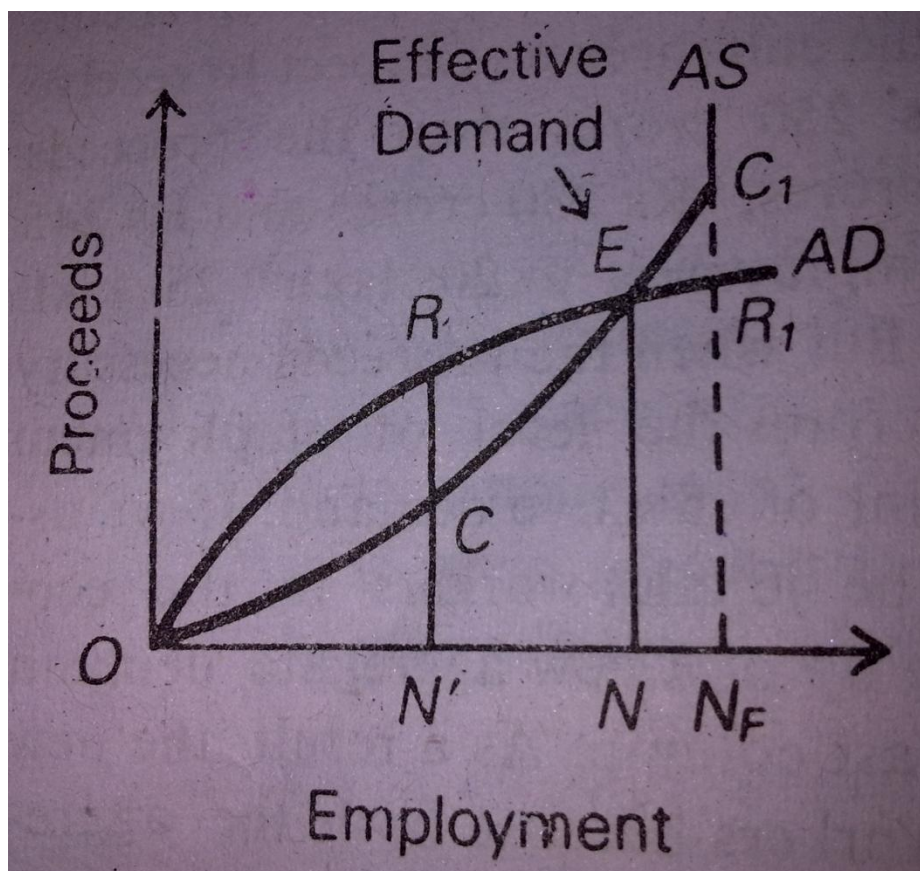


Figure 6.2

Figure 6.2 shows that at ox-axis employment is measured and oy-axis proceeds are measured. Two curves AD and AS are aggregate demand and Aggregate supply curves and they are intersecting at point E at ON level of employment. After this point it will not be profitable for entrepreneurs to increase employment because cost will increase revenue and they will incur losses and before this point the case will be of underemployment equilibrium where the full utilization of the resources in the economy has not been achieved. E is the point of equilibrium and effective demand.

Constituents of Aggregate Demand and Aggregate Price

Keynes emphasized that aggregate demand is composed of consumption spending, investment spending and government spending in closed economy model, whereas in the open economy model net exports are also the constituents of aggregate demand:

$$AD = C + I + G + X - Z$$

The constituents of aggregate demand are discussed below:

1. Consumption

Consumption depends upon two factors i.e. size of nation's income and propensity to consume. Consumption is the function of income and notable contribution of Keynesian theory is the concept of consumption function which states that there is a direct relationship between consumption and income. Keynesian psychological law of consumption function states that "The psychology of community is such that whenever aggregate income rises aggregate consumption also rises but less than increment in income." Increase in income is divided into two parts i.e. consumption and savings.

$$C = f(Y)$$

2. Investment

Investment is a key factor to change the aggregate demand and investment depends upon marginal efficiency of capital and rate of interest. Investment is the net addition made to the capital stock. Investment is positively related to MEC and inversely related to rate of interest. According to Keynes investors try to judge or form future expectations on the basis that recent past will happen in near future and how the other investors behave in the economy.

$$I = f(\text{MEC}, r)$$

3. Government Expenditure

Government expenditure is the major component of aggregate demand. It is also known as autonomous expenditure and is not influenced by income. It is determined by policy makers and generally government serves people and promotes welfare through this expenditure. Hence it is exogenous variable.

4. Net Exports

Net exports are the difference between exports and imports(X-Z). The more the value of exports more will be the demand and vice-verse.

Constituents of Aggregate Supply

Aggregate Supply is determined by two factors i.e.

- i) Factors of Production
- ii) Factor Cost
- i) Factors of Production

There are main four factors of production i.e. land, labour, capital and entrepreneur which contributes to the total output in the economy. Aggregate supply is summation of contribution of all the factors of production.

ii) Factor Cost

In lieu of the services rendered by the factors of production, they get rewards according to their marginal productivities. The rewards are in the form of rent, wages, interest and profits and it is called as factor cost.

Derivation of Aggregate Demand Curve

Keynesian aggregate demand curve shows the intended aggregate expenditure at various levels of national income and aggregate demand curve shows the aggregate expenditure at various price levels. Changes in the price level causes a change in the quantity of goods and services demanded as a result of real balance effect, interest rate and foreign trade effect. This is illustrated in figure 6.3a and 6.3b given below:

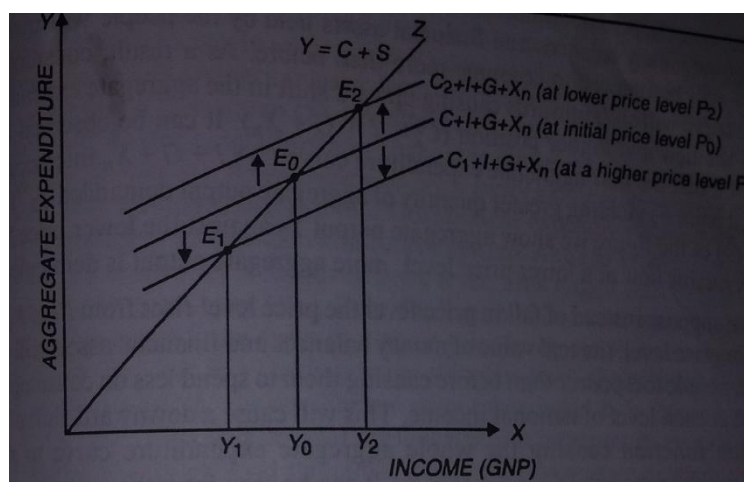


Figure 6.3a

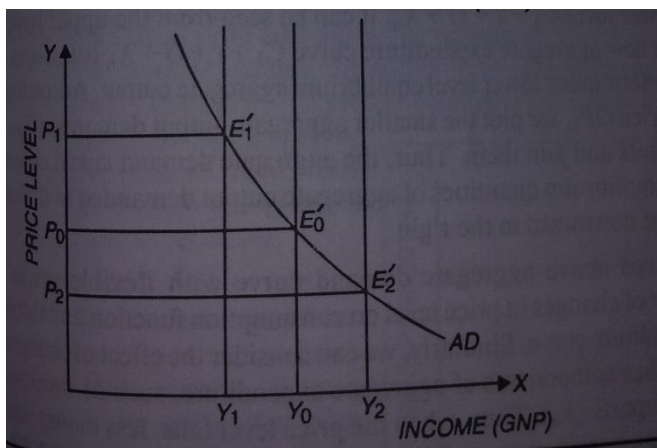


Figure 6.3b

In figure 6.3a we have shown the determination of equilibrium level of national income and equilibrium level of output demanded at the price P_0 , the aggregate demand intersects the 45 degree line at E_0 equilibrium and Y_0 is the equilibrium quantity or output. Now the price falls and the real purchasing power of the people will increase as a result consumption curve will shift upward and AD curve will shift to the new and higher position as shown in the figure 6.3. If there is price rise from P_0 to P_1 , people's purchasing power will fall resulting in the downward shift in the demand curve as shown in the figure. We have derived aggregate demand curve by considering the effects of changes in price level and through it on aggregate expenditure.

Shift in the Aggregate Demand Curve

Shift in aggregate demand curve is due to some other factors than the price level change as government expenditure, taxation and investment. Suppose government expenditure is increased by ΔG then aggregate demand will shift upward as shown in figure 6.4. In the figure, price level is fixed at P , aggregate demand curve shifts upto the higher position and intersects 45 degree line yielding the higher level of equilibrium output Y_2 . So this upward shift is due to increase in government expenditure.

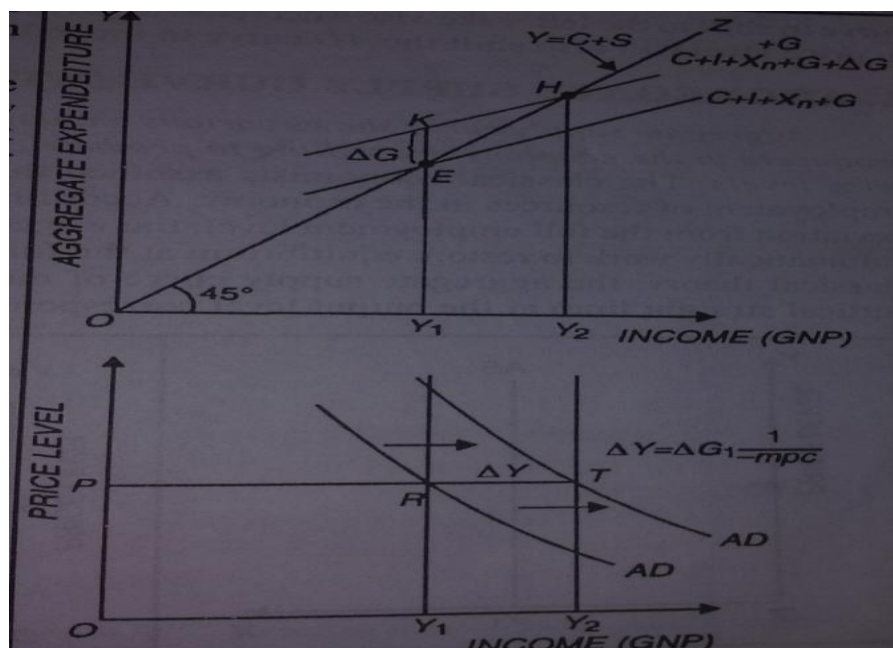


Figure 6.4

Aggregate Supply

Aggregate supply curve shows various amounts of aggregate output which the producers in the economy are willing to produce and sell in the market at various price levels. Keynesian aggregate supply curve is horizontal straight line upto the point and beyond that point it becomes vertical as shown in the figure 6.5 given below. When the economy is in recession, output can be expanded without much rise in cost of production and hence aggregate supply curve is nearly flat. Then with the given stock of capital diminishing returns occur which cause the aggregate curve to slope upward. But as the firms approach full capacity output,

marginal cost start rising which means rising aggregate supply curve, after the full employment equilibrium point aggregate supply curve becomes vertical straight line as depicted in the figure.

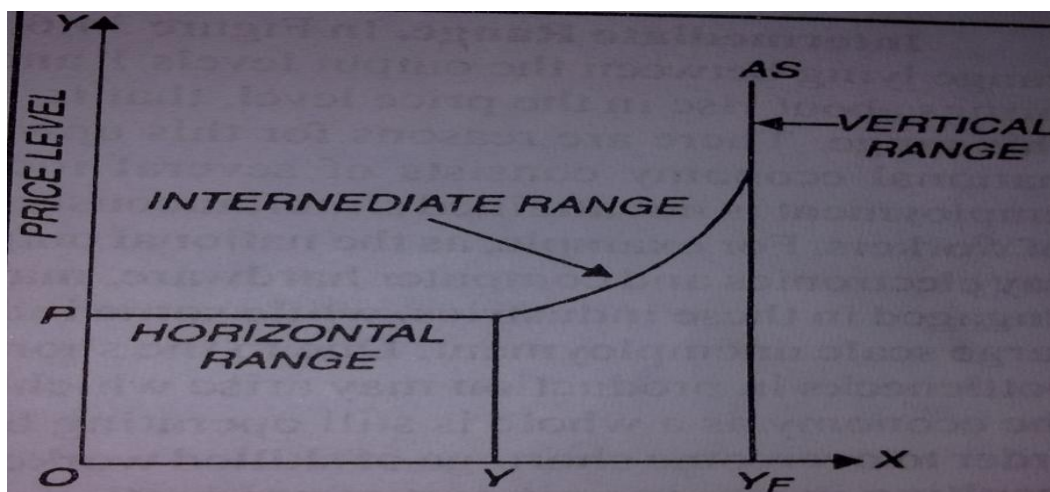


Figure 6.5: Aggregate Supply Curve

Shifts in Aggregate Supply Curve

Shift in aggregate supply curve is caused by factors other than price. If the stock of capital in the economy increases due to technical progress, then factor prices will fall and aggregate supply curve will shift to the right as shown in the figure 6.6. On the other hand rise of prices of raw material or supply curve leftward shift in aggregate supply curve.

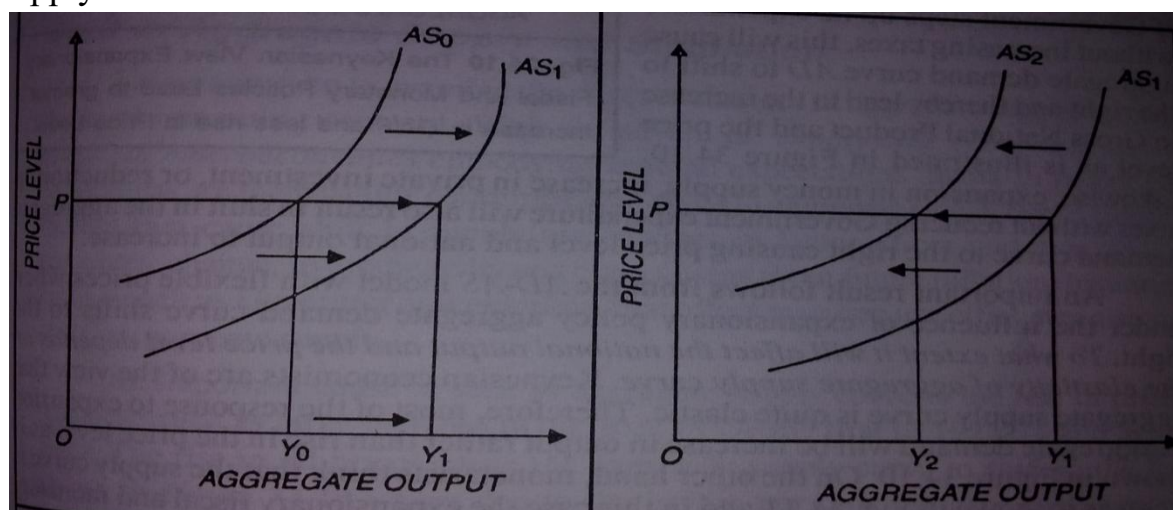
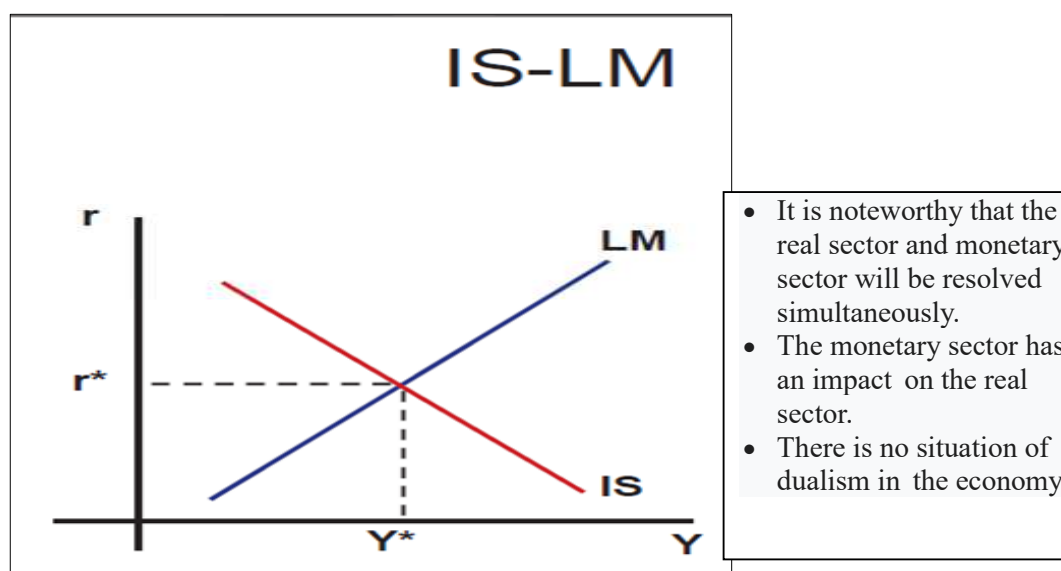


Figure 6.6

6.4 Review of aggregate demand and aggregate supply model

We have seen how aggregate demand and supply can determine equilibrium without full employment. And how aggregate demand and aggregate supply are determined in the Keynesian model. Further development of this model shows how equilibrium can be achieved in commodity and money markets by means of flexible interest rate and price mechanism.



The IS curve shows the points at which the goods market is in equilibrium.

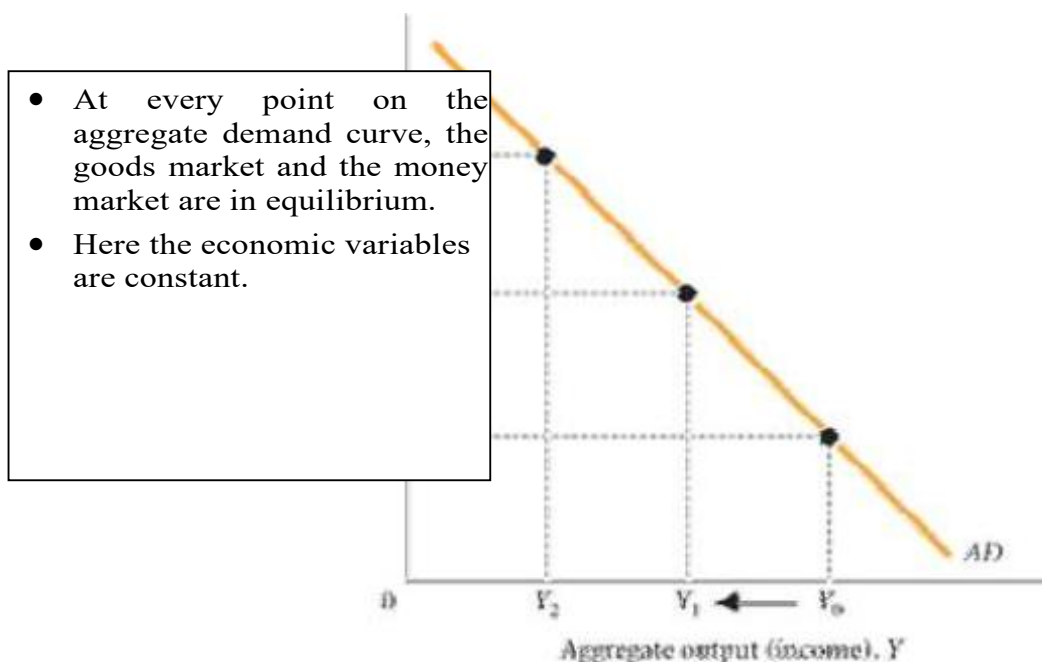
The LM curve shows the points at which the money market is in equilibrium.

The IS curve shows those combinations of interest rate and income at which the commodity market is in equilibrium. A negative relationship is found between investment and interest rate.

The LM curve shows those combinations of interest rate and income at which the money market is in equilibrium. The interest rate is actually the opportunity cost of money, in other words it is the reward for sacrificing liquidity.

Each point of intersection of the IS and LM curves represents a point on the aggregate demand curve which can be drawn between price and Production.

aggregate demand curve



The aggregate demand curve is more complex than the individual demand or market demand curve. The aggregate demand curve is not the market demand curve nor is it the sum of the demand curves of all markets. To understand what the aggregate demand curve represents, we need to understand the interaction between the goods market and the money market (PSD model). There are several reasons for the negative slope of the aggregate demand curve:

Consumption related: A rise in the price level increases the demand for money, which raises interest rates, which in turn reduces consumption (so does planned investment). As a result, there is a decrease in the overall product (income). The initial decrease in consumption (due to the increase in interest rate) causes a decrease in the overall production.

Real money or real surplus effect: A change in the price level changes the real value of money, which results in a change in consumption.

The aggregate demand curve can also change due to changes in economic policies. Following are some reasons for the shift in the aggregate demand curve:

- An increase in money supply (DE) shifts the aggregate demand curve to the right.
- The main reason for the shift is that the increase in money supply reduces the interest rate, which increases planned investment and planned aggregate expenditure. Ultimately, production will increase at expected prices.
- An increase in government expenditure (G) or a decrease in taxation (T)

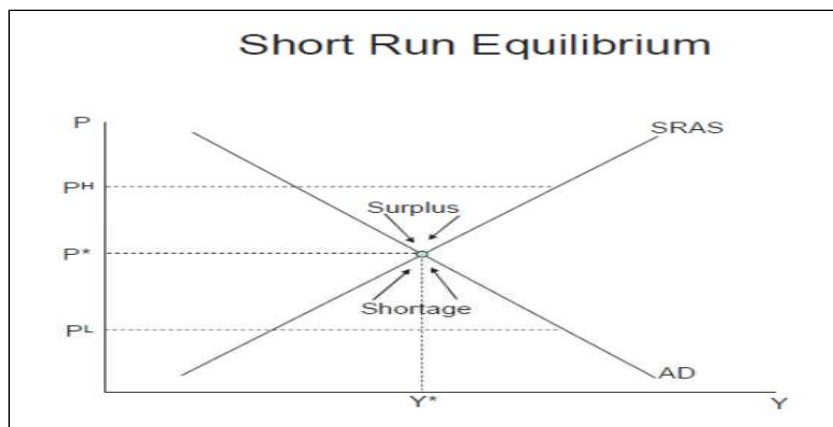
- also shifts the aggregate demand curve to the right. An increase in G leads to an increase in planned expenditure, which leads to an increase in production at every possible price. The decrease in demand leads to an increase in consumption. As consumption increases, the expected expenditure also increases, which leads to an increase in production at every possible price.

The aggregate supply curve has a positive slope and becomes inelastic with respect to price in the long run.

In the short run, the aggregate supply function may shift to the right due to reasons such as technological progress. On the other hand, it may shift to the left due to reasons such as a sharp increase in the price of crude oil.

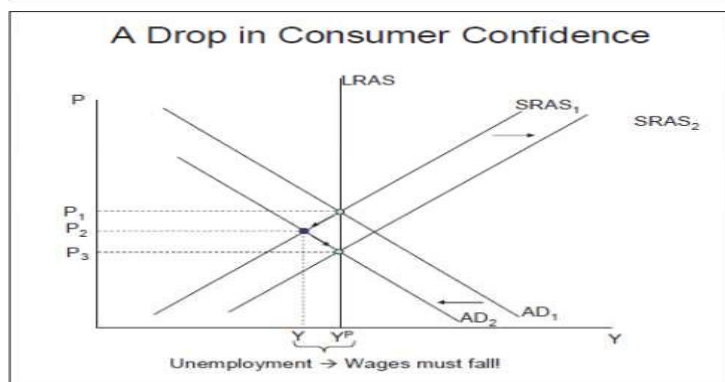
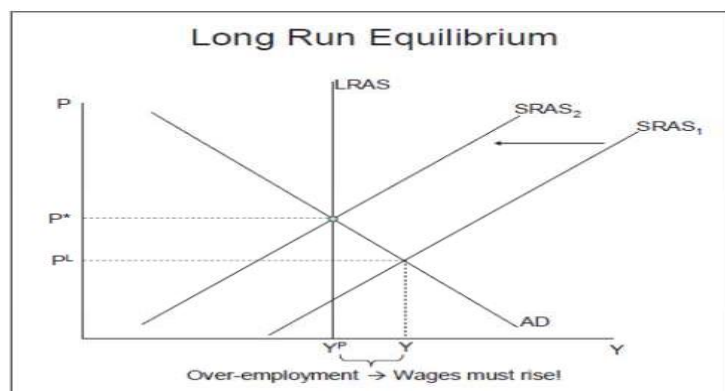
- The quantity of money is not neutral in the short run.
 - An increase in money supply does not necessarily lead to an immediate increase in prices.
 - Prices are rigid due to uncertainty, menu costs and long-term contracts.
- Suppose the price of output rises across the economy.
 - Wages and input contracts do not immediately adjust to higher prices.
 - Profit per unit rises, which increases output.
 - Ultimately, the rise in cost of living will cause all contracts to be adjusted to higher prices, thereby eliminating the increased profits and production will revert to the previous state.
- Money is neutral in the long run.
 - Any change in money supply will bring about a proportionate change in prices.
 - An increase in money supply will not affect the output of the economy in the long run.
- In the long run, production depends entirely on the production capacity of the economy.
- Only changes in real variables can affect potential production.

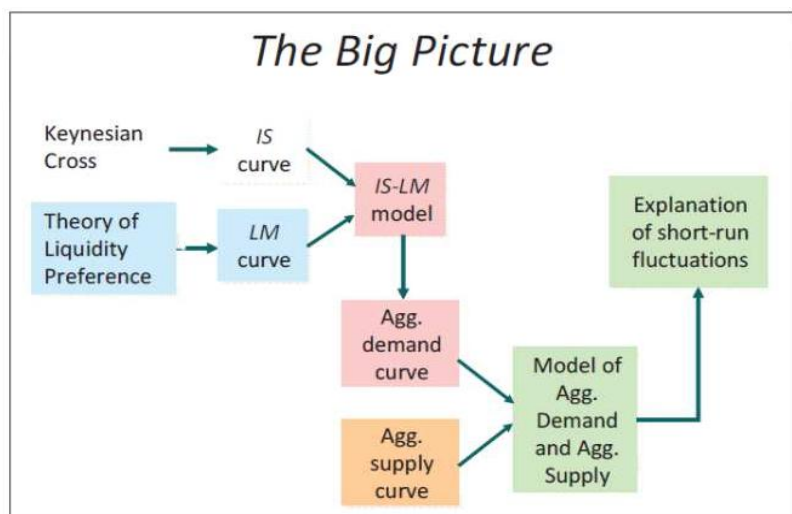
In the short run, equilibrium is determined at the intersection of aggregate demand and short run aggregate supply (SRAS). There will be excess supply at higher price (P^H) and decrease in supply at lower price level (P^L). Prices will tend to adjust and return to the equilibrium level 'p'. A situation of lower prices reflects excess employment on production. A lack of consumer confidence may have the opposite effect, resulting in unemployment.



In the long run the aggregate supply ($SRAS$) curve will be price inelastic and the price (P^*) and output (Y^P) will be

Finally, looking at the big picture, we summarize all the factors analyzed in our model, namely effective demand, aggregate demand, and aggregate supply. The following section discusses the AD-AS model in detail.





6.5 Factors Effecting Aggregate Supply and Aggregate Demand

In the AS/AD model, changes in the equilibrium are due to changes in variable that effect supply and demand. There are a large number of variables which cause a shift in the aggregate demand and aggregate supply curve. The factors which cause the aggregate demand curve to shifts to the right include wealth, population, income, credit availability, government demand, investment, expectations and interest rate changes etc. and the variable which cause aggregate demand curve to shift to the left include taxation and interest rate changes. Further, aggregate supply is also affected by the changes in a large number of variables. Some of these variables are positively associated with supply curve and some are negatively associated with aggregate supply curve. The variables which cause the aggregate supply curve to shift to the right include prior investment, productivity, and credit availability, formation of expectations regarding positive profits etc. and factors which cause the aggregate supply curve to the left include cost of both labour and other resources, taxation, interest rates and foreign supply. Detailed explanation of few important factors influencing aggregate demand and aggregate supply is given below:

Taxation and Government Demand

Taxes are the compulsory payments made to the government by the public. It curtails the disposable income of the public and hence adversely impacts the aggregate demand. Government demand is the government purchases of goods and services and transfer payment made to the public by the government. Government spending tends to

stimulate demand and taxes curtail demand and increase in taxation will reduce aggregate supply also.

Wealth and Expectations

Effect of wealth and expectations of future wealth is strongly correlated with aggregate demand. If the nation has more wealth then purchasing power of the nation will be more. Reasonable measure of wealth would include consumer savings, stocks mutual funds, home equity and property assets and future expectations of acquiring more wealth will also have positive effect on the effective demand.

Costs

An increase in cost which includes costs of raw material, transportation cost, labour cost, energy cost or business taxes will tend to shift aggregate supply curve to the left. The impact of increasing cost on aggregate supply curve is illustrated in figure 6.7 given below:

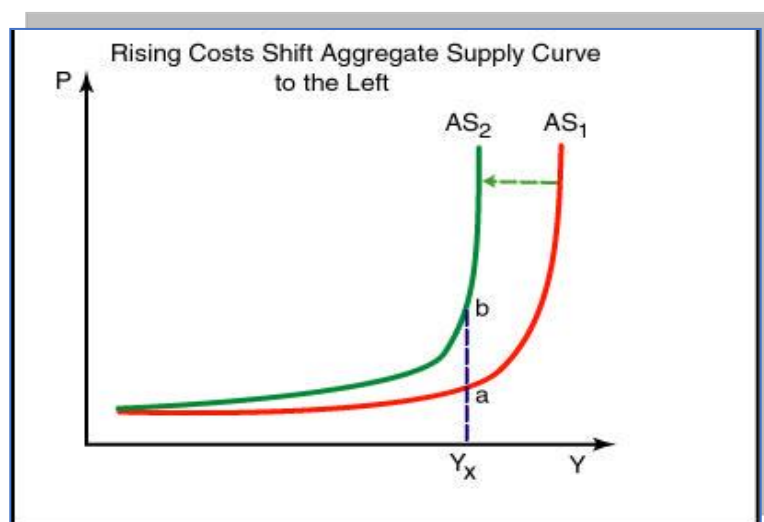


Figure 6.7

In figure 6.7 aggregate supply curve has shifted to the left from AS1 to AS2. It implies that the producers would be willing to supply only Y_x level of output, if faced with rising costs at higher level of prices to eliminate the losses incurred by rising costs. The failure to increase prices will drive some producers out of business.

Productivity

Productivity means anything which increases the level of output with the given resources. Labour productivity is increased when same or less labour produces more output. In an industrialized economy productivity is related to technology and innovation. Research and Development and better engineering practices with the adoption of new technology will lead to more productivity. Productivity has played a significant role in the services sector with the advent of telecommunication and modern office equipment, high speed processing computers etc. Increase in productivity will shift the aggregate supply curve to the right. It means that technological improvement and advanced levels of research and development will raise the productivity level and will increase the standard of living and shift supply curve to the right as shown in the figure 6.8 given below:

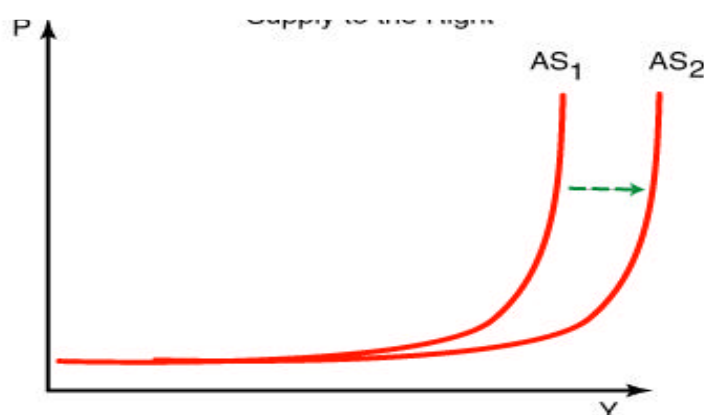


Figure 6.8: Shifting of Aggregate Supply curve to right due to increase in productivity

Wage Increases with Productivity Gain

Productivity gains are more than rising wage cost, then aggregate supply curve will shift right as shown in the graph 6.9. It means economy is experiencing growth and workers expectations of higher income and higher standard of living are satisfied. Economy is showing non-inflationary growth as shown in the figure 6.9. Growth can be accomplished with the larger production of resources but previous level of investment plays a dominant role to increase the productivity. So they are strongly correlated.

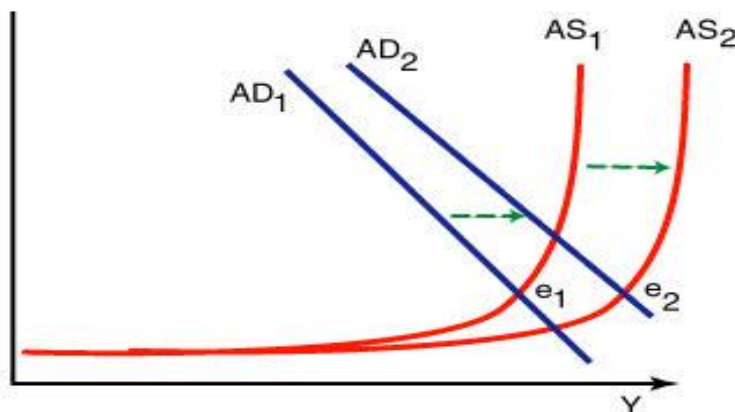


Figure 6.9: Wage Increase with Productivity Gains

Role of Expectations and Aggregate Supply Curve

Interest Rate expectations have an ambiguous effect on the aggregate supply curve but the role of expectations and the effect of these expectations upon business will depend upon the type of business. Businesses with large inventory will expand their business in an environment of inflationary expectations; on the other hand businesses with low inventory will avoid expansion if they expect labour cost to rise. In capital good formation business might accelerate their debt finance expansion in lower interest rates.

6.6 Business Cycle Analysis and Application of Aggregate Demand and Aggregate Supply Model

Aggregate Demand and Aggregate Supply model provides insight to the pertinent questions like how the business cycle is represented or will an increase or propagation in aggregate demand cause growth or inflation in the economy and the most important question is, disappointed consumer expectations can lead to the business cycle or depression or can create passive mood in the economy. Following important issues have been investigated in this section:

1. Business Cycle
2. Effect of stimulation in demand on growth or inflation
3. Effect on Business Cycle of disappointed Consumer expectation

1. Business Cycle

It is shown by the movement of equilibrium over time as the aggregate supply curve and aggregate demand curve both shifts. In the macro-economic dynamics, the aggregate demand is more volatile than aggregate supply curve. So the shift in equilibrium will be due shifts in aggregate demand curve. In the figure 6.10 given below

expansion and recession are shown. Expansion path is shown when equilibrium is moving from left to right which means growth in real gross national product. On the other hand right to left movement represents contraction of GNP which reflects recession in the economy. An upward movement of equilibrium represents an increase in rate of inflation and vice-versa.

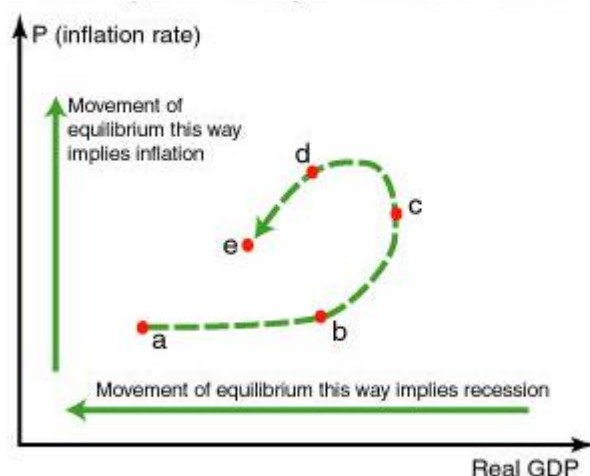


Figure 6.10: Aggregate Demand and Supply Model and Business Cycle

In figure 6.10 given above 'e' is maximum real growth point and at this point cycle is at its peak. 'a' point in the figure represents the recovery phase. The movement from 'a' to 'b' shows the healthy phase of recovery and expansion which indicates moderate increase in inflation and healthy increase in GNP. This movement from 'a' to 'b' is caused by shift in aggregate demand and some shift in the AS curve. Movement from b to c represents the late phase of expansion which is inflationary phase indicates lesser growth and high rate of inflation. Movement from c to d indicates that inflation rate abates as the recession continues and path is meant to be representative. So in each business cycle there is first movement in the equilibrium from left to right during the expansion phase and then a movement from right to left during the contraction phase.

2. Effect of Stimulation in Demand on Growth or inflation

Aggregate demand is more volatile than aggregate supply and is strongly related to business cycle dynamics. Aggregate demand curve can shift to the right because of increase in government spending or decrease in taxes, increasing credit availability,

expansionary monetary policy and cutting interest rates all influence the aggregate demand. Suppose a government adopts expansionary monetary policy then credit and money supply growth rate will surge and interest rate would be reduced. This will stimulate aggregate demand curve to shift right. Theoretically speaking money growth rate would lead to inflation. Figure 6.11 represents the relationship between high money supply growth rate with the adoption of expansionary monetary policy and inflation. Generally this type of monetary policy is adopted during periods of depression, then there will be non inflationary real growth. AD curve will be back on the non-inflationary range of the AS curve, so inflation will not be an issue. In the real world capacity utilization rate in the beginning is usually very low and unemployment rate is high and resources available are more in the economy. With the excess capacity of the resources manufacturers could satisfy their urge to increase sales by utilizing existing capacity, hence inflationary pressures would not emerge as shown in the figure 6.11:

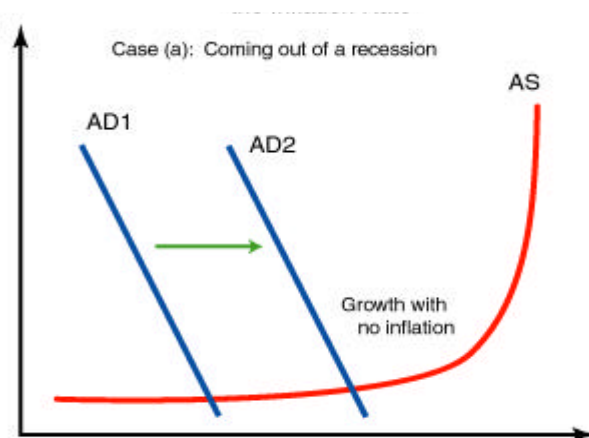


Figure 6.11

In figure 6.12, inflation will be the consequence of the expansionary phase of the monetary policy as excess capacity is diminished, full utilization of resources has already been done in the economy so labour constraints and resource constraints will start emerging and economy will move into the inflationary region of the AS curve. The stronger the growth of money supply, higher will be the inflation rate due to excess demand. Inflationary range of the AS curve means that in the real economy, inflation would be a problem and robust inflationary expectations would be formed and this might continue over few months and then new stimulus to aggregate demand which might possibly affect aggregate supply as well will be provided.

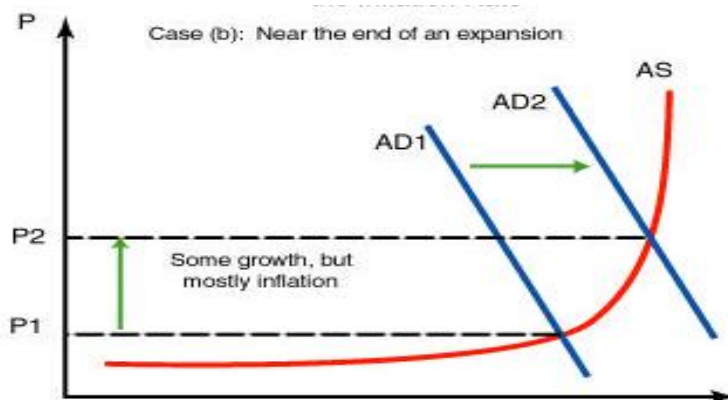


Figure 6.12: Effect of a surge in Aggregate Demand upon the Inflation rate

Figure 6.13 given below shows the movement in AD curve from AD1 to AD2 which is caused by the growth of money supply or monetary stimulus resulting in initial inflation. It will hike the inflation rate from P_1 to P_2 then the secondary effects of inflationary expectations will begin to form and it will move further AD curve AD2 to AD3 and there will be corresponding price from P_2 to P_3 reflecting the inflationary expectations. The secondary effects of inflationary expectations are based on the theory of adaptive inflationary expectation model which says that adaptive expectations are formed from experience and instead of learning from inflation the new expectations formed will shift demand curve and the dynamics of inflationary phase are complex because of these expectations. These expectations put you in a situation of Cobweb model.

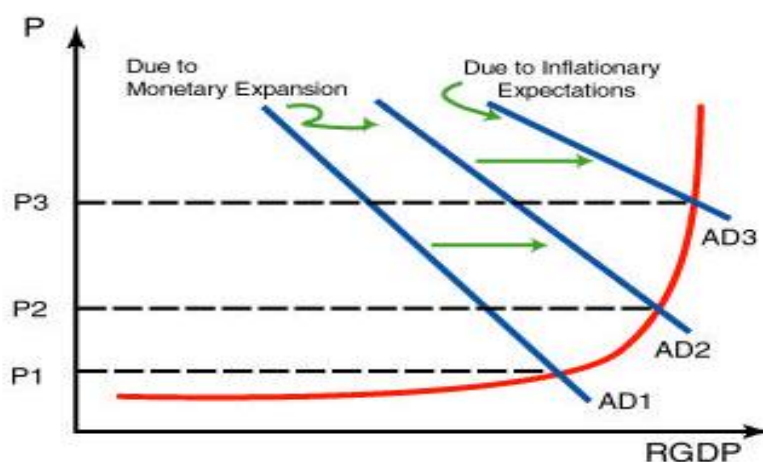


Figure 6.13: Secondary Effects of Inflationary Expectations

3. Effect on Business Cycle of disappointed Consumer expectation

Expectations strongly affect the working of business cycle. They can make the recession worse or milder depending upon the basis of formation of expectations or the type of expectations or how they are formed. They can start a cyclical trend and they will also affect the timing of the cycle.

Consumers form expectations on the basis of their recent experiences. This is also called as expressionist view. Sometimes consumers can go wrong while forming the expectations. According to the theory of adaptive expectations, if consumers experience a high growth period they will expect more growth in future also. So this means they have adapted to the situation but in reality this may not happen and it may lead to disappointment. Figure 6.14 shows that consumer experience a growth of income in recent years and they formed their expectations on the basis of this growth that in near future they will get more income represented by the movement from A to B from times t_0 to t_1 and now they continue to expect income to grow at the same rate at the level CE at time t_2 for the future also. But in reality rate of income growth is less than the previous years and CA is the actual level of income growth depicted in the figure 6.14. Then consumer expectations are disappointed and it will result in volatility in cyclical events. Figure 6.14 shows that the consumer expectations are weak because they perceive less income growth in previous years and on the other hand if income begins to rise it is perceived as windfall gain to them.

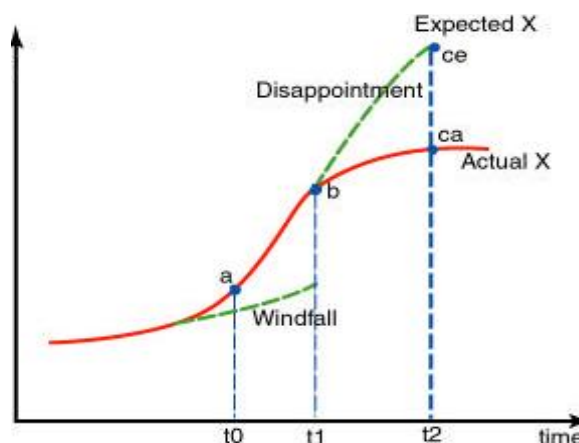


Figure 6.14: Adaptive Expectations based on Recent Short-term

Trends

Role of AS/AD model to combat Inflation and Stagflation

Inflation

Inflation is a phenomenon where there is consistent and appreciable rise in prices and it is due to shifts in aggregate demand or aggregate supply or the combination of both which is called as mixed demand pull cost push inflation. Actual inflationary process contains some elements of both demand and cost factors so the forces operate simultaneously and interdependently in inflationary process. There should be a balance between these two forces.

Stagflation

Stagflation is the combination of stag + flation. Stag means stagnation and flation means inflation. It is also called inflationary recession where the economy experiences stagnation or unemployment with high rates of inflation. The phenomenon of coexistence of high inflation and high unemployment has been termed as stagflation. According to the monetarists or Friedman Phels model expansionary monetary policy can increase employment at the cost of inflation only if the workers don't correctly anticipate the inflation rate. Generally the higher rate of inflation and unemployment is associated with reduction in aggregate supply due to different causes. Some of these causes are given below:

1. Reduction in Aggregate Supply is due to restrictions on labour supply which may be caused by rise in legal minimum wage, rise in wages due to powerful trade unions and increase in marginal tax rates which reduces the work efforts.
2. Increase in indirect taxes may impact aggregate supply adversely. Higher indirect taxes raise both cost and prices and reduce output and employment
3. Aggregate supply may be affected adversely by external forces such as rise in international prices of essential material which leads to increase in domestic production cost and prices and hampers the output.
4. According to the monetarists increase in money wages leads to the hike in cost of production and this increase in money wages is not due to rise in actual price level, but due to changes in the expectations of price rise.

Stagflation has been graphically discussed in figure 6.15 in terms of aggregate demand and aggregate supply curve (AD/AS model).

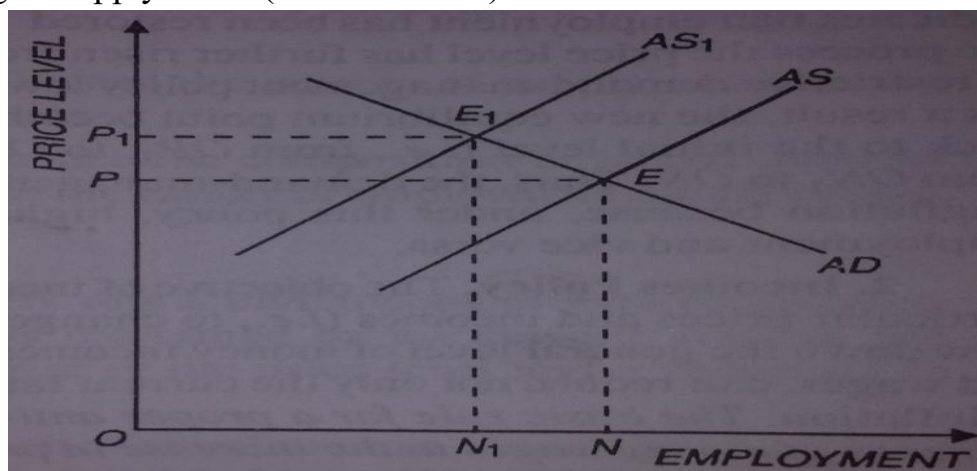


Figure 6.15

The initial equilibrium of the economy is at point E where AD curve is intersecting AS curve at ON level of employment at OP price level. Now the aggregate supply curve shifts upward from AS to AS1 position due to rising cost or increase in indirect taxes. Aggregate supply is reduced and the economy reaches the new equilibrium level E1 where AD curve intersects AS1 curve consequently the employment level falls from ON to ON1 and the price level increases from OP to OP1. This is the irony of the situation where the inflation rate rises and yet unemployment increases.

6.7 Uses of the AD/AS Model

Important results follows from the AD/AS model with flexible prices that under the influence of expansionary policy aggregate demand curve shifts to the right and it will affect the national output and price level. Keynesian view holds that expansionary fiscal and monetary policies lead to greater increase in GNP and less rise in price level. AD/AS model is useful to explain the business cycle, volatility in the market system, imperfections in the market system. AD/AS model is also used as a tool to explain the concept of stagflation and the causes associated with stagflation. AD/AS model is basically used to discuss disequilibrium in the economy and how the equilibrium can be achieved.

6.8 Summary

Aggregate Demand and Aggregate Supply model was first of all proposed by Keynes in his general theory. He says aggregate demand and aggregate supply determine the level of effective demand. Economy may be in underemployment situation or over full employment situation. So to restore the full employment equilibrium there may not be automatic adjustments of demand and supply forces. He has advocated the role of government to promote investment especially in recession. He has stressed the fiscal policy and monetary policy measures to deal with inflation. Macroeconomic scientists believe that AD/AS model is helpful tool to deal with the problem of stagflation. Although the concept of aggregate in quantities was discussed in Walras general equilibrium analysis in market clearing model but the scientific approach was given to this model by Harrods and Domar and other Neo-Classicals who were trying to achieve the path of steady growth in the economy and to deal with the problems of disequilibrium.

6.9 Keywords

Aggregate Demand and Aggregate Supply Theory: This theory is actually related to the total production of the economy.

Effective demand: The level of aggregate demand at which aggregate supply is equal to it or the point at which the aggregate supply curve intersects the aggregate demand curve will be the level of effective demand.

6.10 Check Your Progress

(A) Fill in the Blanks

1. The first formal macroeconomic model is called as aggregate supply model
2. AD/AS model is an aggregation of model
3. AD/AS model is also called static model
4. Effective demand is the point where AD curve intersects..... curve
5. Main Components of aggregate demand are investment, consumption, ...and.....

(B) True/False

6. Taxation impacts the aggregate demand inversely.
7. Rising Costs are positively related to aggregate supply

8. Wealth and wealth expectations are positive indicators for demand.
9. An increase in productivity shifts the supply curve to the right
10. AD/AS model is very helpful tool to explain business cycles

6.11 Answers to Check Your Progress

- (A)** 1. Aggregate Demand 2. Microeconomics 3. Comparative 4. AS
 5. Government spending, net exports
- (B)** 1. True 2. False 3. True 4. True 5. True

6.12 Terminal Questions

1. Discuss the AD/AS model in detail.
2. Discuss the role AD/AS model in explaining business fluctuations.
3. Discuss the concept of stagflation with reference to AD/AS model.

6.13 References

1. Ahuja H L (2001) Macroeconomic Theory and Policy.
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UNIT 7: INFLATION

Structure:

- 7.1 Introduction
- 7.2 Meaning of Inflation
- 7.3 Types of Inflation
- 7.4 Keynesian Concept of True Inflation
- 7.5 Concept of Inflationary Gap
- 7.6 Theories of Inflation
- 7.7 Mark-Up Inflation Model
- 7.8 Concept of Stagflation
- 7.9 Other Concepts Related to Inflation
- 7.10 Causes and Control of Inflation
- 7.11 Measures to Control Inflation
- 7.12 Inflation and Unemployment
- 7.13 Summary
- 7.14 Keywords
- 7.15 Check Your Progress
- 7.16 Answers to Check Your Progress
- 7.17 Terminal Questions
- 7.18 References

Objectives

After studying this unit, students would be able to understand:

1. The meaning of Inflation
2. Types of Inflation
3. Impact of Inflationary gap on the economy
4. Theories of Inflation
5. Concept of Stagflation
6. Causes and Control of Inflation
7. Trade off between unemployment and inflation

7.1 Introduction

Inflation means consistent and appreciable rise in prices. It is purely a monetary phenomenon which is affecting different countries of the world differently. High degree of inflation leads to adverse effects on labour, productivity and efficiency. Causes of inflation include growth in the money supply and rising cost and mark-up profits. Government is taking various fiscal and monetary measures to curb inflation as adopting dear money policy, varying the cash reserve requirement and correcting the balance of payment equilibrium. In this unit we have covered various aspects related to inflation like meaning of Inflation, and other terms associated with inflation, types of inflation, theories, and causes of inflation and measures adopted by government to control inflation.

7.2 Meaning of Inflation

It is very difficult to define inflation or to give a precise and concise definition of inflation. Many authors have tried to define inflation in their own way. Original the term was first defined by Neo-Classicals. They meant by it a galloping rise in prices as a result of the excessive increase in quantity of money. For them inflation is a situation characterized as a destroying disease born out of lack of monetary control whose result undermine the rule of business, creating havoc in markets and financial ruin of even the prudent. This statement was advocated by R J Bell and Peter Doyle in 1969. Prof. Crowther says “inflation is a state in which value of money is falling i.e. prices are rising”. According to Gregory, “Inflation is a state of abnormal increase in quantity of money”. Hawtrey says “it is issue of too much currency” and Coulborn emphasizes it as a phenomenon, “where too much money chases too few goods”. According to Friedman “Inflation is a purely monetary phenomenon or its a process of sustained and steady rise in prices.” Gardener Ackley turned inflation as a persistent and appreciable rise in general level or average of prices. Shapiro defines inflation as a persistent and appreciable rise in general level of prices. Emile James opines that “Inflation is self perpetuating and irreversible upward movement of prices, caused by an excess of demand over capacity to supply. John Maynard Keynes thought that only when a further increase in quantity of money producers no further increase in output and entirely spends itself on an increase in cost unit fully proportionate to the increase in effective demand could the condition be appropriately designated as one of true inflation.

We can evolve two major things from these definitions about inflation:

1. Inflation is a situation where there is continuous and steady rise in prices
2. It is a situation where there is appreciable increase in prices.
3. In general we can define inflation as a steady, continuous and sustained rise in prices.

7.3 Types of Inflation

Sustained rise in prices may be of varying magnitudes. Main types of inflation are discussed in detail below:

1. Creeping Inflation

When the rise in price is extremely slow or it is at snail's pace, in terms of speed less than 3%pa increase in price is termed as creeping inflation. This type of inflation is essential for economic growth.

2. Walking or Trotting Inflation

In walking or trotting inflation price rise is modest; generally up to 7 percent per annum increase in price is visible. Although this type of inflation is not bad for economy but it provides a warning signal to the government.

3. Running Inflation

In this type of inflation prices start rising rapidly at a rate of 10 to 20% per annum. This type of inflation affects the economy adversely. Particularly middle income group and poor class people are affected by it deeply. It is also called horse inflation as horse runs faster. It requires monetary and fiscal actions from the government; otherwise it can cause damage to the economy.

4. Hyper Inflation

When price rise is extremely high, it rises at a double or three digit rate. The rate of inflation in this category ranges from 20% to 100% per annum or more, it is termed as hyper inflation. It is also called run away or galloping inflation. This type of inflation is generally uncontrollable and seen in war like situations. It brings total collapse of the monetary system, there is continuous fall in the purchasing power of money.

The speed with which prices tend to rise is shown in figure 7.1 given below:

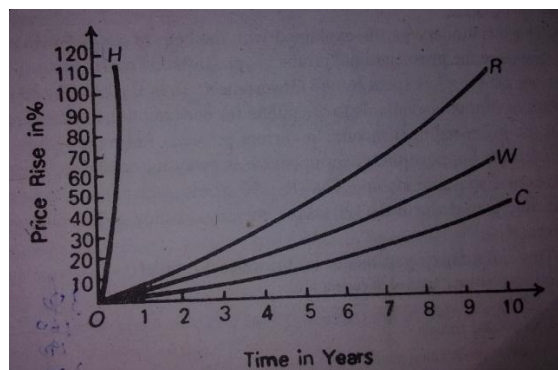


Figure 7.1

7.4 Keynesian Concept of True Inflation

Keynes opines that the inflation is caused by an excess effective demand and he says actual inflation only comes in or sets in after the level of full employment

has been attained. According to him “So long as there is unemployment in the economy, employment will change in the same proportion as the quantity of money and when there is full employment prices will change in same proportion as quantity of money”. He does not deny that there can be price rise before full employment and this type of phenomenon is called semi-inflation or reflation. According to Keynes full employment is a point where true inflation sets in as shown in figure 7.2 given below:

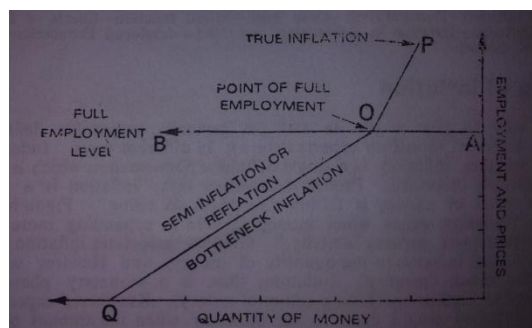


Figure 7.2

As shown in the figure 7.2 given above, prices start rising before the point O but it cannot be termed as true inflation. True inflation is the point P which is beyond full employment equilibrium level.

7.5 Concept of Inflationary Gap

The concept of inflationary gap is propounded and developed by J M Keynes in his pamphlet 'How to pay for war' published in 1940. Inflationary gap is a situation in the economy when effective demand and anticipated expenditure exceed the available output at base prices. According to Lipsey, 'The inflationary gap is the amount by which aggregate expenditure would exceed aggregate output at the full employment level of income'. Keynes attributed it to the excess of expenditure over income at full employment level. At full employment level, there is excess of aggregate demand over aggregate supply, because the economy is at full employment level real output cannot increase. The excess aggregate demand therefore will lead to an increase in prices unless government resorts to fiscal or monetary action.

Inflationary Gap

The inflationary gap can be explained with the help of an example as illustrated below:

Let us suppose that gross national product at pre-inflationary prices is Rs. 300 Crores. Out of this, Rs.100 crore is spent by the government and output worth Rs. 200 crores is left for consumption. Suppose further that the gross national income is Rs. 350 Crore, since the government has to collect taxes worth Rs. 100 crores, then the disposable income left for the public is Rs. 250 crores. So the income available is more than the available output i.e. available income is Rs. 250 crores and available output is Rs. 200 crores. Difference of Rs 50 crore (Rs. 250 – Rs 200) is the excess amount of money available which is called as inflationary gap. Concept of inflationary gap is explained below further in a simplified manner:

	Rs.(Crores)
a. Gross National Income (at current prices)	350
b. Taxes	100
c. Disposable Income (a-b)	250
d. GNP at pre-inflationary prices	300
e. Government Expenditure	100
f. Output available for consumption (d – e)	200
g. Inflationary Gap (c – f)	50

The concept of inflationary gap in the form of a graph is explained below through figure 7.3.

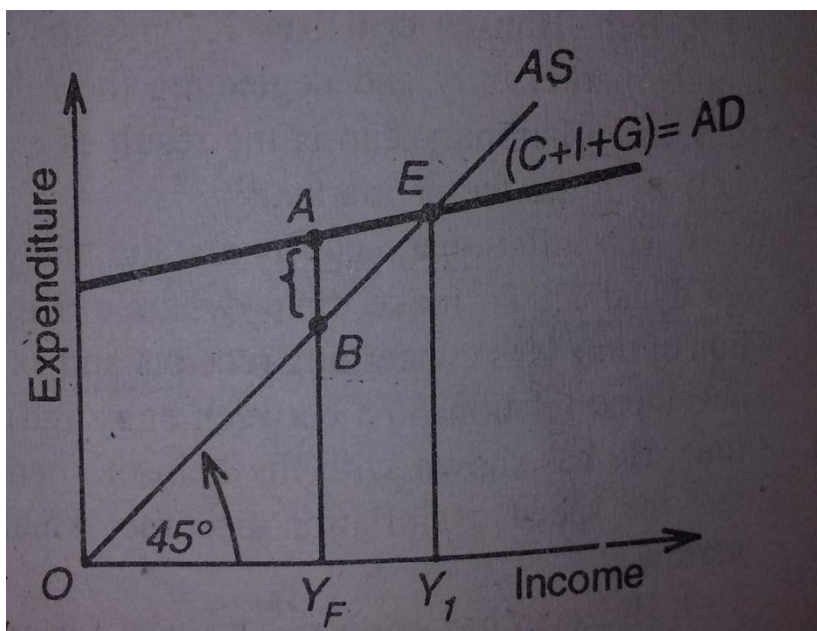


Figure 7.3:

In figure 7.3 Y_F is the full employment level, AD is the aggregate demand curve comprised of consumption plus investment plus government expenditure i.e. $C+I+G$. It intersects the aggregate supply (AS) curve 45 degree line at point E at OY_1 income level which is more than full employment level, so the amount by which aggregate demand exceeds aggregate supply is the inflationary gap shown as AB in the figure 7.3.

Inflationary Gap can be wiped out by increase in savings to reduce the aggregate demand but it may lead deflationary tendencies. Inflationary gap can also be curbed by increasing taxes and reducing expenditure. Concept of Inflationary gap has been criticized by Friedman, Koopman and Hansen. Basically the concept is a flow concept and it is confined to goods markets only and it is a static analysis. Holzman has criticized Keynes for using multiplier technique to analyze inflationary gap.

7.6 Theories of Inflation

We have vast literature on theories of inflation and there are numerous theories of inflation but there is no single theory which is capable to explain inflationary effects on the various economies of the world. After the Second World War debate is going on to search the causes of inflation. Mainly there are five theories of inflation:

1. Demand Pull or Monetarist view on Inflation
2. Cost Push Theory
3. Structural Inflation
4. Sectoral or Demand Shift Inflation
5. Mixed Demand Pull-Cost Push Inflation

1. Demand Pull or Monetarist View of Inflation

Demand pull inflation is caused by excess of demand over available supply of goods. It happens when aggregate demand is rising on account of increase in money supply relative to the available supply of goods and services at existing prices. It is the case of too much money chasing too few goods. Friedman, Hawtrey, Golden Weiser, Hansen who regard inflation as a purely monetary phenomenon strongly favour this notion that inflation is caused by excess of money supply. As a result of excessive money supply, there will be an excess of demand exceeding the total output in the economy, consequently prices will rise resulting in fall of interest rate, increasing investment expenditures and prices. Since inflation is caused by excess in demand, it can be curbed only by the demand reducing fiscal and monetary policies.

Further there are three approaches associated with demand pull inflation.

- i. Monetary theory of Inflation
- ii. Keynesian Theory of Inflation
- iii. Bent Hansen's Model of Inflation

i. Monetary Theory of Inflation

Monetarists believe that excess of money supply is the major cause of inflation. They regard inflation purely as a monetary phenomenon. They have based their theory on classical theory of money given by Fisher. Fisher's identity equation is expressed as $MV=PT$ where M is the money supply, V is the velocity of money, P is the general price level and T stands for transaction of goods and services or available level of real output. According to the Fisher equation, V and T are assumed to be constant; price level varies proportionately and directly with supply of money. In the classical notion, aggregate supply is assumed to be fixed and economy is operating at full employment level, consequently when money supply increases, it creates excess in demand but the aggregate supply cannot be increased due to full employment of resources. This paves the way for rising prices and if the prices persistently and continuously go on rising the situation is called as true inflation.

Friedman holds the view that inflation is always and everywhere a monetary phenomenon that arises from a more rapid expansion in quantity of money than in total output. He emphasizes that inflation is caused due to an increase in demand which is the result of an increase in money supply available to people to spend it on purchasing goods and services, as a consequence prices tend to rise. When there is monetary expansion in the economy, that is more stock of money supply is available through bank credit to the people, nominal income of the people increases and it will immediately raise the demand for the goods which in turn will raise the demand for labour, now the workers will put pressure for higher wages, consequently the factor prices will rise, profit margins will be reduced and prices of product will increase. In the beginning price rise is slow and gradual and people expect them to fall later on. As a result people try to readjust their money holding, and prices start rising more rapidly than in proportion to money supply.

The quantity theory of money can be represented in the form of a figure 7.4a and 7.4b as follows:

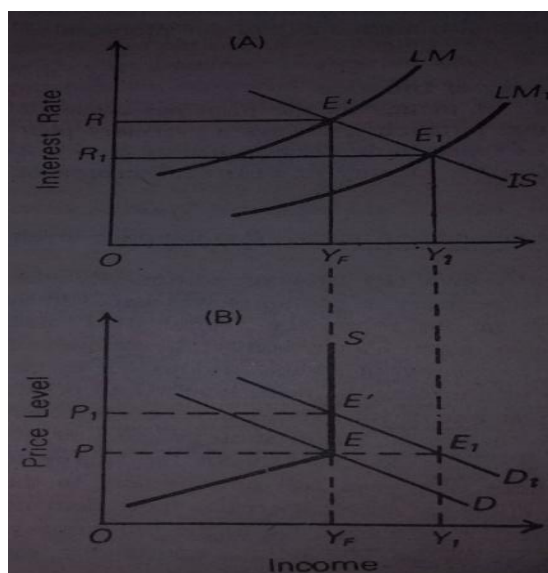


Figure 7a and 7b

In figure 7.4a and 7.4 b it is shown that P is the price level determined by the forces of demand and supply of money. Full employment level is represented at Y_F level at E' equilibrium where R is the interest rate, with the expansion of the money supply LM curve will shift from left to right and intersects with IS curve at new equilibrium point E, consequently rate of interest falls to R₁. As aggregate supply is fixed so there will be no change in IS curve. As a result aggregate demand will rise shifting D to D₁ and this

excess of the demand is represented at E1 equilibrium level and hence there will be price rise from P to P' as shown in figure 7.4 b above. Price will be exactly in the same proportion to the real value of money.

ii. Keynesian Theory of Demand Pull Inflation

Keynesian theory is based on the concept of inflationary gap. According to Keynes, demand pull inflation is caused by excess in aggregate demand. This demand is generated from many sources such as consumers, businessman and government. Aggregate demand is a net component of consumption demand plus investment demand plus government expenditure. When aggregate demand is more than aggregate supply at full employment level, inflationary gap arises. The larger the inflationary gap, more will be the inflation. According to Keynes, inflation sets in only after the economy has reached the full employment equilibrium level. Before the full employment equilibrium, if the quantity of money increases, rate of interest will fall which will mean more investment and in turn increased aggregate demand and it will have positive effect on the level of output till the economy reaches the full employment equilibrium. Once full employment equilibrium is established, excess in demand will push prices. Keynesian model is depicted in the figure 7.5a and 7.5b given below:

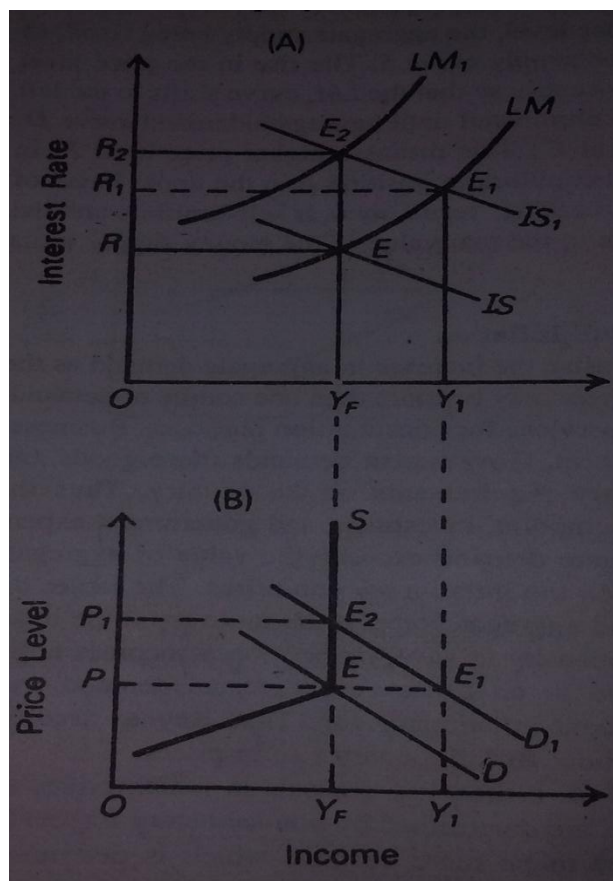


Figure 7.5a and 7.5b

Let the economy is in equilibrium at point E where the IS and LM curves are intersecting at full employment Y_F level at the R interest rate. In figure 7.5b it can be seen that D is intersecting S at point E and price P is determined at this level. Now there is increase in government expenditure which will shift IS curve to the IS_1 and new equilibrium will be established at E_1 where the income level and interest rate both rises implying increase in demand from D to D_1 . This excess in demand will raise price level from P to P_1 . A new equilibrium will be established at higher rate of interest R_2 although at full employment level Y_F .

iii. Bent Hansen's Model of Excess Demand

Bent Hansen is the originator of the dynamic model of excess demand in which he has established two separate price levels one for product market and the other for factor market.

Assumptions of the model

1. There exists perfect competition in both the factor and product market
2. Prices will be same
3. One variable factor will produce only one commodity
4. There is a fixed level of output

Hansen model can be explained in the form of graph as given in figure 7.6 below:

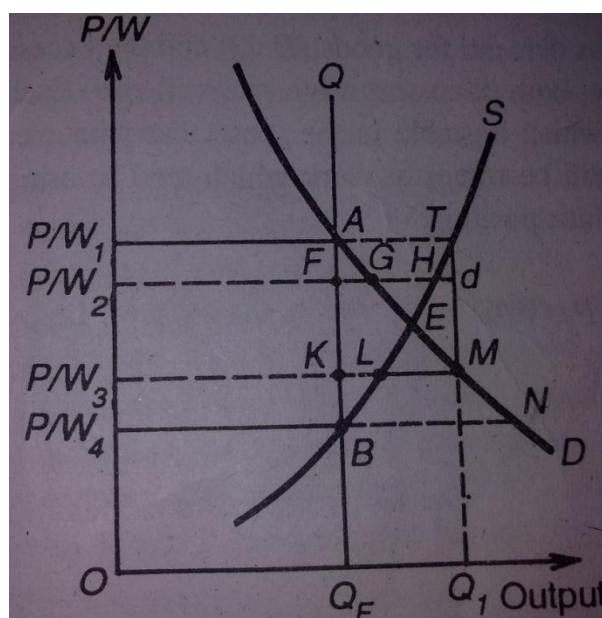


Figure 7.6

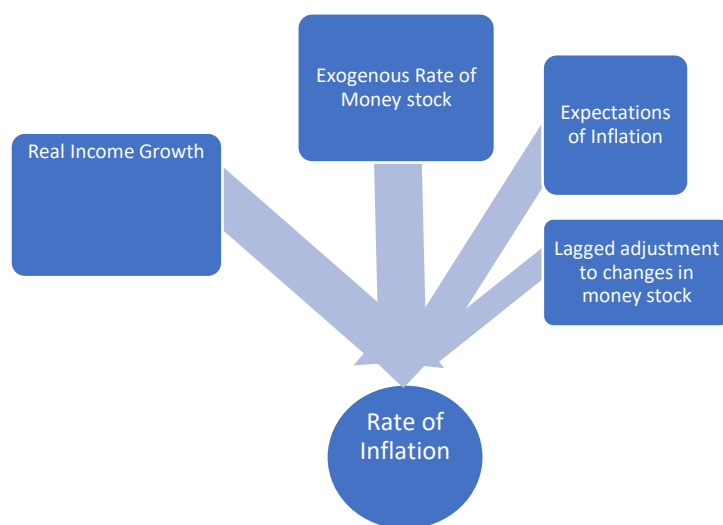
On OX axis the output is measured and on OY axis price/wage ratio is measured. S is the supply curve which has a direct relationship with P/W ratio and D is the demand curve which varies inversely with P/W ratio. The line parallel to OY axis represents the full employment level of output Q_F . The gap D and Q is the inflationary gap in the goods market and gap between S and Q is the inflationary gap between factor markets. Two curves D and S intersect at point E which is the right of full employment level. This shows that there is a positive gap in both the goods and factor market which is virtually not possible. It can only happen if there is a monetary pressure of inflation and that can only be there if P/W is between P_1/W_1 and P_4/W_4 . Hansen has used two equations to illustrate his version:

$$dp/dt = f(D-Q) \quad (i)$$

$$dw/dt = F(S-Q) \quad (ii)$$

dp/dt measures the changes in prices and dw/dt measures the changes in wages respectively. If $D-Q$ is equal to zero i.e. $dp/dt = 0$ and $S-Q = 0$ i.e. $dw/dt = 0$, it shows static equilibrium state. If the two gaps are positive both the prices and wages will show positive trend. This means if the excess demand for goods and the excess demand for factors is positive this will have positive impact on both prices and wages simultaneously.

In the standard monetarist model, rate of inflation is the result of rate of growth of real income accompanied with the income elasticity of demand for real balances and impact of expectations regarding inflationary tendencies and lagged adjustments to the changes in money stock. Rate of growth of money stock is assumed to be exogenous. The model is depicted below:



Standard Monetarist Model

Vogel in 1974 introduced a term for expectation of inflation in structural form. He stressed that for less developed countries we need to use structural variables along with the study of expectations.

The major causes of inflation according to monetarists are increase in money supply, increase in government expenditure and deficit financing.

2. Cost Push Theory of Inflation

Inflation which is caused by increase in cost is called cost push inflation. It was propounded as a theory in 1960s. It was observed in developed countries that production was declining on account of decline in demand, but the prices were soaring high so it was concluded that inflation can also be the result of rising cost and fall in output and employment. In the words of A.S. Compagana “Cost push inflation is the consequence of rise in cost. It is

characterized by insufficiency of aggregate demand, unemployed resources and excess capacity.” J.C Ranlert puts it as “The basis of cost push theory of inflation is that organized groups, both business and labour establish higher prices for their products or services than they would prevail in perfectly competitive prices”.

Richard quandt and William Thorp in 1959 in their work ‘The new Inflation’ expressed that inflation is caused by wage increase due to trade union pressures, this hike in wages moves or pushes costs of inputs up and this results in higher cost of living index also. There are two attributes for cost push inflation:

- i) Wage Pull
- ii) Profit Push

Cost push theory can be explained with the help of figure 7.7 below:

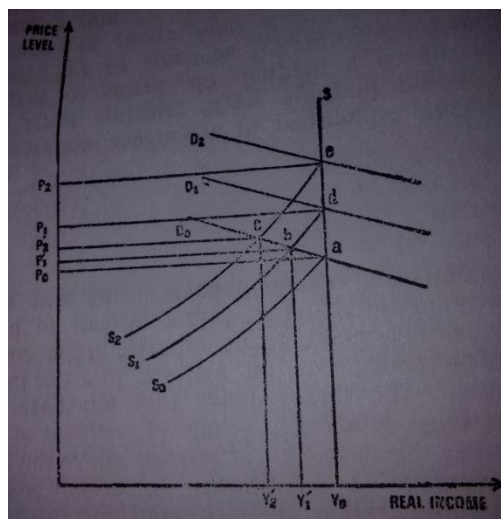


Figure 7.7

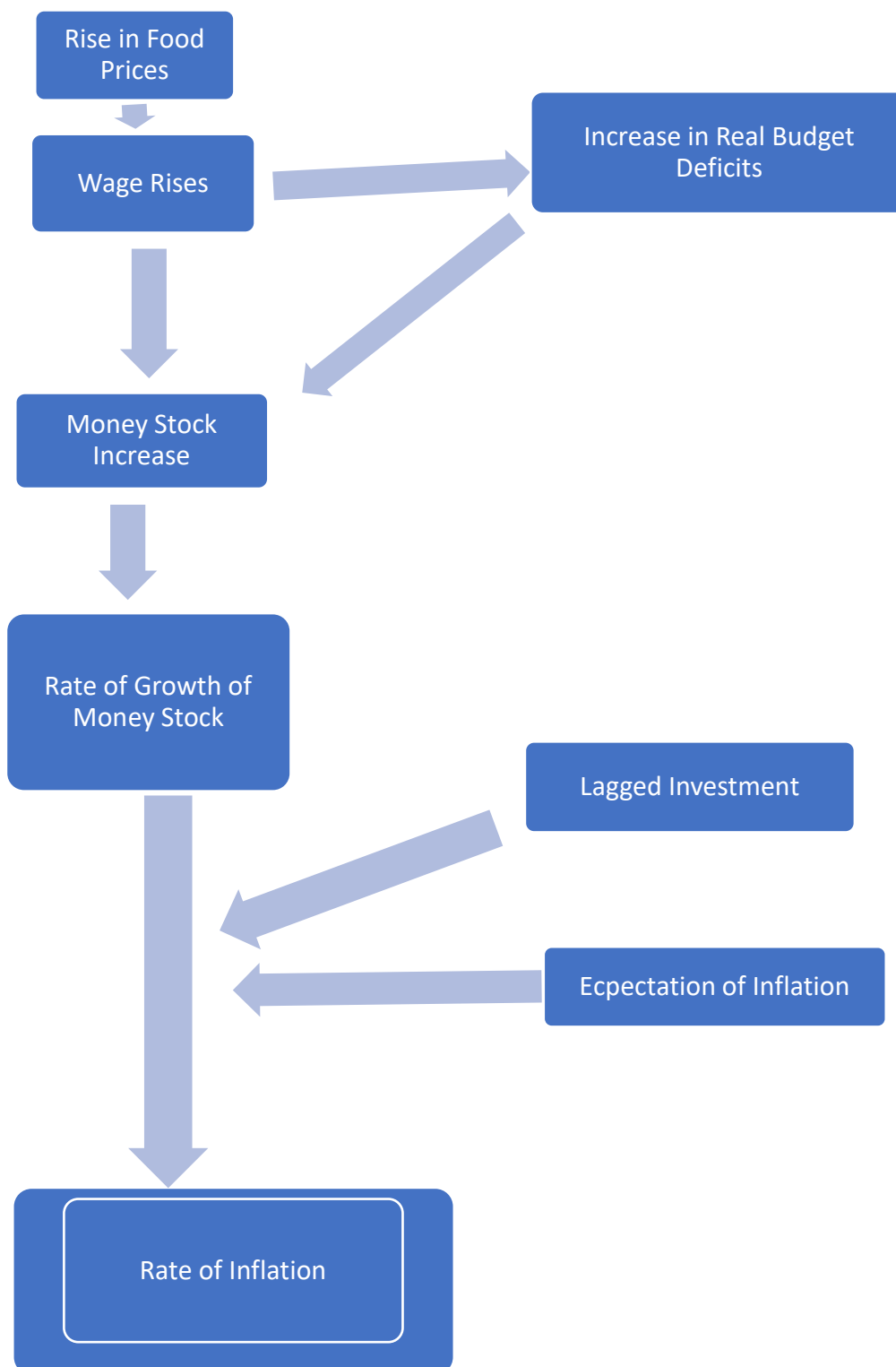
In the figure 7.7 it is shown that supply curve moves upward from S_0 to S_1 , S_2 and so on. SOS is the original supply curve and DO is the original demand curve. With the pressures from labour union, wages have been pushed up. As a result SOS curve has

been shifted to S_1S curve and prices have been pushed up from p_0 to P_1 and so on. There is corresponding fall in output level from Y_0 to Y_1 and so on, so rise in price level is accompanied by unemployment. Each increase in money wage will lead to lower level of output, high prices and resultant unemployment.

3. Structural Theory of Inflation

For the less developed countries different theory has been proposed by Myrdal, Stresen and several Latin American economists who have stressed that there exist market imperfections and rigidities of various types in less developed economies. The main bottlenecks in such economies are infrastructural bottlenecks, foreign exchange bottlenecks, the budget resource gap and food bottleneck etc.

A structural model of inflation is explained with the help of chart below:



So the structuralists have attributed three main causes of inflation:

1. Prices of Agriculture commodity
2. General Price level
3. Wages

As the demand of agriculture commodities increase there is consequent rise in prices as supply of agriculture commodities cannot be increased due to defective land tenure system, lack of storage and marketing facilities, bad monsoon etc. With the increase in price of food products, wages earners will press for increase in wages and this will further push the demand and prices which can be explained in the figure 7.8 given below:

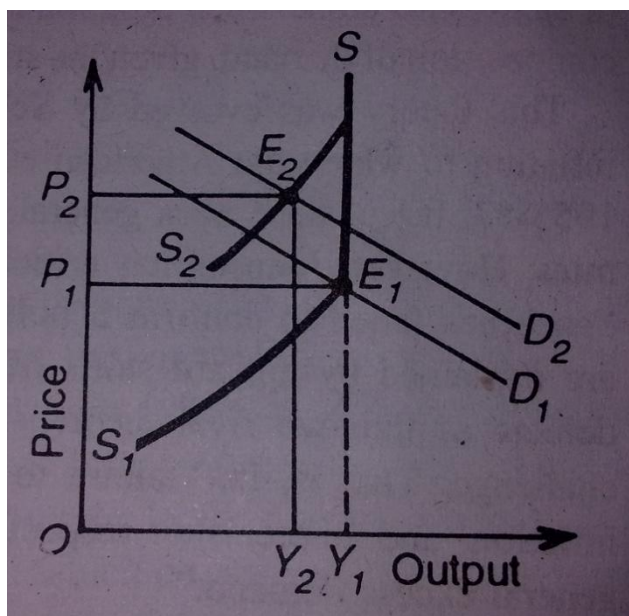


Figure 7.8

The effect of increase in wage rate on prices can be seen from this figure 7.8. On account of rise in wage rate, the aggregate demand shifts from D_1 to D_2 . But the supply curve is shifting downward from S_1 to S_2 , because the output cannot be increased due to imperfection and rigidities. This will cause supply curve to become constant after a certain point as shown in the figure from point E_1 . New supply curve is intersecting D_2 at point E_2 where the prices are moving upward but output is less than the previous equilibrium.

The causes of structuralist inflation in the less developed country are mainly high cost of import substitutes, slow rate of export growth, sluggish foreign exchange growth, devaluation of currency and deterioration of terms of trade. Another important factor is the nature of tax system which is faulty in these economies.

4. Sectoral Demand Shift Theory

The concept was put forward by Charles Schultz who explained that inflation is the result of changes in the composition of aggregate demand. This theory is based on the fact that in many sectors of the economy, wages and prices are flexible upward in response to increase in demand, but not flexible downward when demand declines. So the sectoral demand shifts theory emphasis on the composition of demand. Let us suppose that the demand for the output of some industries increases substantially and the demand for other industries fall by the same amount, hence the aggregate demand remains the same. In the expanding industry, demand for labour shoots up and corresponding rise in wages will be there and prices moves in upward direction. But wages don't fall in industry with falling demand as there is downward rigidity in case of wages. Thus overall demand will increase.

5. Mixed Demand Pull/Cost Push Inflation

Mixed demand inflation is associated with both demand pull and cost push factors. It is basically the combination of excessive demand and rising cost which allows inflation to persist in the economy that is why it is called as mixed inflation. Both the approaches are supplementary rather than competitive in nature. Sometimes cost push factors are linked with demand pull factors which leads to inflation in the economy.

7.7 Mark-Up Inflation Model

Mark-up inflation model is propounded by Gardner Ackley and later on it was further developed by Holzman and Dusenberry independently of each other. Mark-up model is based on the assumption that wages and prices both are administered and are fixed by the workers and business firms. While fixing the prices of their goods firms add profit to the material and labour cost. Wages are determined on the basis of fixed mark-up and cost of living. Thus Mark-up covers both overhead costs and profits. Ackley says that 'Inflation may start from an initial autonomous increase either in business and labour mark-ups'. Ackley gives the concept of inflation spiral which means that both workers and firms use percentage mark-up i.e. each of them fixes their administered prices

according to the prices he pays, then inflation is there to stay because if one firm raises its prices, cost of other firms are raised and this process is endless. On the other hand if the consumers have to buy the commodity having high prices, their overhead cost rises and this may lead to higher demand for wages. This situation is like a web and can only be resolved if the productivity and efficiency of labour could be enhanced. But if both the parties expect a hundred percent gain of productivity, the result will be disastrous leading to mounting inflation. To curb this sort of inflation, Ackley has recommended wage and price guidelines to be administered by national wage and price commission.

7.8 Concept of Stagflation

It is the term associated mainly with the advanced economies like USA and UK. In the recent year they have witnessed decline output and rising unemployment i.e. coexistence of stagnation and inflation. According to P.A. Samuelson “Stagflation involves inflationary rise in prices and wages at the same time. The people are unable to find jobs and firms are unable to find customers for what their plants can produce.” According to Penguin’s dictionary of economics “Stagflation is a state of economy in which economic activity is slowing down, but wages and prices continue to rise.”

Stagflation is also known as slump inflation. There are different views amongst economists regarding the causes of stagflation. First group of economists think that it was the result of combination of circumstances, specific policies adopted by the government both of fiscal and monetary nature and shock. Other group of economists hold the view that stagflation is the result of gradually changing expectations about inflation.

A former prime minister of UK admitted in 1977 “He used to think that you could spend your way out of recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that the option no longer exists and that in so far as it ever did exist, it worked by injecting the inflation into the economy. And each time that happened the average level of unemployment has risen. Higher inflation followed by higher unemployment that is the history of last twenty years.”

In the words of Haberler, “The combination of unemployment and inflation is a very delicate matter, if we fight recession, we stimulate inflation and if we fight inflation we stimulate recession.”

7.9 Other Concepts Related to Inflation

Deflation

Deflation is characterized by falling prices and falling level of output and employment. According to Prof. Paul Einzing, “It is the state of disequilibrium in which the contraction of economic power tends to cause or is the effect of a decline of price level.” Deflation is the result of insufficiency of effective demand.

Reflation

It is deliberately undertaken to revive economies out of depression. According to Prof. G.D.H. Cole “Inflation deliberately undertaken to relieve depression is reflation.”

Disinflation

It is the process by which inflationary trend in prices can be brought down without effecting the level of employment.

Concepts of Inflation, Deflation, Reflation and Disinflation are exhibited below in figure 7.9:

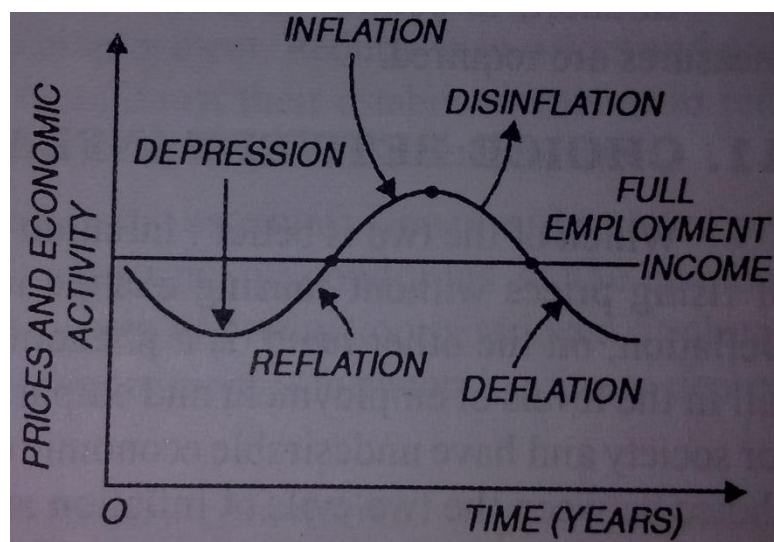


Figure 7.9

7.10 Causes and Control of Inflation

Inflation inflicts disastrous consequences in the economy. General causes of inflation are excess in demand, rising cost and mark-up profits.

Demand Side Causes

1. Increase in Expenditure
2. Cheap Money Policy
3. Black Money
4. Deficit Financing
5. Increase in Government Expenditure

6. Increase in the Income of People
7. Increase in Money Supply
8. Enlargement of Private Sector
9. Public debt Repayments

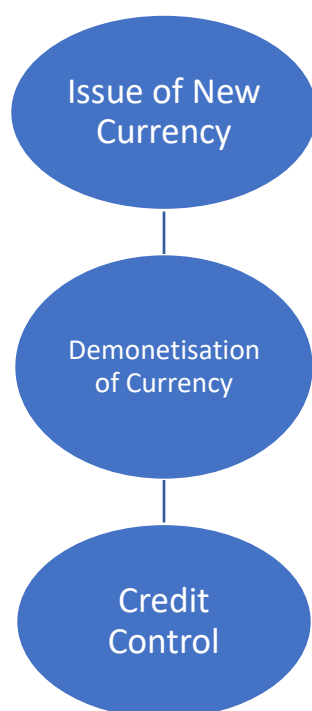
Supply Side Causes

1. Shortage of Raw Material
2. Uncertainty of weather and monsoon
3. Natural disasters and calamities
4. Artificial scarcity
5. International Factors
6. One sided Production
7. Increase in Exports

7.11 Measures to Control Inflation

There are various measures adopted by the government to control inflation which is given below:

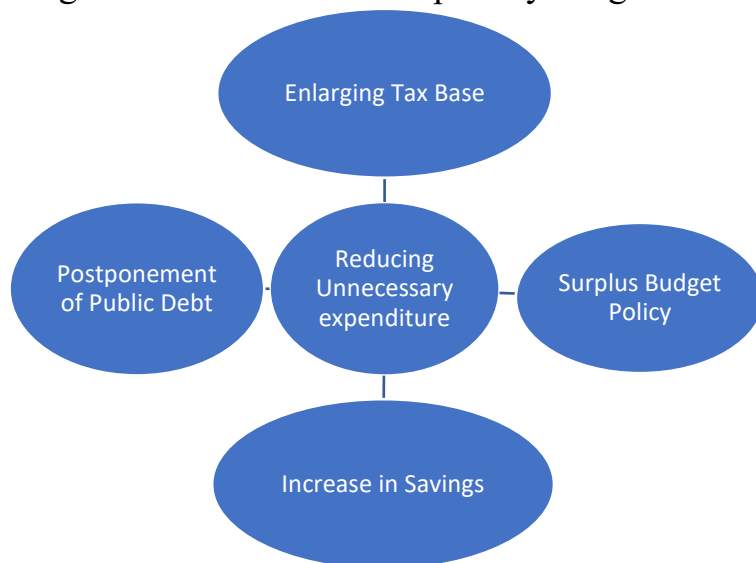
1. **Monetary Measures:** Following three measures fall in the category of monetary measures:



Monetary Measure adopted by Government to Control Inflation

2. **Fiscal Measures**

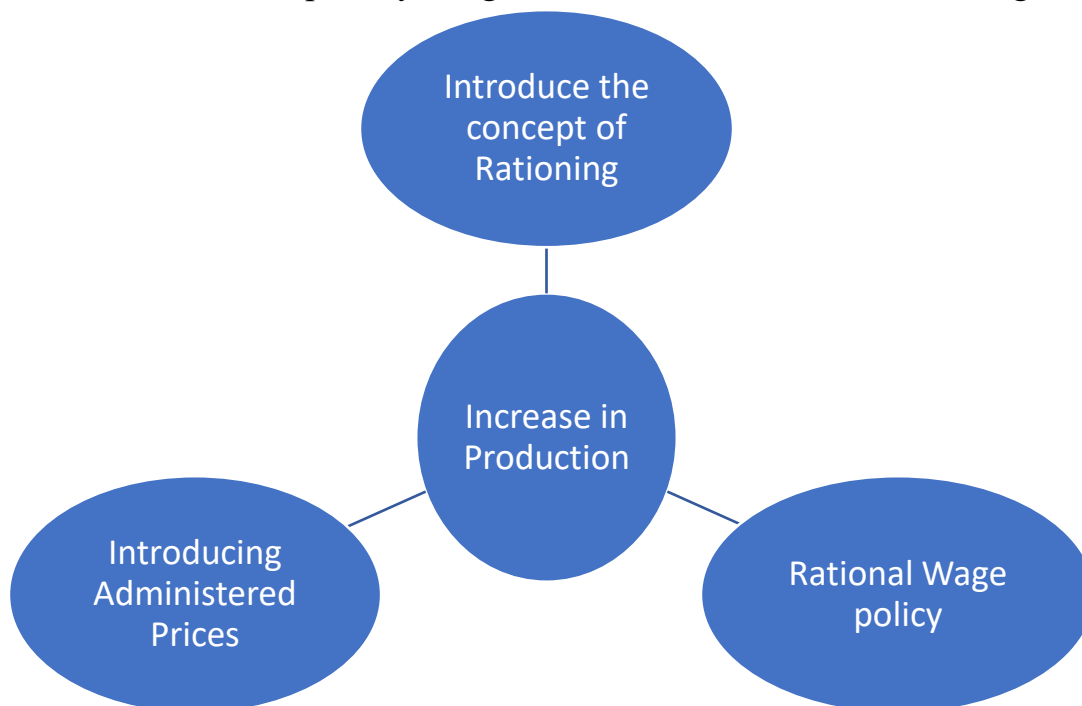
Following fiscal measures are adopted by the government to control inflation:



Fiscal Measures adopted by Government to Control Inflation

3. **General Measures**

General measures adopted by the government to control inflation are given below:



General Measures adopted to Control Inflation

7.12 Inflation and Unemployment

A W Phillips presented an empirical relation between inflation and unemployment in 1958 and is popularly known as Phillip curve hypothesis. He has analyzed the data for UK for the period (1861-1957) and concluded that there existed a stable inverse and non-linear relationship between the rate of change of money wages (w) and unemployment (u). When unemployment is low, money wages goes up and vice versa. It can be illustrated in figure 7.10 given below:

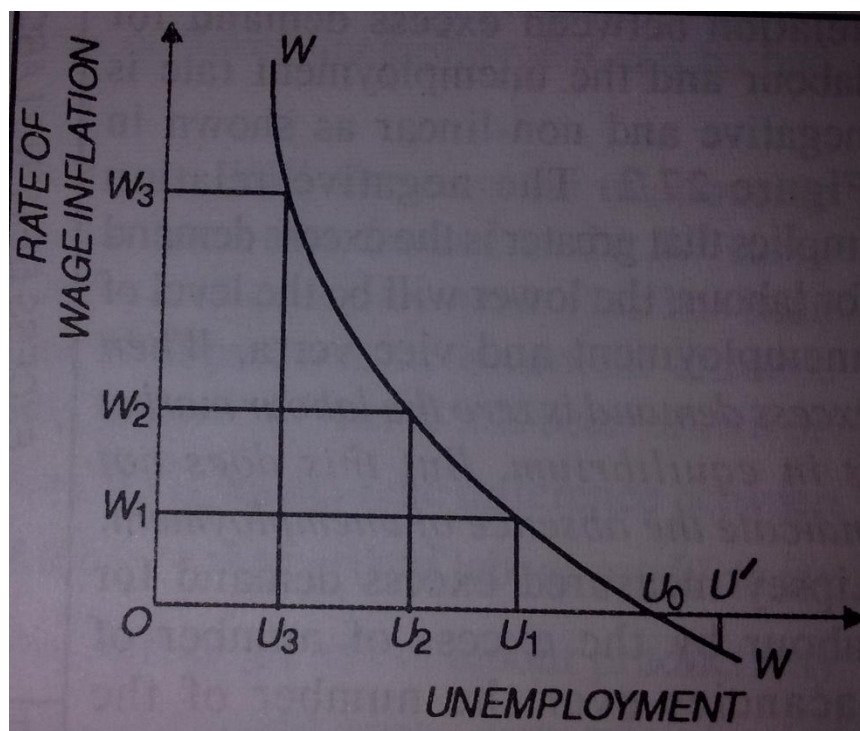


Figure 7.10

Phillips curve is the convex to the origin, downward sloping conveying adverse relationship between rate of inflation and unemployment. At OW_3 wage rate which is on higher side unemployment is negligible at OU_3 . If unemployment increases to U_1 , wage rate inflation will fall. For the negative wage inflation, unemployment level needs to be excessively high. PC curve shows when the wage rate is high, unemployment rate is low and vice versa.

Lipsey observe that inverse relationship between wage inflation and unemployment can be ascertained from two relations:

1. An inverse non-linear relationship between excess demand labour and unemployment
2. Positive relation between the rate of money wage and the magnitude of excess demand for labour

Lipsey's equation can be written as:

$$W = f(D-S/S)$$

Where W is the wage inflation, which is an increasing function of the proportionate change in the excess demand for labour. D and S are the demand and supply function. Lipsey has used excess demand in place of wage inflation used by Phillips as shown in the figure 7.11 given below:

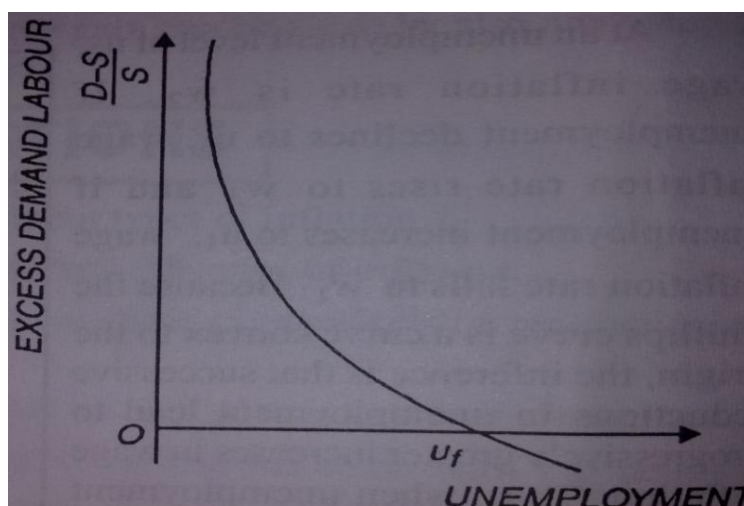


Figure 7.11

Long run Phillips Curve Derived By Milton Friedman

Friedman and Phelps have propounded long run Phillips curve and maintained that in the long run there can be no trade off between inflation and unemployment. Hence in the long run there can be no discrepancy between actual and expected rate of inflation, so the Phillips curve becomes vertical. Their hypothesis is also known as adaptive hypothesis. Friedman uses the concept of natural rate of unemployment or equilibrium rate, at this rate there is neither a tendency for inflation to increase or decrease. At this level actual rate of inflation tends to be equal to expected rate of inflation. It can be explained with the help of figure 7.12 given below:

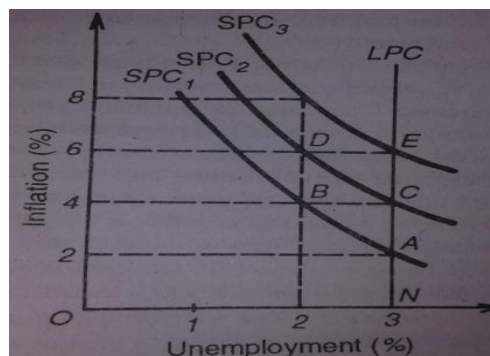


Figure : 7.12

Initially the economy is at 2% rate of inflation and there is natural rate of unemployment at 3%, now the people expect the inflation to persist in the future at 2% level, government adopts expansionary monetary policy to reduce the rate of unemployment from 3 to 2%, this will increase demand and raise the inflation rate to 4%. Now the actual rate of inflation (4%) is greater than expected rate of inflation, economy will move from point A to B from SPC_1 curve to SPC_2 curve as labour was expecting inflation at the rate of 2% only and they have settled for wages accordingly. When they realize that expected inflation is more they will demand more wages, as a result unemployment will again rise from 2 to 3%. If the government has decided to maintain the level of unemployment at 2% they have to tolerate high rate of inflation. Now for 2% unemployment rate, SPC_2 curve moves along point D but here the actual rate of inflation is 6% more than the expected rate of inflation which is 4%, again when they will find the discrepancy between the two they will seek higher wages, raising the cost of production, then the short run Phillips curve will shift from SPC_2 to SPC_3 and unemployment will again resort back to 3% level at point E in the figure 7.12. If we connect all the points A, C and E, we can trace long run Phillips curve which is vertical parallel to OY axis at the unemployment rate of 3%. Hence in the long run there is no trade off possible between inflation and unemployment, Phillips curve become vertical in the long run.

7.13

Summary

Inflation is characterized as a general and continuous rise in price level. Main causes of inflation are excess in demand and rising cost and profits. Many theories have been put forward by different economists regarding the causes of Inflation. All the major theories are based on demand pull and cost push factors, but for the lesser developed countries the structuralist theory has emphasized the role of market imperfections, shock

and rigidity in the economic system, imbalances between exports and imports in determining inflation. Mixed demand inflation is another concept put forward by the economists which emphasis that both demand and supply factors are jointly responsible for the inflationary pressure in the economy. Another concept stagflation which is associated with advanced countries which means stagnating output and rising inflation. Various measures have been adopted by the government like fiscal, monetary and general to curb inflation. AW Phillips has suggested that we have to make some tradeoff between inflation and unemployment but Friedman says that in the long run there is no possibility of such trade off.

7.14 **Keywords**

Inflation: Inflation is a steady increase in the price of goods.

Creeping Inflation: Inflation is when the increase in prices is very low or less than 3% of the GDP.

Stagflation: It is a state of the economy in which economic activity is declining and wages and prices are continuously rising.

Deflation: It is a situation in which prices fall and employment and production decrease.

7.15 Check Your Progress

(A) Fill in the Blanks

- i) When the price rises in double digits or three digit rates it is termed as.....inflation
- ii) Inflation is a state in which the value of money is falling i.e. are rising.
- iii) Too much money chases too.....goods
- iv) The concept of inflationary gap is propounded by.....
- v) According to Lipsey the inflationary gap is the amount by which would exceed aggregate output at the full employment level of income.

(B) True/False

- i. Deflation is characterized by rising prices and falling level of output.
- ii. Stagflation is also known as slump inflation
- iii. Structuralist theory of inflation stress that there exists market imperfection and rigidity of various types in less developed economies which are the main causes of inflation.

- iv. Monetarist hold that increase in money supply causes inflation
- v. True inflation sets in after the full employment equilibrium level has reached.

7.16**Answers to Check Your Progress**

- (A) i. Hyper ii. Prices iii. Few iv. J M Keynes v. Aggregate Expenditure
- (B) i. False ii. True iii. True iv. True v. True

7.17**Terminal Questions**

1. Discuss the Bent Hansen's Excess demand of model inflation.
2. What are the causes of Inflation and measures taken by the government to resolve the problem of inflation?
3. Discuss the Phillips curve hypothesis and the various views associated with it.
4. Critically examine the cost push theory of inflation.

7.18**References**

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UNIT 8: UNEMPLOYMENT

Structure:

- 8.1 Introduction
- 8.2 Meaning of Unemployment
- 8.3 Types of Unemployment
- 8.4 Theories of Unemployment
 - 8.4.1 Classical Theory of Employment
 - 8.4.2 Keynesian Theory of Employment
 - 8.4.3 Marxian Theory of unemployment
- 8.5 Effects of Unemployment
- 8.6 Measurement of Unemployment
- 8.7 Natural Rate of Unemployment
- 8.8 Measures to Control Unemployment
- 8.9 Indian Scenario
- 8.10 Summary
 - a. Indian Scenarion
 - b. Check Your Progress
- 8.13 Answer to Check Your Progress
- 8.14 Terminal Questions
- 8.15 References

bjectives

After studying this unit, students would be able to understand:

1. The meaning and types of unemployment
2. Theories of unemployment
3. Effects of Unemployment
4. Measures of Unemployment
5. Measures for Controlling Unemployment
6. Historical aspects related to Unemployment

8.1 Introduction

Unemployment can be defined as non availability of job to an otherwise eligible and interested person. According to International Labour Organization (ILO) unemployment occurs when people are without jobs and they have actively sought work within the past four weeks. Unemployment has always been a major problem for most of the countries of the world. During recessionary periods the more becomes more severe. Recent sub-prime crisis in America, European economy crisis and Greece turmoil have rendered a large number of people unemployed in the world. Causes, consequences and solutions for unemployment have always been a matter of great concern and debate in the society particularly amongst the economists. A large number of studies have been conducted by the economists to find the solutions to the problem of unemployment. Classical and neoclassical economics believe that market forces automatically help in solving the unemployment problem. On the other hand Keynesian economics emphasizes that problem of unemployment is cyclical in nature and feel that government intervention can help in resolving this problem. Further Marxists feel that the main cause of unemployment is capitalism and require abolishing capitalism. They feel socialism can help in overcoming this unemployment problem. Besides comprehensive theories of unemployment there are certain models which deal the specific categories of unemployment. In this unit of the study material we have covered definition of unemployment, types of unemployment, theories of unemployment and steps etc. which can help in reducing the unemployment problem of a country.

8.2 Meaning of Unemployment

A wide variety of researchers have tried to define unemployment in their own words. According to **Gillin and Gillin** “unemployment is a condition in which a person able and willing to work normally, dependent upon his earning to provide the necessities of life for himself and family is unable to obtain gainful employment”.

Karl Pibrain defines “unemployment is a condition of the labour market in which the supply of labour power is greater than the number of available openings.”

In the words of **Fairchild** “unemployment is forced and involuntary separation from remunerative work on the part of the normal wages and normal conditions.”

Sergeant Florence says “unemployment has been defined as the idleness of persons able to work.”

8.3 Types of Unemployment

As unemployment is a universal problem and is found in every country more or less, therefore, economists have classified unemployment into various categories i.e. cyclical unemployment, frictional unemployment, structural unemployment and classical unemployment, seasonal unemployment, hardcore unemployment, hidden unemployment, obstructional unemployment, developmental and contractional unemployment. Few main categories of unemployment are explained below:

1) Structural unemployment

Structural unemployment arises when there is inadequacy of productive capacity to create enough jobs for all those able and willing to work. India's unemployment is mainly structural in nature, here productive capacity is much below the needed quantity, and further the rate of increase in productive capacity is slow. On the other hand, addition to labour force is being made at a first rate on account of the rapidly growing population. Thus, while the number of new productive jobs is increasing in the country, but the rate of increase in job opportunities being low the absolute number of unemployed persons is rising from year to year.

2) Disguised unemployment

This type of unemployment is wide prevalent in India. It is found in agriculture and small scale industry segment of the country. It means engagement of large number of workers in productive work. For example suppose a piece of land is owned and used for agriculture purpose by one person. This person has two sons. After these sons grow up, they also get engaged in the same work. Earlier one person was doing that work and now three persons are doing that work. Disguised unemployment can also be termed as sharing of same work i.e. the existing work is shared by the large number of workers. In such a situation, even if many workers are withdrawn, the same work will continue to be done unhindered by the remaining few people. It follows that all the workers are not

needed to maintain the existing level of production. The contribution of such workers to production is nothing. It is found that the very large numbers of workers on Indian farms actually hinder agricultural works and thereby reduce production.

3) Cyclical unemployment

This type of unemployment is caused by trade cycles or business cycles. Because of changes in trade or business cycles demand of the products keeps on fluctuating. During the periods when demand is less, production is either slowed down or stopped which causes unemployment. General state of depression causes wide unemployment and the period of cyclical unemployment is longer and almost all industries get affected because of this, the intensity of affect may vary from industry to industry. Like air aviation industry got the worst hit because of recent sub-prime and European economy crisis whereas the intensity on other domestic industry was not that severe.

4) Seasonal unemployment

The demand of some products is associated with the seasons. For example hosiery goods are demanded more in winter and ice creams are demanded more in summers. This seasonal nature of demand also causes unemployment. This seasonal unemployment occurs at certain seasons of the year. In India around 70 percent of the population is dependent on agriculture which is a seasonal activity. Farmers and agriculture labour are busy during sowing and harvesting season whereas during the rest of the year they remain almost free i.e. unemployed.

5) Underemployment

Underemployment means a person working at a level below his capacity e.g. an engineer on failure in getting an appropriate job start his own business may be said to be underemployed. Apparently, he may be deemed as working and earning in a productive activity and in this sense contributing something to production. But in reality he is not working to his capability, or to his full capacity. He is, therefore, not fully employed. In India this type of unemployment is widely visible. This may be because of mismatch between knowledge, and skills provided in educational institutions and the knowledge or skill required by the industry resulting in people not getting the job and industry suffering because of non availability of qualified and skilled workforce.

6) Open Unemployment

This is a type of scenario where qualified workforce is available and they are also interested in doing the job but work is not available i.e. people are able to work and are also willing to work but there is no work for them. Open employment is also known as unemployment. Open unemployment is different from disguised unemployment and underemployment in that while in the case of former unemployment workers are totally idle, but in the latter two types of unemployment they appear to be working and do not seem to be away their time.

7) Voluntary Unemployment

Voluntary unemployment as the name itself is indicating occurs when a working person willingly himself leave the work i.e. in voluntary unemployment, a person is out of job on his own desire. Voluntary unemployment is attributed to the individual's own decision. This type of unemployment may be caused due to employee's quarrel with the employer and resign or one may have permanent source of income, absentee workers, and strikers and so on. A worker may also leave the job because the remuneration being offered by the employer may be much less than expected and worker may find it difficult to make his both ends meet and either he wants higher wages or does not want to work at all.

8) Involuntary unemployment

It occurs when the number of jobs is less than the number of trained and eligible workers. This type of unemployment exists because of the socio-economic environment in which individuals operate. Obviously this state of affairs arises because of the non-availability of work. In underdeveloped and developing economies major chunk of unemployment falls in this category. Cyclical unemployment, structural unemployment, and classical unemployment are largely involuntary in nature.

8.4 Theories of Unemployment

Various theories of unemployment explaining the causes of unemployment, impact of unemployment, efforts required to resolve unemployment problem as given by economists are explained below:

8.4.1 Classical Theory of Employment

The term classical theory was used to denote the thought of classical economists like Ricardo, Adam Smith and neo-classical economists like Marshall and Pigou. According to the classical theory, full employment is a normal feature of a capitalist economy. Classical theory is based on Say's law of markets which assumes flexibility of wages, rate of interest and prices. If there is unemployment in the economy, it will be for a short period, because under unemployment situation economic forces like demand and supply will change in such a manner as to remove unemployment. In a situation, of unemployment demand for labour is less than supply. Due to low demand, money wages for the labourer will fall and consequently will raise the demand for labourer, hence unemployment will be removed and full employment situation will be restored.

Full employment is a situation in which everyone who wants to work is working except for those who are frictionally and structurally unemployed. According to Ward, "Full employment is a level of employment associated with normal level of unemployment." So even in a situation of full employment there may be a co-existence of some types of unemployment which are frictional unemployment, structural unemployment, seasonal unemployment and technical unemployment.

Assumptions of Classical Theory

1. Laissez-Faire Economy
2. Perfect Competition
3. Closed Economy
4. Money is only a medium of exchange
5. Rational Man
6. Direct relation between money and real wages
7. Equality between saving and investment

Explanation of Classical Theory of Unemployment

According to classical theory employment is determined by the production function and the equilibrium of demand and supply forces of labour production function expresses the relationship between the factors of production and volume of production.

$$P = f(L, K, N, T)$$

In short period (K) production technique (T) and (L) remains constant. Volume of production hence depends on the level of employment (N).

$$P = f(N)$$

So, production is a function of level of employment.

Level of employment in an economy will be determined by the intersection of demand and supply of labour.

Demand for Labour

Labour is demand till its marginal revenue productivity is equal to wage i.e. :

$$W = MRP = P \times MPP$$

Supply of Labour

It refers to the number of labourers who are willing to work at the given rate of wages. Level of employment is determined where the supply and demand curves intersect each other as shown in the figure 8.1 given below:

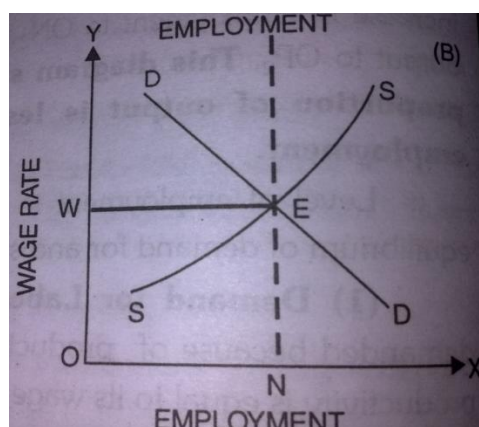


Figure 8.1

In the figure 8.1 ON level of employment is determined at the point of equilibrium E where DD curve is intersecting SS curve at the OW wage rate.

In the short run, due to certain reasons, unemployment situation may arise in the economy but some adjusting forces will restore full equilibrium situation, so classical theory is based on two facts i.e. Flexibility of wages, interest and prices and Say's law of markets.

Flexibility of Wages

Wage rate is determined on the basis of demand and supply forces of labour.

$N_D = f(W/P)$ diminishing function

$N_S = f(W/P)$ increasing function

$N_D = N_S$ equilibrium function, where equilibrium wage rate is determined.

Professor Pigou opines that if in unemployment situation, no government interference is made, then money wage will automatically be reduced to such an extent to restore the situation of full employment. Professor Pigou has explained the concept with the help of following equation:

$$N = QY/W$$

Here N stands for level of employment, W stands for money wage rate and QY is that part of national income which is paid as wages.

Classical Theory of Employment can be explained with the help of figure 8.2 given below:

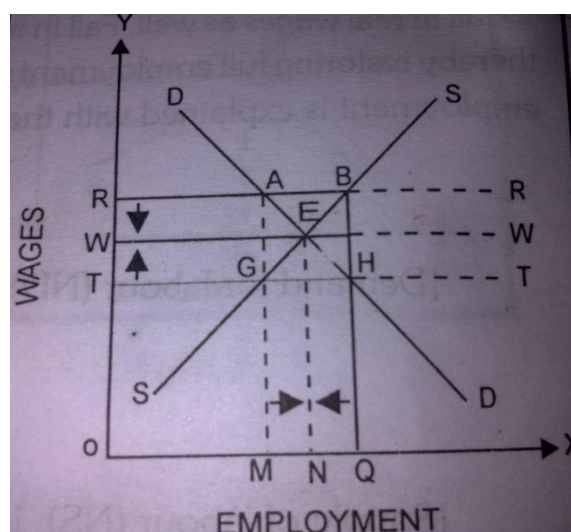


Figure 8.2

Level of employment is measured on X- axis and wage rate is measured on Y-axis. DD and SS are the demand and supply curves respectively. The point of intersection of two curves i.e. point E here demand for labour is equal to supply of labour and ON level is the full employment level. Now wage rate increase from OW to OR, then there will be less number of labourers who will be given employment because wage curve cuts demand curve at point A. It will be a situation of disequilibrium, in this situation supply will be more than demand this will be a case of involuntary unemployment equivalent to OQ-OM = MQ. Unemployed workers will be willing to work at low wages, hence wage rate will fall from OR to OW and hence full employment situation in the economy will be restored.

Say's Law of Market

J.B. Say propounded a law of market which states that supply creates its own demand. This law is popularly known as Say's Law of Market. Say's law hold good if saving is equal to investment. To maintain the equilibrium between savings and investment he assumes the flexibility of rate of interest.

$$I = f(1/r)$$

Investment is the inverse function of rate of interest.

$$S = f(r)$$

Savings is a direct function of rate of interest.

$S=I$ i.e. savings is equal to investment

If temporarily there is unemployment due to investment being less than savings then it implies that aggregate demand is less than its aggregate supply. It will result into fall in rate of interest and correspondingly there will be less savings and low rate of interest will serve as an inducement to invest. So savings will be once again equal to investment and full employment situation will be restored.

8.4.2 Keynesian Theory of Employment

Lord J. M. Keynes has propounded theory of unemployment. Keynes stated that full employment is not a normal feature of capitalist economy, there can be unemployment in every economy. Main cause of unemployment was deficiency in aggregate demand compared to aggregate supply.

Assumptions of Keynesian Theory

1. Based on Short Period Analysis
2. Closed Economy
3. Perfect Competition
4. Labour is the only factor of production
5. Labour has money illusion
6. Money access medium of exchange and store of value
7. Underemployment equilibrium
8. Interest is a monetary phenomenon

Explanation of Keynesian Theory

According to Keynesian theory, in short period, national income depends upon the level of employment because other factors of production remain constant. Level of employment is determined by effective demand. Effective demand refers to that level of

aggregate demand at which it is equal to aggregate supply. According to Keynes, “The volume of employment is given by the point of intersection between aggregate demand function and aggregate supply function. In short period aggregate supply remains constant and level of employment can be increased by increasing aggregate demand. Aggregate demand is of two types i.e. consumption demand and investment demand. Keynes has focused on the role of investment demand to achieve the objective of full employment. Keynesian Theory of Employment is explained with the help of figure 8.3 given below:

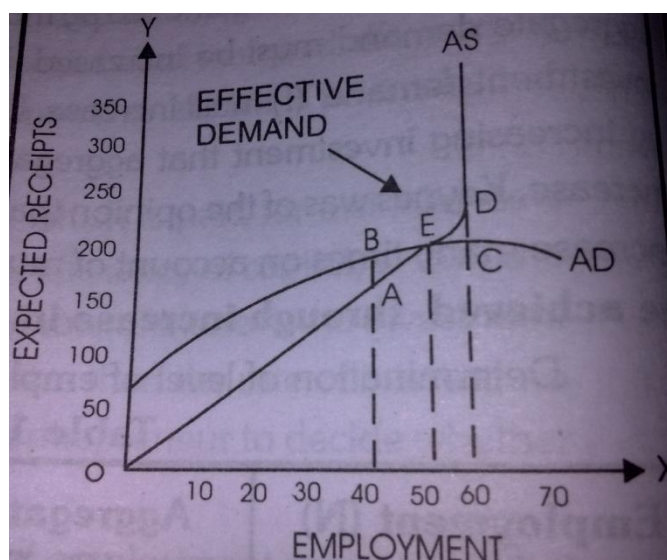


Figure 8.3

In the figure 8.3 given AS is the aggregate supply curve and AD is the aggregate demand curve. Point E is the equilibrium point where aggregate demand is equal to aggregate supply. Here 50 lac persons are getting employment. If the level of employment is reduced then the aggregate demand will be more than aggregate supply by AB. Aggregate demand will be more than aggregate supply, producers will produce more till they establish the equilibrium and vice versa.

Achievement of full employment

Keynes has discussed that equilibrium is possible even with the unemployment in the economy which is called underemployment equilibrium. According to Keynes to remove unemployment, it is important to increase aggregate demand, in order to increase aggregate demand investments must be increased and aggregate demand curve will shift upwards and full employment equilibrium can be achieved. There may be a

case of over full employment, so he has established that economy is not always in full employment equilibrium position. The explanation of Keynesian underemployment and over full employment equilibrium is given in the figure 8.4 given below:

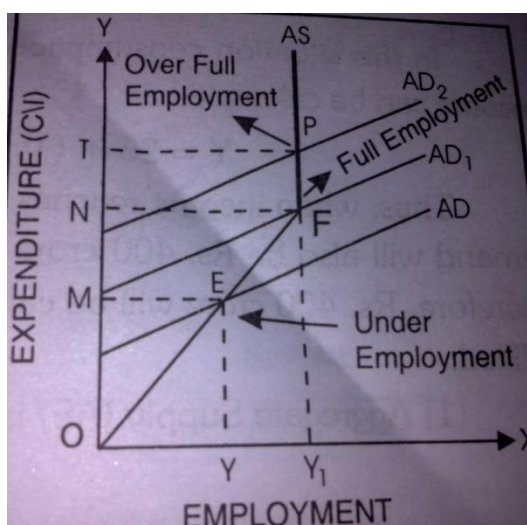


Figure 8.4

On X-axis level, we have measured employment; on Y-axis expenditure has been measured. It can be seen from the figure that economy is in equilibrium at point E where aggregate demand curve intersects aggregate supply curve at OY level of employment. But YY_1 lakhs persons are still unemployed. Hence it is underemployment equilibrium. As a consequence there will stimulation in investment and increase in aggregate demand then new demand curve will shift upwards as shown in the figure and intersects aggregate supply curve at point F which indicates new equilibrium and OY_1 workers will get employment. It is called as full employment equilibrium. Even after this point, if investment is increased then aggregate demand curve will further shift to AD_2 and this demand curve will intersect supply curve at point P which will be new equilibrium point and called as over full employment equilibrium point. In this situation there will be no increase in output and employment and will have inflationary effects on the economy as economy has already established its full employment situation at point F.

8.4.3 Marxian Theory of unemployment

According to Karl Marx, in a capitalist system unemployment is inevitable and crises of mass unemployment cannot be ignored. Karl Marx analyzed the working of the capitalist system and published his work in the first volume of *Capital*, in 1867. Although Marx's economic theories faced severe attack by economists who defended capitalism, the theories continued to face recognition in working class circles, particularly in the prolonged depression of the 1930's. One of the main reasons for the universal recognition of the work of Marx in those years was his treatment of unemployment; he showed how unemployment arises and why it is necessary to capitalism. According to Karl Marx in a capitalist system working class is divided into employed and unemployed which results in creation of "reserve army of labour" which creates downward pressure on wages. Reserve army of labour fight amongst themselves for scarce jobs which bring down the wages. Low wages benefit the system by reducing economic rents. Yet, it does not benefit workers. Capitalist system unfairly manipulates the market for labour by perpetuating unemployment and lowers laborers' demands for fair wages. Workers are pitted against one another at the service of increasing profits for owners. According to Marx, the only way to permanently eliminate unemployment would be to abolish capitalism and the system of forced competition for wages and then shift to a socialist or communist economic system. For contemporary Marxists, the existence of persistent unemployment is proof of the inability of capitalism to ensure full employment.

8.5 Effects of Unemployment

Almost all the countries of the world have/are facing this problem. In case of some countries the problem of unemployment is more severe while in case of some other countries it is less severe. The developed countries like the U.S., England, Australia, France, Germany, Italy, etc. are also suffering from this problem; in our country this problem is more pronounced. With the passage of time it has become worse. It has become a threat to India's economic well-being and social development. It is one of the major causes of our poverty, backwardness, crimes and frustration among the people. India is the second largest country after China in terms of populations and man-power. But because of large scale unemployment there is no suitable employment for them. They are forced to remain idle. Excessive unemployment poses serious threat to the socio-economic environment of a country. Some of the serious socio-economic problems associated with excessive unemployment are listed below:

1. Crime Rate Increases
2. Poor standard of living
3. Reduced Government Income of direct and Indirect taxes
4. Aggravate the problem of poverty
5. Countries with high unemployment rate have faced high divorce rate

8.6 Measurement of Unemployment

Officially, the unemployed are people who are registered as able, available and willing to work at the going wage rate in a suitable job but who cannot find work despite an active search for work. Typically two methods i.e. Unemployment rate and Labour Force participation rates are used to measure the rate of employment in the country, besides these two measures various national and international agencies like OECD, Eurostat, and International Labor Comparisons Program have also proposed some methods for measurement of Unemployment. Few basic methods used to measure level of unemployment are given below:

Unemployment Rate: It is the ratio of unemployed workers to total workforce. Total workforce here includes both employed and unemployed work force.

$$\text{Unemployment Rate} = \frac{\text{Unemployed Workers}}{\text{Total Workforce}}$$

The other method which is used to measure rate of unemployment in the economy is the Labour force participation rate. The labor force participation rate indicates the proportion of the available "working age" population that is willing and able to work and is either employed or actively seeking employment. It is found by dividing the labor force (total civilian labor force) by the population (total non institutionalized civilian population). Officially, a person is unemployed if he or she is in the labor force but does not have a job. Therefore, in order to calculate unemployment, we need to understand how to measure the labor force.

The Formula

The calculation of the labor force participation rate is officially given by this formula.

$$\frac{\text{Labor force participation rate}}{\text{civilian labor force}} = \frac{\text{civilian labor force}}{\text{civilian labor force}} \times 100$$

total non institutionalized
civilian population

While this "official" labor force participation rate is the most common participation rate, other variations are bandied about from time to time. One participation rate is the ratio of the civilian labor force to the total population of the country rather than just the total non-institutionalized civilian population.

Whereas unemployment rate measures the relationship between number of workers eligible for employment but not in job to total number of persons eligible for employment. On the other hand Labour force participation measures the relationship between total eligible workers in the population with total population.

In the words of International Labour Organization, "unemployed workers" are those who are currently not working but are willing and able to work for pay, currently available to work, and have actively searched for work. The ILO describes 4 different methods to calculate the unemployment rate:

8 Labour Force Sample Surveys are the most preferred method of unemployment rate calculation since they give the most comprehensive results and enables calculation of unemployment by different group categories such as race and gender. This method is the most internationally comparable.

9 Official Estimates are determined by a combination of information from one or more of the other three methods. The use of this method has been declining in favor of Labour Surveys.

10 Social Insurance Statistics such as unemployment benefits, are computed base on the number of persons insured representing the total labour force and the number of persons who are insured that are collecting benefits. This method has been heavily criticized due to the expiration of benefits before the person finds work.

11 Employment Office Statistics are the least effective being that they only include a monthly tally of unemployed persons who enter employment offices. This method also includes unemployed who are not unemployed per the ILO definition.

The primary measure of unemployment, U3, allows for comparisons between countries. Unemployment differs from country to country and across different time periods. For example, during the 1990s and 2000s, the United States had lower

unemployment levels than many countries in the European Union, which had significant internal variation, with countries like the UK and Denmark outperforming Italy and France. However, large economic events such as the Great Depression can lead to similar unemployment rates across the globe.

United States Bureau of Labor Statistics

The Bureau of Labor Statistics measures unemployment of those over 15 years of age. It uses two different labour force surveys conducted by the United States Census Bureau and/or the Bureau of Labor Statistics and calculates six different measures of unemployment, U1 to U6, and measures different aspects of unemployment:

- U1: Percentage of labor force unemployed 15 weeks or longer.
- U2: Percentage of labor force who lost jobs or completed temporary work.
- U3: Official **unemployment rate** as per the ILO definition occurs when people are without jobs and they have actively looked for work within the past four weeks.
- U4: U3 + "discouraged workers", or discouraged workers include those unemployed workers who have stopped looking for work because they believe that no work is available for them under current economic conditions.
- U5: U4 + other "marginally attached workers", i.e. those who intend to and are able to work, but have not looked for work recently.
- U6: U5 + Part time workers who want to work full time, but cannot due to economic conditions.

8.7 Natural Rate of Unemployment

It is the average rate of unemployment. The actual rate of unemployment in the economy fluctuates around this rate. In a recession, the actual unemployment rate rises above the natural rate. On the other hand in a booming economy, the actual unemployment rate falls below the natural rate. The natural rate of unemployment is caused by a combination of frictional unemployment and structural unemployment. Frictional unemployment arises when new workers or other workers take time to find new job. Often it is seen that employees don't straight away join those jobs whatever come their way, rather they try to always find the best match. This finding of best job always takes time and is a cause of frictional employment. Frictional unemployment is short-term phenomenon. Structural unemployment arises because of displacement of the

work force due to change in technology etc. Those workers who remain unemployed for a long time, six months or more, and have trouble in finding work because of a lack of skills, fall into the category of structural unemployment.

8.8 Measures to Control Unemployment

1. Review of Education System

Education system should be so designed that it helps in producing the work force equipped with industry required knowledge, skills and aptitude. Education system prevailing in our country is centuries old and has outlived its life. Our doctors, engineers after spending huge money and time in getting the professional degrees and run to government jobs after completing their education. Our education system is required to be changed to meet present day requirements. It will go a long way in resolving the problem of unemployment.

2. Encouragement for Growth of Industry

Industry is the main source of employment for the youths. Government should provide congenial environment for the growth of the industry.

3. Special Employment Schemes

In case country is facing severe unemployment problems then it's the duty of government to create special opportunity of employment. These opportunities may be created through introduction of employment

schemes. In India government has taken upon itself the task of providing compulsory employment of 100 years to unemployed youth through MANREGA.

4. Development of Agricultural Methods

Indian economy is an agrarian economy, a large chunk of Indian population is employed in agriculture and allied agriculture activities. Modernization of agriculture techniques and methods like development of irrigation facilities, good seeds, modern agricultural equipments, consultancy services for the farmers etc can improve the income from agriculture and therefore can help in reducing the unemployment problem significantly.

Besides above measures revival of cottage and village industry and transport and communication system can further help in improving the employment scenario in the country.

8.9 Indian Scenario

The current picture of employment will also guide for its improvement in future. Some aspects of the current employment scenario are as follows:

12 In 1999-2000, 7.3% of the total labour force was unemployed. In absolute terms, the number of unemployed people was 265.8 lakh. Since the above estimates are based on the current daily status, the number of unemployed also includes those who were underemployed or underemployed. But this does not include those who are working at very low income and productivity levels.

13 The proportion of poor among employed people is as high as that among the total population, which indicates that a large number of people are engaged in employment that is sufficient to provide subsistence level employment.

14 Only 8% of total employment was in the organised sector. More than 90% of the people were engaged in the informal sector, which was mostly outside any social security and other benefits and was in many other types of difficulties due to limited institutional facilities.

15 The educational and skill level of the existing labour force is very low.

Supply of labour

Age structure of population: The size of economically active population is determined on the basis of its age structure. Population growth rate will decrease

from the present (1991-2000) rate of 1.95% per annum to 1.25% by 2020. At present, the population growth rate of the working age group is about 2.4%, which is higher than the overall population growth rate and will continue for many years. The population growth rate and the growth rate of the working age group (15-59 years) will become equal by 2030.

Since labour force participation is not equal across all age groups, the size of the labour force is affected by the age structure.

Labour Force Participation: Labour force participation has declined from 1993-94 to 1999-2000. Labour force participation across age groups mostly shows long-term trends or shows little change. Male and female labour force participation has declined over a long period of time. States with higher per capita income have higher male and female labour force ratios. A recent study of the Planning Commission found that the growth

rate of labour force will be 1.8% per annum in the next 10 years, and in the subsequent 10 years it will be 1.5% to 1.6%. This means that the annual increase in labour force will be about 70 lakh.

Skill of labour force: The income of a worker i.e. his wage level is determined by his productivity. Both the technologies i.e. capital based and skill level of the workers determine the productivity of the worker. The educational level of workers in India is very low. About 44.0% of workers were illiterate in 1999-2000 and 22.7% were educated only up to primary level. If we take secondary education as the minimum requirement to function in a modern economy, only 33.2% of workers were educated to that level. This percentage was as high as 57.4% among urban workers, while in rural areas it was only 25.4%.

The above figures only discuss general education as distinct from marketable skills. While some jobs in the modern economy, such as office clerkships, do not require any skills other than a specific level of academic education, many jobs require specialized skills. Vocational skills of workers in India are very low as compared to other countries. The young group (20-24 years) of the labour force which has received vocational training is only 5 percent in India whereas in industrialized countries it is very high. Around 60-80 percent of the workers receive vocational training. In developing countries this percentage is much less than in developed countries, but still they are ahead of India. For example, in Mexico it is 28 percent and in Peru it is 17 percent.

These figures show that the education and skill levels of our strength are lower than those of rapidly developing countries. Our education system is mainly inclined towards theoretical teaching, driven by the notion that an academic degree is mandatory for a government job. This is important because there is job

security and pay scales that are higher than market wages. The net conclusion is that the education system has neglected vocational training and has also neglected to create awareness among students to acquire marketable skills.

Labour demand

In order to maintain employment opportunities for the long term future, strategies for increasing the supply of additional annual labour force must be taken into account. According to a report by a special group on the creation of 10 million jobs every year, it is necessary to achieve a balance between the supply and demand of labour as far as

possible, even in the short term. If the demand for labour is normal and work is available, it will yield significant results. However, there is a great concern about adjusting the current income and productivity levels and the labour force in the long term perspective given the scenario period. This can be done through a number of efforts, mainly the following:

1. Structural economy
2. Formal and informal sectors
3. Labour laws
4. Patterns of labour migration.

8.10 Summary

Unemployment can be defined as the non-availability of jobs to those people who intend to get the job, are putting in efforts to get the job and are eligible for the job. There are various categories of unemployment like cyclical unemployment, Structural unemployment, seasonal unemployment etc. Various theories have been propounded by the economists regarding the causes of unemployment, impact of unemployment and interventions required to overcome the unemployment problem of the country. Measurement of unemployment rate is a matter of debate around the world. Different countries are using different methods for finding out the rate of unemployment. Therefore, unemployment problem of different countries is not comparable. Keynes believes that unemployment is a cyclical problem and can be overcome through government intervention.

○ **Kryword**

Unemployment: It is a condition of labour market in which the supply of labour force is more than the available opportunities.

Underemployment: Underemployment or underemployment means that if a person is working less than his capacity, then he is underemployed.

Open unemployment: This is a similar situation when there are people willing and able to work but no work is available for them.

○ **Check Your Progress**

8 Fill in the Blanks

- occurs when the number of jobs is less than the number of trained and eligible workers.

- means a person working at a level below his capacity e.g. an engineer on failure in getting an appropriate job start his own business.
- type of unemployment is caused by trade cycles or business cycles.
- **Sergeant Florence** says “unemployment has been defined as the of persons able to work.”
- unemployment can also be termed as sharing of same work i.e. the existing work is shared by the large number of workers.

9 True/False

6. According to Keynes aggregate demand is of two types i.e. consumption demand and investment demand.
7. Discouraged workers include those unemployed workers who have stopped looking for work because they believe that no work is available for them under current economic conditions.
8. Official unemployment rate as per the ILO definition occurs when people are without jobs and they have actively looked for work within the past two weeks.
9. The labor force participation rate indicates the proportion of the available "working age" population that is willing and able to work and is either employed or actively seeking employment.
10. The concept of reserve army of labour relates to Marxian theory of unemployment.

8.13 Answer to Check Your Progress

- (A) 1. Involuntary Unemployment 2. Under Employment 3. Cyclical 4. Idleness 5. Disguised
- (B) 1. True 2. True 3. False 4. True 5. True

8.14 Terminal Questions

1. Define unemployment. Discuss the methods used to measure unemployment.
2. Compare and contrast Marxian theory of employment with Keynesian theory of employment.

3. Discuss the methods given by Bureau of Labour standards for measurement of unemployment.
4. What is unemployment? Discuss the various types of unemployment.

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UNIT-9 ECONOMIC PLANNING IN INDIA

Structure

- 9.1 Introduction
- 9.2 Economic Planning
 - Characteristics of the planning process
 - Rationale for Economic planning
 - Planning Policy:-
- 9.5 Planning Commission and Five Year Plans
 - 9.5.1 Period of 1989-1991:
 - 9.5.2 12th Plan (2012-17)
- 9.6 Achievement of Economic planning in India
 - 9.6.1 Development of Industries
 - 9.6.2 Development of Economic Infrastructure
 - 9.6.3 Development of Social Infrastructure
 - 9.6.4 Employment
 - 9.6.5 Modernisation
 - 9.6.6 Self- Sufficiency and Self-Reliance
- 9.7 Summary
- 9.8 Keywords
- 9.9 Check on Progress
- 9.10 Answer to Check Your Progress
- 9.11 Terminal Questions
- 9.12 References

Objectives:

After studying this unit, you should be able to:

- Describe the meaning and characteristics of economic planning.
- Understand the planning and economic planning process.
- Be able to study various five year plans in detail.
- To know the achievements of economic planning in India.
- Comparative study of economic planning in India.

9.1 Introduction

In the economic literature, economic planning has been used in different ways in different economic systems, which has created confusion in understanding it.

Today people will hardly agree on any one aspect of economic planning. Therefore when economic planning is talked about it becomes difficult to understand which context/aspect is being talked about unless the nature of an economic system is clearly mentioned.

a. Economic Planning:-

Economic planning implies existence of an economic system in which each production unit use only the productive resources allocated to it, and disposes of its product according to the directives from the central authority. This concept of economy planning is kenos and covers only what is often described as collectivist economic planning which has been adopted in socialist countries in the second sense, economic planning means merely laying down the targets for some public and/ or private enterprise such a policy is sometimes pursued in capitalist economies in these economies, the state does not take an overview of the economy. Therefore, the type of planning may at post be called partial or piece-meal planning in the third sense, planning refers to setting of targets for the economy as a whole, purporting to allocate the country's resources between the branches of the economy. India has adopted economic planning in this sense in the fourth and final sense, the term planning refers to the system whereby the government enforces upon private enterprises certain targets which it determines for them. This so called system of economic planning induces various measures to regulate the activity of the private enterprises. It is clearly indicated that the term economic planning has been used in economic literature to describe widely different types of economic systems which in a way has now become a source of confusion. Today people rarely agree on the content of economic planning. Therefore, one way finds it difficult to understand as to which system one is referring

to when one talks of economic planning unless one clearly spell out the nature of that system.

In India development plans were formulated and carried out within the firework of the mixed economy mixed economies are by the co-existence of private and public sectors. The private sector typically comprises four dirt net productive Activities:

- (1) Substance farming and handicrafts
- (2) Small-scale individual and family owned commercial business and industry.
- (3) Medium sized commercial enterprise in industry, trade, transport and agriculture.
- (4) Large enterprises mining companies and plantations, producing for domestic and/or foreign markets.

The public sector generally ramous confined one can identify two principal components of economic planning:

The government mobilizes domestic resources and also revises which are expected to in duce productive activities in the private sector. From this point of view development of infers structure particularly railways, hydroelectric prophets and irrigation system receives overriding priority. The other activity that has invaded government direct involvement in the post is setting up of heavy industry inductees involving large finance and long gestation period. The government has also adopted on the one hard certain economic policies (e.g. taxation, industrial licensing tariffs, ways, prices and interest rates) which stimulated private economic activity and on the other introduced restrictive physical controls in order to ensure a harmony between the social objectives of the government and the behaviour of the private produces and businessmen.

From the above characterization of planning in India, it is clear that economic planning in the country did not entirely replace market infect the market and economic planning are completer to one another.

i. Characteristics of the planning process

Three basic aspects of planning phase:

- Holistic/integrated development model.
- Project appraisal and cost benefit analysis.

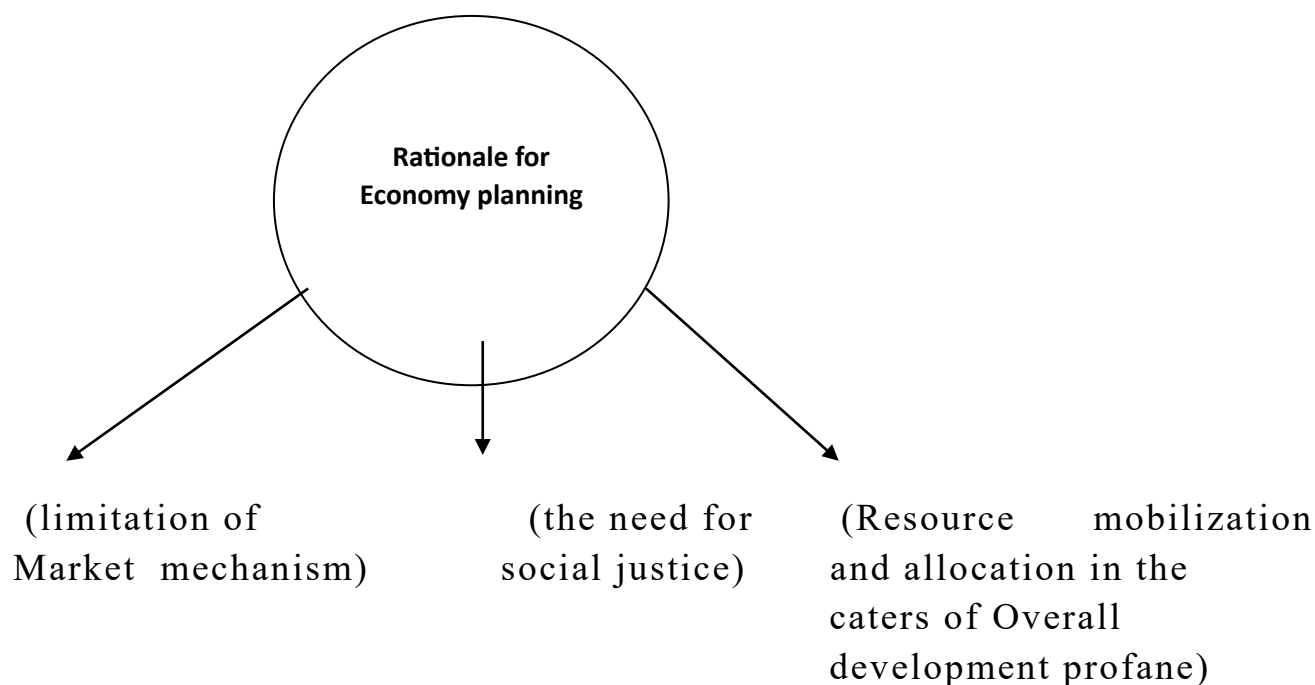
Reasons for failure of planning:

- Lack of planning and its scientific approach
- Unavailable and unexpected data.
- Unpredictable economic disruptions.
- Institutional weaknesses.
- Lack of political will.

b. Rationale for Economic planning:-

Economic planning has been accepted in India as a development tool on account of various reason of these the following are the most important:

- Failure of market mechanism
- Management and allocation of resources
- Foreign aid
- Psychological impact



Limitation of Market Mechanism:- Need for economic planning has often been felt on account of the limitations of the market mechanism in

respect of both efficiency and equity. Among the socialists the conviction that market system discriminates against the working class is quite strong therefore, when they capture state power, they attempt to abolish private ownership of the means of production and subordinate the role of the market to the planning authority. In market economies both developed and under developed planning has been co-opted for overcoming the limitation of the market mechanism in developed economies no one believes that the market mechanism will ensure economic activity at full employment often inadequacy of effective demand in those countries leads to recessions of various degree which can only be eliminated by the effective intervention of the state either by inducing investment activity in the private sector or by undertaking certain projects in the government sector itself. For providing incentives to investors in the private sector, often greater reliance is placed on monetary and fiscal measures.

The need for economic planning in India was felt particularly due to its economic backward country realized that the path of economic development followed by England, the U.S.A Japan was no longer available it relying entirely on market mechanism this country could not even hope to come out of the low level equilibrium trap in which had fallen during the period of its colonial subjugation in the socialist path of development done there was ray of hope. The country, therefore, wanted to benefit from the soviet union's experiences in economic planning.

The need for social justice:- India like many other third world countries had earlier thought that economic growth will automatically solve its poverty problem. However the experience of past suggested that in aggregate enterprise economic gains of economic growth do not necessarily trickle down. In fact market forces operate in such a manner that further concentration of economic power takes place growth bypasses those every people who deserve to be helped most. It is the reason why in this country need for undertaking poverty alleviation programmes in the overall prime work of development planning felt. Moreover, India will find it increasingly difficult to tackle the unemployment problem if it relies entirely on market forces. The labour market in this country suffers from previous types of imperfections further seasonal operations in agriculture

pressure of population on land and lack of labour transfer opportunities due to inadequate development are some such factors which make taking of unemployment problem rather difficult if human resources are to be used fruitfully. India must adopt scientific than power.

Resource allocation in the Overall Development Profile:- the context of overall development programmed. India suffers from resource constraints and therefore it has to use the resources judiciously. Investment projects in this country should not be chosen entirely on the basis of private profitability. In case that it permitted, large investment will be made into socially how priority areas, such or consumption goods for rich in a society where income distribution it highly skewed, competitive market will dictate a pattern of investment which will not be consistent with the overall long term objectives of the country. In developing countries, the choice of developed projects should rest on social benefits rather than private profitability. Hence the state's intervention in the economy with a view to optimize social gain some utilization of scarce resources becomes necessary.

Since economic planning in India has been considered a few more efficient system of merging the affairs of the economy than relying exclusive, on the market mechanism, it is necessary for us to follow the planning in this country we thus propose to explain practical aspects of planning considered to be important by the economists.

c. Planning Policy:-

In India, this planning body is known as the planning commission. The main function of the Commission is to prepare economic plans.

A plan is a deliberate attempt to decide how a country's resources should be used. Some of its common objectives/goals include growth, modernization, full employment, self-reliance and equality, but all these points are not given equal importance in all the plans. Every plan has some specific objectives, such as development or improvement of agriculture. For example, the specific objective of our first five-year plan was improvement of the agriculture of the state and the objective of the second plan was improvement/development of industries.

The Planning Commission was established in March 1950 by an ordinance of the Government of India. It works under the National Development Council (NDC). It also advises on five-year plans and implements them. India's economic development depends on the formulation, implementation and control of five-year plans and this work is done by the Planning Commission. The following officials are included in the Planning Commission:

- Chairman- Prime Minister of India
- Vice-Chairman- A Union Cabinet Minister
- Full-time Member and Members
- Vice-Chairman and Full-time Members collectively deliberate upon the formulation of plans in the Commission.

Objectives of Planning Commission

- To encourage rapid improvement in the standard of living of the people.
- To make efficient and proper use of the resources of the country.
- To promote production and provide employment opportunities to all.

The functions of the Planning Commission can be briefly understood as follows:-

- Responsibility of evaluating all types of resources of the country.
- Increasing the scarce resources.
- Determining the priority of use of resources and preparing a blueprint for their best use.

Government expenditure being more than government receipts:-

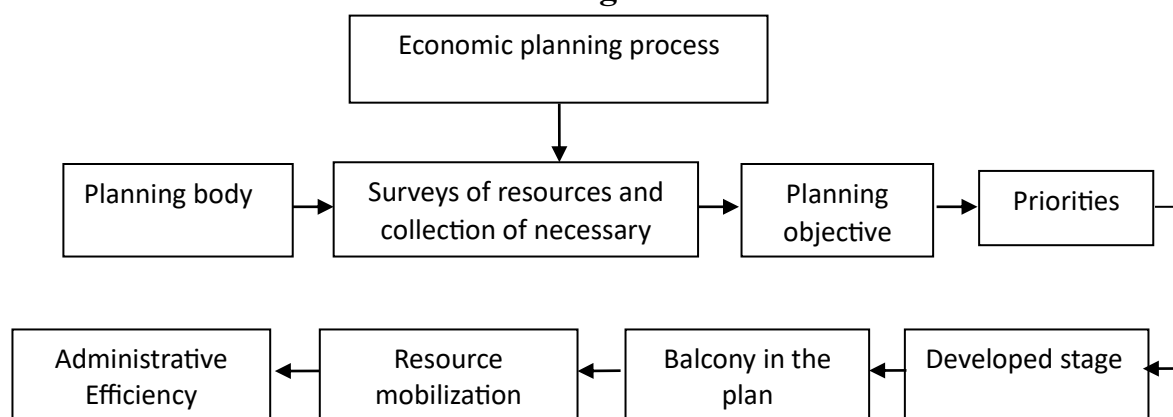
- Due to wages, salaries, pension and other establishment expenses.
- 90-93% Essential expenses.

Non-availability of sufficient funds for implementation of projects/programmes:

Following reasons came to notice:-

1. 10% Required for North East.
2. 8.2% Required for Tribal areas.
3. 20% Essential for SC, ST and gender budgeting.

Process of Economic Planning



• **Survey of resources and collection of necessary data:** Survey of resources and collection of necessary data on the other aspects of the economy are two important requisites of economic planning. The size of the plan is often limited by the availability of the resources therefore the planning body must know the value of material human and capital resources at its disposal while formulating a plan.

• **Planning objectives:-**

Economic planning impels certain goals. These goals are often clearly defined and the efforts directed under the plan to treatise them. According to Coiffing and Enos, in plans there is to be found “a hierarchy of objectives, from the general to the specific from the abstract to the particular from immeasurable to the measurable in a plan, we should find all the levels the most abstract the aspirations which reflect the ultimate aim of the society the intermediate goals which are still abstract but which may be capable of being reached during the period over which the plan operates, and the least abstract the targets which are specific, quantitative results that the plan is designed to achieve. The long-term objective of economic planning in this country have been spelt out in various plan documents probably the main objectives are:

- (1) economic growth
- (2) self-reliance
- (3) removal of unemployment
- (4) reduction of income inequalities
- (5) elimination of poverty

• **Priorities:-**

Economic planning required that providing are spelt out for the public investment programme. No country can ever meet all the investment requirements of its various sectors we all know that in a growing economy infrastructure should be developed, basic and more particularly the machine making industry should be set up agriculture should also be developed so that the supply of food does not become a major constraint and finally no country can wait endlessly for the spread of education and medical finality. Therefore India way level well be fined privation under its plan. If that of not been done, then the manger resources would have been so much diffused that their possible impact on the overall growth activity would have been host.

- **Development strategy:-**

Economic planning implies a strategy for the realizations of the broader goals in the absence of pooper strategy the planning might lack direction and the realization of the potential may always be in doubt.

- **Balancing in the plan:-**

In India planners attempt to ensure two types of bala in a plan. The first in the monetary or financial balance which implies that planned spending at the macro level has to be equal to the disposable financial income. In recent years inability on the part of the planners to ensure this balances payments problem. The second in the physical balance this implies inter-sartorial consistency between the demand and supply.

- **Resource mobilization:-**

Indian plans lay down investment far get for both public and private sectors. As for as the private sector is concerned the major responsibility for resources lies with the private production units. These units raise either equity capital or obtain loans from banks and other financial institutions. The role of the sate in this case is subsidiary as it merely facilitates mobilization of savings for investment in the private sector. For public sector outlay, funds are obtained from both domestic and external sources.

- **Administrative Efficacy:-**

Since a plan has to be implemented by the state machinery. Its success greatly depends on the quality of administration which a country has in India, the administration in both in efficient and corrupt and this invariable

provider ample scope for scuttling the plan at the various levels. For the success of a plan a necessary condition is that the administrative staff prepares good feasibility reports of the proposed projects, point out snags in them and suggested way and means to remove them.

The Indian economy has travelled a long distance since independence reflected in its structural composition and resilient high growth rate especially after the reforms of 1991. At present Indian economy is the ninth largest economy in nominal GDP terms and fourth largest economy in PPP terms. The per capita income stands at ₹ 54527 (in factor cost (a) current price).

However, high economic growth and resiliency pales into significance when viewed from human development social economic indicators mass poverty, under nutrition, growing inequality both income wise rural urban wise. This represents a great Indian paradox. This needs to be solved through a well calibrated planning which is reform oriented and the same time inclusive.

9.5 Planning Commission and Five Year Plans

The planning commission was setup in March 1950 by a resolution of union cabinet. It is an extra constitutional non-statutory body. The present composition of planning commission is the Prime Minister is the ex-officio chairman. Sh. Montek Singh Ahluwalia is its deputy chairman. Shri Ashwani Kumar minister of state for planning is the ex-officio member of the planning commission. Other full time members are Shri B.K. Chaturvedi, Smt. Saumitra Chaudhri, Dr. (Mrs.) Syeda Hameed, Dr. Narendra Jadhav, Prof. Abhijit Sen, Dr. Mihir Shah, Dr. K. Kasturangan, Shri. Arun Maria. Function of the planning commission are as follows:

- To estimate the physical capital and human resources of the country. To prepare plan for making effective and balanced utilization of human resources.
- To determine the various stage of planning and to propose the allocation of resources on the priority basis.
- To act as an advisory body to the union government.

First Five Year Plan (1951-56):-

The first plan emphasizes, as its immediate objective, the rehabilitation of the refugees, rapid agricultural development so as to achieve food self-sufficiency in the shortest possible time, and control of inflation. The plan aimed at increasing the rate of investment from 5 to about 7% of national income. The first plan was based on Harrod-Domar Model. The main points of the first plan were:

- On 8 December 1951, the first Prime Minister of India, Jawaharlal Nehru, presented the First Five Year Plan in Parliament.
- The First Five Year Plan was a major effort to bring the country's economy out of the cycle of poverty.
- In this plan, agriculture (including investment in dams and irrigation sector) was given an important status. Due to partition, agriculture sector suffered a lot and it was in dire need of attention at this time.
- The total budget of the plan was Rs.206.8 billion (26.6 billion rupees, 1950 exchange rates) divided into seven broad sectors namely irrigation and power (27.2%), agriculture and community development (17.4%), transport and communication (24%), industry (8.4%), social service (16.64%), land reconstruction/upliftment (4.1%) and (2.5%).
- The aim/target was to have an annual GDP growth rate of 2.1%, but in this plan the growth rate was 3.6%.
- During the First Five Year Plan, the net domestic product grew above 15%.
- Meanwhile, the monsoon was good and the crop income was also high, which increased the exchange reserve and per capita income increased by 8%.
- Due to rapid population growth, the national income was more than the per capita income.
- Bhakra Dam and Hirakund Dam along with various other irrigation projects were initiated during this period.
- The World Health Organization along with the Indian government worked on child health and reduced child mortality rate which indirectly led to population growth.

- At the end of the First Five Year Plan in 1956, 5 Indian Institutes of Technology (IITs) were started.
- The University Grants Commission (UGC) was set up to manage the funds for higher education in the country and to promote and invest in higher education.
- Agreements were signed to set up five steel industries/undertakings,
- though these undertakings were brought into existence only in the middle of the Second Five Year Plan.

Second Five Year Plan (1956-61):-

Second five year plan (FYP) sought to promote a pattern of development to establish socialistic pattern of society. The second plan aimed at rapid industrialization with particular emphasis on the development of basic and heavy industries such as iron and steel, heavy industry. The IInd Five Year Plan was based on Mahalanobis Model. The main points of which were:

- The focus of the Second Five Year Plan was on industrialisation, especially heavy and basic industries.
- Domestic industrial production was boosted with the development of the public sector.
- Based on the Mahalanobis model, Indian statistician Prashant Chandra Mahalanobis developed an economic development model in 1953.
- The scheme assumed a closed economy with trade focusing only on imports of capital goods.
- Hydroelectric power projects and five steel plants were set up in Bhilai, Durgapur and Rourkela.
- Coal production increased.
- Some more railway lines were added in the North East.
- The Atomic Energy Commission (AEC) was established in 1957 under the chairmanship of Hon. J. Bhabha.
- "Tata Institute of Fundamental Research" was established as a research institute.

- In 1957, a Talent Search Campaign (TSC) and Scholarship Programme was launched with the objective of finding young and talented students to work in the field of nuclear energy.

Third Five Year Plan (1961-66):-

The basic aim of this plan was to push the economy up to the take off stage of development. The plan aimed at securing of marked advance towards self-sustaining growth. The third plan gave top priority to agriculture with an aim to attain self sufficiency in food grain and to increase the agriculture production to suffice the requirements of export and industry. The third plan was an ill-fated plan as India faced two wars with China in 1962 and Pakistan in 1965. Besides, India also faced severe drought in 1965-66. The focus of the Third Five Year Plan were:

- The focus of the Third Five Year Plan was on agriculture, with increasing rice production being the main focus.
- The Indo-China war led to inflation and the priority became stabilizing prices.
- Dam construction continued.
- Various cement and fertilizer enterprises were established.
- Punjab produced wheat in abundance.
- Many primary schools were opened in rural areas.
- Panchayat elections were introduced and states were given more responsibilities for development.
- State Electricity Boards and State Secondary Education Boards were established.
- State Road Transport Corporations were established and the responsibility of construction of local roads was given to the states.

Three Annual Plan (1966-69):-

The original draft outline of fourth plan prepared in 1966 had to be abandoned on account of pressure exerted on the economy by two years of drought war devaluation of rupee and stagflation. Instead, three annual plan (1966-69) were implemented during this period.

Fourth Five Plan (1967-74):-

The fourth plan set before itself the two principal objectives “growth with stability”. And progressive achievement of self reliance. The fourth plan aimed at an average 5.5 percent rate of growth in the national income and the objective of “growth with justice” and “Garibi Hatao” (removal of poverty). The main points of this plan were:

- Indira Gandhi's government nationalized 14 major banks and Green Revolution encouraged agriculture.
- In addition, East Pakistan (present-day Bangladesh) was in a critical condition due to the Indo-Pakistani War of 1971, which led to the formation of the Bangladesh Liberation War. Funds available for industrial development were used to resolve the conflict.
- India carried out its underground nuclear experiments in 1974. This was due to pressure from the United States to send its Seventh Fleet into the Bay of Bengal to deter India from going to war against Pakistan and to further expand the conflict.

Fifth Five Year Plan (1974-79):-

The fifth plan proposed to achieve two main objective viz, removal of poverty to achieve two main objective viz, removal of poverty and attainment of self reliance, through better distribution of income and a very significant growth in domestic rate of saving. This plan was terminated by Janta Party before March 1978. The main points of this plan were:

- The main focus of this plan was employment, poverty alleviation and justice.
- In addition to the above, this plan also aimed to achieve self-sufficiency in the field of agricultural production and defense.
- In 1975, the Electricity Supply Act was enacted. Through this Act, the Central Government could easily enter into the field of electricity generation and its distribution.
- In 1978, the newly elected Morarji Desai government cancelled the scheme.

Sixth Five Year Plan (1980-85):-

There were two sixth plans. The focus of the Janta government sixth plan-rolling plan was enlargement of the employment potential in agriculture and allied activities, encouragement to household and small industries producing consumer goods to consumption and to raise the incomes of the lowest income classes through a minimum needs programme. When the sixth plan (1980-85). Was introduced, the planners rejected the earlier Govt. approach and brought back Nehruvian model of growth. Its main points were as follows :-

- When Rajiv Gandhi was elected Prime Minister, the young Prime Minister's focus was mainly on industrial development, especially on information technology.
- For the first time, “Indian National Highway System” was introduced in India and various roads were widened under it. Tourism was expanded.
- The Sixth Five Year Plan was the beginning of economic liberalisation. Price control was abolished and ration shops were closed. This led to an increase in the price of food items as well as the cost of living.
- Family planning was expanded to prevent overpopulation. People in more developed areas adopted family planning and in other areas it was not adopted and high birth rate continued in these areas.

Seventh Five Year Plan (1985-90):-

The seventh plan sought to emphasise policies and programmes which would accelerate the growth of food grain production, increase employment opportunities and raise productivity. The economy recorded 6 percent growth during this plan against the targeted 5 percent. Its main points were:

- The Seventh Plan brought the Congress Party back to power.
- The focus of this plan was to increase industrial production capacity through technological improvements.
- The main areas of focus in the Seventh Plan were social justice (Sanskrit), elimination of cruelty to the weaker sections of the society (Vachchatampad), use of modern technology, agricultural development, poverty alleviation programmes, provision of food, clothing and shelter, He

wanted to increase the productivity of small and large scale farmers and make the Indian economy an independent economy.

- Having waited for 15 years to achieve a sustained growth rate, the Seventh Five Year Plan focused on achieving it by the year 2000 and its essential elements.

- The plan expected an increase in the number of workers to 39 million and employment at the rate of 4% per year.

- Some of the unexpected achievements of this scheme are as follows:

- Balance of Payments (Earthquake vs. Balance of Payments) Estimated: Exports Rs. 33 thousand crores, Imports (-) Rs. 54 thousand crores, Trade Balance - Rs. 21 thousand crores.

Merchant goods Import (Estimated): Rs. 95,437 crores

Balance of Payments Estimated: Exports-Rs. 69.7 thousand crores, Imports- (-)

95.4 thousand crores, Trade Balance: (-) Rs. 34.7 thousand crores

9.5.1 Period of 1989-1991:

- There was political instability in India till 1989-91, therefore, no five year plan was implemented during this period. Till 1990-92, only annual plans were implemented.

- In 1991, India faced a crisis of foreign exchange reserves. This year the reserves were only one billion US dollars, so the government, under pressure, started the process of reforms in the socialist economy.

- P.V. Narasimha Rao (28 June 1991-23 December 2004) was the 12th Prime Minister of independent India and the head of the Congress Party, who is also known as the father of reforms in the Indian economy. It mainly initiated the process of transformation of Indian economy and gave rise to various events which had an impact on national security.

- Around this time, Dr. Manmohan Singh started the process of reforms in the Indian free market system and made the nation, which was almost on the verge of bankruptcy, self-reliant again. This was the time when privatization and liberalization started in India.

Eighth Five Year Plan (1992-97):-

The eighth plan was postponed by two years because of political upheavals at the centre and it was launched after a worsening bop position and inflation during 1990-91. The plan undertook various drastic policy measures to combat the bad economic situation. As a consequences there was rapid growth in the economy which can be seen in the sectoral growth computed for Eight Plan. These were:

- (1) rapid economic growth,
- (2) high growth of agriculture and allied sector, and manufacturing sector,
- (3) growth in exports and imports, improvement in trade and current account deficit.

The most notable feature of Eight plan period was that the GDP grew at an average rate of 6.8 percent exceeding the targeted growth rate of 5.6 percent. The main points of this scheme are as follows:

1. Modernization of industries was the main feature of the Eighth Five Year Plan.
2. Under this plan, the process of freeing the Indian economy from various controls began, the objective of which was to improve the conditions of current account and balance of payments.
3. On 1 January 1995, India became a member of the 'World Trade Organization (WTO). This plan came to be known as the 'Rao and Manmohan Model' of economic development.
4. The main objectives of this plan were to stabilize population growth, reduce poverty, generate employment, strengthen basic services, build institutions, develop human resources, Panchayat Raj, Municipalities, Involvement of NGOs and decentralisation and people's participation.
5. Priority was given to the energy sector with a target of 26.6%.
6. The average annual growth rate was 6.7% while the target was to achieve 5.6%.

Ninth Five Year Plan (1997-2002):-

The ninth plan were developed in the context of four important dimensions of state policy and with persistence of development for 15 year

quality of life, generation of productive employment regional balance and self-reliance summarizes the main dimensions of its policy.

- The main highlight of the Ninth Five Year Plan of India was that it aimed at achieving rapid industrialisation, human development, full employment, poverty alleviation and self-reliance on indigenous resources.
- The Ninth Five Year Plan was also created as a celebration of the Golden Jubilee of India's independence.
- The main objectives of the Ninth Five Year Plan were as follows:-
- Giving priority to the agricultural sector and focusing on rural development.
- Creating necessary employment opportunities and encouraging poverty alleviation.
- To bring stability in prices to accelerate the growth rate of the economy.
- To ensure food and nutrition security.
- Make basic investments on education for all, pay special attention to clean drinking water, primary health care, transport and energy.
- Controlling rapid population growth.
- Encouraging various issues of social concern such as women empowerment.
- Liberal market system to increase private investment.
- In the Ninth Five Year Plan the growth rate was 5.35% while the target was to achieve 6.5%.

Tenth Five Year Plan (2002-2007):-

Increasing unemployment and rapid growth in labour force led to shift in policy focus to address these issues. The tenth plan therefore aimed at creating 50 million job opportunities during the period, by planning special emphasis on employment intensive sectors of agriculture, immigration, agro forestry, information technology, communication and other services. the plan addressed the issue of poverty the unacceptably level of social indicators. It was also for the first time and state wise growth and other monitorial targets were worked on in consultation with the state.

1. The main objectives of the Tenth Five Year Plan were:-

1. Reduction of poverty by 5% by 2007.
 2. Providing profitable and high quality employment to the increased number of workers.
 3. To reduce gender disparity in education and wage rates to 50% by 2007.
 4. To increase literacy rate to 75% in the 10th Five Year Plan.
 5. To reduce population growth rate to 16.2% between 2001 and 2011.
 6. Providing clean and safe drinking water to all villages within the plan period.
 7. Cleaning of all polluted rivers by 2007.
2. Economic growth again accelerated during this plan period and surpassed 8% by 2006.

Eleventh Five Year Plan (2007-2012):-

Eleven FYP was set against the backdrop of minimal growth in agriculture (2.1%) during the 10th plan and the said objectives of National common minimum programme (2004). Thus, the objective of the Eleventh plan was 'Towards faster and inclusive growth. The 11th plan targeted at achieving 1 percent growth on an average. However the mid-term appraisal of 11th plan has estimated that average annual GDP growth will be 8.2 percent. During the 11th plan there has been progress on inclusiveness viz, education, health, enlistment of SCS/ STS/ minorities etc. however this progress is less than expected as we are likely to miss MDG targets. Information has become a major concern along with uncertain global economic environment. The main objectives of plan were following:

- **Income and Poverty**
- To increase the GDP growth rate from 8% to 10% and maintain the growth rate of 10% in the 12th Five Year Plan so as to double the per capita income by 2016-17.
- Increasing the agricultural GDP growth rate to four percent.
- Generating 70 million employment opportunities.
- Reducing educated unemployment to 5%.
- Increase wages of unskilled workers by 20%.

- Reduce consumption poverty rate by 10%.

- **Education**

- To achieve the target of reducing the dropout rate from elementary education from 52.2% in 2003-04 to 20% in 2011-12.
- To develop and maintain minimum standards of education in schools at the elementary level and to ensure its implementation by continuous testing and control of education.
- To increase the literacy rate (Special Literacy Rate) to 85% for the age group 7 years and above.
- Reduction of gender disparity in literacy by 10%.
- Increase in the proportion of population receiving higher education from the present 10% to 15% by the end of the plan period.

- **Health**

- target to reduce child mortality rate by 28 points and maternal mortality rate to only 1 per 1000 births.
- To reduce the total fertility/productivity rate to 2.1.
- To provide clean and safe drinking water to all by 2009.
- To reduce malnutrition among children aged 0 to 3 years to half of its current rate.
- To reduce anaemia (anaemia) among women and girls by 50% by the end of the scheme.

- **Women and Children**

- To increase sex ratio of 0-6 years age group to 935 by 2011-12 and to 950 by 2010-17.
- To ensure that 33% of the direct benefits of all government schemes reach women and girls.
- Ensuring that all children can enjoy their childhood without the burden of working.

- **Infrastructure sector**

- To provide electricity to all villages and BPL by 2009 and to provide 24 hours electricity.
- To connect all areas with population of more than 500 in hills and other areas with population of more than 1000 by all weather road by 2009 and to provide this benefit to all by 2015.
- Connecting every village with telephone by 2007 and connecting every village with broadband connectivity by 2017.
- i. Providing houses for all the poor to live in by 2016-17.
- **Environment**
- ii. Increased forest and tree plantation to 5%.
- iii. Achieving air quality in all major cities as per World Health Organization (WHO) standards by 2011-12.
- iv. Mixing of wastewater (Muslim) by cities with clean river water by 2011-12.
- v. Increasing share in energy sector to 20% by 2016-17.

9.5.2 12th Plan (2012-17)

Basic objective:- faster, more inclusive, and sustainable the approach paper aims at achieving a percent growth in GDP.

Inclusiveness:- for growth to be more inclusive better performance in agriculture, factor creation of jobs in agriculture. Faster creation of jobs in manufacturing stronger efforts at health education skill development is required among others.

Challenges:- The major sectoral challenges identified during the 12th plan are in energy. Water and environment.

9.6 Achievement of Economic planning in India:

Major achievements of economic planning in India are as under:

9 Increase in national income:-

Increase in national income is a sign of economic development prior of planning and during British, national income of increased at the rate of 0.5 percent per annum during the period of planning, the rate of increase in national income has been 4.1 percent per annum although the rate of increase has been less than the targeted rate, yet it is significant for having

broken the vicious circle of economic stagnation the target of increase in national income during the first.

The overall growth rate during 2003-04 and 2005-05 was 8.2 percent. During the current fiscal year 2006-07, the GDP growth rate is likely to be 9.2 percent, as per advance estimates of central statistical organization. This rise in national income has been most beneficial for the economic development of India.

ii Increase in Per Capita Income

Prior to independence, rate of increase in pr capita income had been almost zero, but during the period of planning per capital income increased at the rate of 2 percent per annum- in the First Plan it rose by 1.8 percent and in the second it was 2.1 percent- in the Third Plan it decreased to 0.2 percent. However, during three one-year plans, per capita income increased at the rate of 1.5 percent-In Forth Plan it came down to 1 percent but in the Fifth Plan it increased appreciably to 2.7 percent in Sixth and Seventh Plans also it increased to 3.2 and 3.6 percent respectively. In the Eight Plan increased to 4.5 percent. In the Ninth Plan, it increased to 3.3 percent in the Tenth Plan, it increased to 6.1 per cent.

During the period of planning (1951-2005), the average rate of growth of per capita income at constant prices has been 2.3 percent per annum-Thus, development planning in India is a pointer to the fact that the process of growth has friendly set in by removing of the weakness of stagnant economy of the British era.

iii Increase in Rate of Capital Formation

Formation plays a significant rose in the economic growth of a country. During Five Year Plans rate of capital formation has significantly increased. Rate of capital formation depends on the rate of saving and investment in 1950-51 rate of saving was 5.5 percent of national income by the end of First Plan it increased to 11.2 percent.

Rate of saving increased to 13.8 percent and 22.5 percent in Fourth and Fifth plans respectively. In the Seventh it was 21.7 percent and in the Eight Plan it was 25.6 percent. In the year 2005-07, it rose to 34.8 percent. The rate of investment by the end of First, second, Third, and Fourth plans was 10 percent. 12.7 per cent, 13.9 percent and 14.5 percent respectively-11

increased to 16.5 percent in fifth plan-Rate of capital formation was 24.1 percent in Seventh Plan-in the Eight Plan it increased to 26 percent -But during Ninth Plan i.e, 2001-02, rate of capital formation declined to 24.2 percent and that of saving 23.5 percent in the last year of Tenth Plan i.e., 2006-07, rate of capital formation was 36%.

iv Institutional Reforms in Agriculture and Green Revolution

Contributed to the development of agriculture in two ways- Firstly, Land reforms have been introduced in agriculture- secondly, since 1966 stress has been on the technological advancement of agriculture. It culminate into green revolution in 1951-52, the production of food grains was 550 lakh tones- in 2006-07 the production of food grains increased to 2,161 lakh tones sugarcane production in 1950-51 was 69 lakh tones. It increased to 3,453 lakh tones in 2006-07. Sincerely, production of cotton and jute in 1950-51 was 50 lakh and 25 lakh bales respectively.

Plan was set as 2.1 percent per annum, but actually it increased at the rate of 3.7 percent per annum growth rate of all plans ranging from second to Tenth Plan was proposed to be 5 percent or above pre annum, but the objective could be achieved only during Fifth, Sixth, Seventh, Eight and Ninth Plans- in the Ninth plan, growth rate increased to 5.5 percent per annum in the Tenth Plan, growth rate increased to 7.8 percent per annum in the Eleventh Plan, target of growth rate had been fixed at a percent per annum.

Rise in national income is decidedly a significant achievement of planning. In the first decade of planning, i.e., from 1950-51 to 1960-61 the rate of average annual increase in national income has been 3.8 percent, but in the second decade, i.e, from 1960-61 to 1970-71 and 1980-81, it rose to 3.3 percent in 1980-81 to 2002-03 it increased to 5.9 percent in fact, during the period of planning (1951-2005) the average rate of growth in national income at constant prices has been 4.4 percent per annum in the year 2004-05 and 2005-06 this growth rate at (1999-2000 prices) was 5.7 percent and 7.4 percent respectively.

In 2006-07 their production went upto 227 lakh and 103 lakh bales respectively. In 1950-51, areas under irrigation was 226 lakh hectares. In 2003-04, it increased to 768 lakh hectares-Agriculture production during

the period of planning has increased tremendously use of chemical fertilizers, better seeds and improved methods of cultivation have increased methods of cultivation have increased per hectare productivity of land many times- In 1954 per capita availability of cereals was only 360 grams per day . In 2006 per capital availability of cereals and pulses increased to 422.4 grams per day- During the period of planning growth rate of agricultural production remained on the average 2.8 percent per annum-Agriculture growth rate was 5.6 percent in 1950-51 it decreased to 4 percent in 2006-07.

9.6.1 Development of Industries

During the period of planning, Growth rate of industrial production has been around 6.9 percent per annum,. On the account of planning, industrial sector in India has developed very much.

9.6.2 Development of Economic Infrastructure

During the period of planning economic infrastructure has developed considerably. In this period total length of railways lines increase to 63221 km. Of it 17,900 km were electrified. Length of road has increased from 1,57, 000 km to 3300000 km. Goods carried by railway wagons has increased from 7.3 crore tones in 1950-51 to 51 crore tones in 2005-06. Shipping has increased from 3.9 Lakh GRT in 1950-51 to 77 Lakh GRT in 2004-2005. Power generation capacity in 1950-51 was 2300 mw which in 2005-06 increased to 1,45, 600 mw.

9.6.3 Development of Social Infrastructure

During the planning period, country's social services like education, health and medical facilities, family planning, etc also developed appreciably. Death rate that stood at 27 percent notice and in 1951 came down to 7.5 per thousand in 2006. Average life expectancy increased from 32 years in 1951 to 65.4. years in 2006-2007. Several deadly deseases like malaria, etc., have been eradicated. A chain of National Laboratories and Research centres has been set up across the country. Educational facilities were expended considerably. The number of school going students has increased three-fold and that of collegiate five fold since 1951. The number of annual admissions to degree courses in Engineering colleges increased from 7, 100 in 1950 to 1,33,000. Number of hospital- beds doctors, nurses,

medicines and family planning clinics and medical facilities has greatly increased. Number of hospitals and dispensaries has gone upto 32, 156. Now there is one doctor per, 900 persons in the country.

9.6.4 Employment

Employment was provided to 70 lakh person in First Plan. It is estimated that by the end of Eleventh Plan about 40.3 crore people will be provided employment.

9.6.5 Modernisation

Structural and institutional changes taking place during the period of planning testify to the fact that the economy is heading for modernization.

9.6.6 Self- Sufficiency and Self-Reliance

Definit success has been achieved in the field of self- sufficiency. self-reliance during the period of planning. In 2005-2006, the total authorized foreign aid was Rs. 18, 938 crore and utilization out of it was Rs, 18, 888 crore. In 2006-07, the authorized foreign aid was Rs 31,790 crore and utilization out of it was Rs 19, 419 crore.

9.7 Summary

Economic Planning refers to the achievement of the objectives of economics development in a given time period, keeping in view the resources of the country. In Short Indian has undoubtedly made perceptible economic progress during the period of planning. The country has succeeded in laying the foundation of growth in the field of industries, power, multipurpose projects and agricultural production. A super structure for the comfort and prosperity of the poor people can easily be constructed on this dependable foundation. The main objective planning in India are raising a standard of living, achieving of self- sufficiency in industrial and agricultural production and removing of inequalities of wealth and income.

9.8 Keywords

Economic Planning: Economic planning means the existence of an economic system in which each production unit uses only those resources of production which are allotted to it and distributes its production as per the instructions of the central authority.

Planning policy: A plan is a deliberate attempt to decide how the country's resources should be used. Some of its common aims/objectives include growth, modernisation, full employment, self-reliance and equality. But all these points are not given equal importance in all the schemes.

Planning Commission and Five Year Plans: The Planning Commission was established in March 1950 by an ordinance of the Central Cabinet. The Planning Commission estimates the country's human and non-human capital, prepares plans and acts as an advisory body to the government.

Development of Social Structure: During the planning period, the country's social services such as education, health, family planning and medical services etc. also witnessed commendable development.

9.9 Check on Progress

1. means the existence of an economic system in which each production unit uses only those resources of production which are allotted to it and distributes its production as per the instructions of the central authority.

2. The need for economic planning in India was felt mainly due to its

3. The planning institution in India is known as

4. The Planning Commission was established in March by an ordinance of the Union Cabinet.

5. The Fifth Five Year Plan had two main objectives: "poverty eradication" and "self-reliance" by increasing the rate of income at a bet.....

9.10 Answer to Check Your Progress

1. Economic Planning 2. Economic Backwardness 3. Planning Commission 4. 1950 5. Distribution and Domestic Savings

9.11 Terminal Questions

1. What is economic Planning?
2. Who makes plan in India?
3. What is the main objectives of planning?
4. Explain the Rationale and process of Economic Planning?

5. Define the concept of comprehensive development planning?
6. To what extent has economic planning been successful in increasing the growth rate of the Indian economy?.

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UNIT 10

NEW ECONOMIC POLICY

Structure:

- 10.1 Introduction
- 10.2 Meaning of New Economic Policy
- 10.3 Main division of New Economic Policy
- 10.4 Need for new Economic Policy
- 10.5 Features of New Economic Policy
- 10.6 Main components of New Economic Policy
- 10.7 Achievement and Shortcomings of New Economic Policy
- 10.8 Summary
- 10.9 Keywords
- 10.10 Check Your Progress
- 10.11 Answers to Check Your Progress
- 10.12 Terminal Questions
- 10.13 References

Objectives:

After reading this unit you will be able to:

1. Define new economic policy,
2. Understand division of new economic policy,
3. List out components of New Economic Policy,
4. Appreciate New Economic Policy,
5. Describe the achievement and shortcoming of New Economic Policy.

10.1 Introduction

New Economic Policy was introduced in the year 1991. Before 1991 public sector had been assigned important role in the economic development. Private Sector was subject to rigorous controls. But it was realized that public sector was inefficient because of bureaucratization, red-tapism, overstaffing. Lack of initiative etc. Net result of all this was the acute economic crisis in India, in the year 1991. Foreign Exchanges Reserves were too depleted to finance our imports for two weeks. Fresh loans were

not available and nonresident fund were being withdrawn. Lack of confidence in the Indian economic system became almost a global phenomenon. It was high time to introduce or new economic policy in order to redeem the economy from this crisis and put it back on the road to rapid and constant development.

Since July 1991, the Government of India has taken many policy measures with the objective of pulling the country out of economic crisis and accelerating the rate of economic Growth. Main among them are:

A. Replacing controlled economy by liberal one, i.e. reducing controls and promoting liberalization.

B. Encouraging private sector.

C. Promoting foreign direct investment.

D. Introducing improved technology.

E. Encouraging modernization of agriculture.

F. Introducing extensive changes in trade policy, monetary policy and fiscal policy.

G. Keeping fiscal deficit under control.

All these measures are called New Economic Policy. Thus New economic policy refer to various policy measures and changes undertaken since July 1991 with a view to increase productivity and efficiency of the economy by creating an atmosphere of competition.

10.2 Meaning of New Economic Policy

According to C. Rangarajan Former Governor of RBI, “The new economic policies comprise various policy measures and changes introduced since 1991. The trust of new economic policy is toward creating more competitive environment as a means to improve the productivity and efficiency in the economy.” The new economic policy laid emphasis on Liberalization, Privatization and Globalisation. The controls were liberalized so as to encourage setting up of new industrial units and explanation of existing industrial units. Private sector was given more important role in the process of economic development. The areas reserved for public sector were opened for private sector. Foreign investment limits on foreign equity participation were like realized.

Thus, the main objectives of new economics policy are to promote competition and efficiency. Globalisation, Liberalisation and Privatization will promote competition. This increased competition will promote efficiency.

10.3 Main Divisions of New Economic Policy

The main divisions of new economic policy are as follows

i) Structural Policies

These policies relate to consolidating the supply of the economic system. These include the following:

1. Industrial Policy-Privatization, Liberalization and Globalization.
2. Foreign Trade Policy.
3. Foreign Investment Policy.

2. Stabilization Policies: Stabilization Policies relate to consolidating the demand side of economic system. It includes:

1. Monetary Policy
2. Fiscal Policy

Structural and Stabilization reforms can be efficient only when these are simultaneously introduced, because both tend to supplement each other. Some of the notable parameters of structural reforms are: (1) Liberalisation (2) Privatisation (3) Globalisation. Liberalisation means free market economy. It marks a change from a restrictionist regime to a free regime. Privatisation means allowing the entry of private sector into areas hitherto exclusively reserved for the public sector, Globalisation means progressive integration of Indian Economy with the world economy. This implies opening up of the Indian economy to foreign direct investment. Monetary and fiscal reforms are the principal parameters of stabilization policy.

10.4 Need for New Economic Policy

Need of new economic policy was felt mainly because of the following reasons:

- a) To slow down the fiscal deficit.
- b) To solve the problem of unfavourable balance of payments.

c) On account of Gulf War in 1990-91 prices of petrol shot up. Gulf crisis thus further worsened already adverse India's balance of payments position. This further increased balance of payment deficit.

d) To increase the Foreign Exchange Reserve.

e) Continuous rise in price deteriorated further the country's economic position further. So Govt. realized the need for new economic policy.

f) Poor performance of Public sector undertaking, need of new economic policy was felt, which provides more importance to private sector as compared to public sector.

On account of the above compelling factors, it became inevitable for the government to adopt new economic policy. The objective was to speed up economic growth and attract foreign capital.

10.5 Features of New Economic Policy of India

What are the main Features of New Economic Policy of India?

The main features of the new economic reforms/policy are stated below:

1. Liberalisation:

The fundamental feature of the new economic policy is that it provides freedom to the entrepreneurs to establish any industry/trade/ business venture.

The entrepreneurs are not required to get prior approval for any new venture. What they need is that they have to fulfill certain conditions to get into a line of one's choice.

The procedure involving a case by case examination of the proposals for new ventures has been wiped off. Apart from this the entrepreneurs no longer need licenses to come into business. The capital markets have also been freed and opened to the private enterprises.

A new company can now be floated with new issue of shares, debentures etc. In case the entrepreneurs require imported equipment, they are no longer required to approach the central authority for foreign exchange. The area of liberalization is (i) licensing business, (ii) Foreign Investment (iii) Foreign Technology (iv) Establishment, Merger, Amalgamation and taken over, and (v) Simple Exit policies.

2. Extension of Privatization:

Another feature of the new economic policy is the extension in the scope of privatization. Now, the majority of economic activities will be conducted by the private sector. In the wave of privatization, out of 17 industries reserved for public sector, 11 industries have been given to the private sector.

Moreover, Govt has also privatized the ownership of some public sector undertakings by the sale of capital of some selected enterprises to the private sector.

The field of privatization has further been extended by offering greater opportunities of investment to the foreign private investors. Economic Policy seeks to accord priority role to the private sector. Tendency to expand private sector is evident from the following facts:

(i) Number of industries reserved for public sector has been reduced from 17 to 6. Private sector can now set up its units in the field of iron and steel, energy, air transport, etc.

(ii) Till the end of 6th Plan, share of public sector in total investment continued to be greater than that of the private sector. It is intended to be reduced to 45% in the 8th Plan. Thus 8th Plan aims at raising the share of private sector investment to 55% of the total.

(iii) Shares of public enterprises are to be increasingly sold to the workers and general public, with a view to increasing the participation of private individuals.

(iv) A large part of industrial investment of the private sector to be financed by; National Industrial Finance Institutions. These institutions, while sanctioning loans for the new projects, used to exercise their right of 'Conversion' invariably. It implied the right of converting the loans into share capital by the Financial Institutions.

Thus, the private firms were always under the constant threat of conversion. According to the New Industrial Policy, the Financial Institutions will not insist on the conversion clause. With the expansion of privatization there is every possibility of increase in productivity and efficiency.

3. Globalization of Economy:

The new economic policy has made the economy outwardly oriented. Now, its activities are to be governed both by domestic market as also the world market.

It means unification of the domestic economy with the world, economy. In fact, this has become possible by various policy initiatives taken by the Govt. For instance, devaluation of rupee in June 1991 was intended to do away with the artificially controlled overvalued exchange rate of the rupee.

Now, the rupee has been made fully convertible on current account of the balance of payments. Moreover, elimination of licensing of a large number of import items has enabled the importers to import any where in the world. The reduction in custom duties on imports has also been done to bring them in line with the duties in other countries of the world.

In short, globalization means

- (a) Reduction of trade barriers with a view to allowing free flow of goods to and from the country.
- (b) Free flow of foreign capital in terms of investment i.e., direct and portfolio for ensuring conducive atmosphere.
- (c) Free flow of technology, and
- (d) Free movement of labour and manpower.

4. Market Friendly State:

The role of the state is one that is confined to selected non-market areas and is largely to ensure a smooth functioning of the market economy.

As compared to past, the ownership of some selected enterprises has been transferred to private sector. Its activities as owner of resources have been confined to two types of activities.

One covers the activities which are badly needed for the operation of the economy and the other pertains to social services such as education, health, etc.

However, more importantly, the state is to ensure a smooth functioning of the market. For this, the state has to ensure stability in the market through the use of macro economic policies. The state will also intervene in the market when it fails.

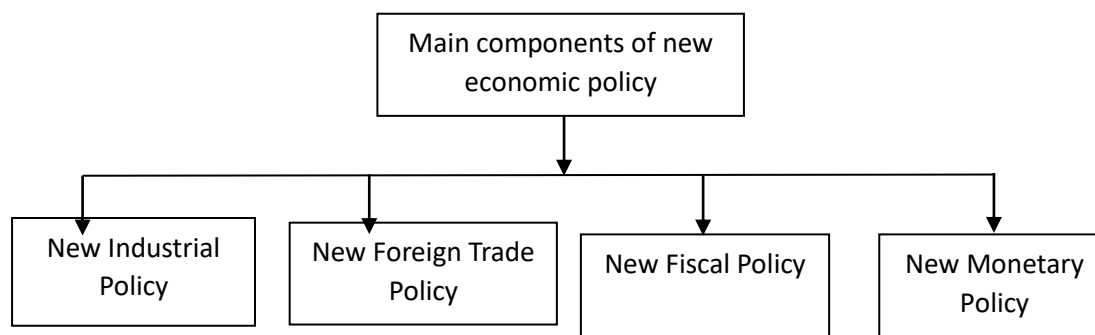
5. Modernization:

New economic Policy accorded high priority to modern techniques. It aims at to augment the growth rate of sunrise industries. In order to import technical dynamics to Indian industry, the Govt, decided to clear all foreign collaborations. Private entrepreneurs will be free to settle the terms of such collaborations on their own behalf.

Moreover, Govt has also been trying to stimulate private entrepreneurs to establish their own research and development centers by offering them various tax concessions. Efforts are also being made to revive and modernize the sick industrial units both within the public and private sectors.

10.6 Main Components of New Economic Policy

Main components of new economic policy 1991 are as follow:



1. New Industrial Policy of 1991

The government announced the new industrial policy on July 24, 1991 in line with liberalization measures taken during the eighties. It makes a drastic shift from earlier was policy initiatives. The main objectives were:

- i) To unshackle the Indian industrial economy from cobwebs of unnecessary bureaucratic control.
- ii) To introduce liberalization with a view to integrate the Indian Economy.
- iii) To remove restriction on direct foreign investment as also to free the domestic entrepreneur from the restriction of MRTP Act, and
- iv) To shed the load of police enterprises which have shown a very low rate of return or were incurring losses over the year.

All these reforms of industrial policy led the government to take a series of initiatives in respect of policies in the following areas:

- a) Industrial Licensing
- b) Foreign investment

- c) Foreign technology
- d) Public Sector Policy
- e) MRTP ACT.

Industrial Licensing

The new policy abolished all industrial licensing, irrespective of the level of investment except for certain industries relating to security and strategic concern, social reasons, concern relating to safety and overriding environment reasons.

Foreign Investment

In order to invite foreign investment in high priority industries, requiring large investments and advanced technology it was decided to provide approval for direct investment upto 51 percent foreign equity in such industries.

Foreign Technology

With a view to injecting desired level of technology dynamism to Indian industry. Government should provide automatic approval for technology agreements rallied to high priority industries within specified parameters.

Public Sector Policy

According to Industrial Policy Resolution, 1991, the priority areas for growth of public enterprise in the future would be as follows:

- i) Essential infrastructure, good and services.
- ii) Exploration and exploitation of oil and mineral resources; and,
- iii) Technology development and banking of manufacturing capabilities in areas which are crucial in long term development of economy and when private sector investment is inadequate.

Concession from Monopolies Act

According to the provision of monopolies and restrictive trade practices act all those companies having assets with more than Rs 100 Crore used to declared MRTP units and such units were subject to several restrictions. Now the companies covered in MRTP Act have been given large-scale concessions. In respect of MRTP companies, the capital investment limit fixed earlier has been removed. As a result, there would be no restriction on industrial houses for setting up new undertakings or expansion of existing undertakings take over and amalgamation. However, under this

policy more emphasis will be laid on checking unfair trade practices. In the year 2002, MRTP Act has been abolished and in its place a much liberal competition Act has been passed.

Hence New Industrial Policy is highly liberal policy. Its main objective into free Indian Industry from unnecessary administrative and legal control. As a result of this policy, there is the possibility of revolutionary and fundamental changes in Indians Industrial sector.

2. New Foreign Trade Policy

The objective of the new foreign trade policy is to liberate foreign trade from several restrictions so as to render it more competitive. One of the main features of new Economy Policy is globalization of Indian economy and rendering it more open. Globalisation implies free interaction of the economy with other countries of the world in the field of production, trade and finance. In simple words, it means encouraging foreign investment and foreign trade by removing all restrictions. New Economic Policy makes the following provisions for openness of the economy:

i) Prior of New Economy Policy 1991, foreign capitalists could invest in Indian companies upto 40 percent of equity capital and every case of foreign investment required government sanction. Now in certain industries the foreigners can invest upto 100 percent of paid up capital and sanction for it is granted as a matter of routine.

ii) In July, 1991, government of India devalued Indian rupee by 20 percent by way of international adjustment of exchange rate. In devolution external value of Indian currency is reduced in comparison to currencies of other countries. The objectives of devaluation were to promote exports, reduce imports and to accelerate the inflow of foreign capital. Now, Indian rupee is fully convertible in foreign currency.

iii) New Foreign Trade Policy was declared for five years i.e. 1992-1997. Main characteristic of this policy was liberalisation. Under this policy all controls and restrictions on foreign trade were withdrawn. Open competition was encouraged and to facilitate it, all sorts of facilities were provided to industrial units and exports houses. Barring a few specified commodities, any other commodity can be freely exported and imported. Another features of this policy is that administrative controls have been

minimized. The present Export-Import policy for the year 2004-2009 is also a liberal policy.

iv) In order to render Indian Economy Internationally competitive, custom duties and tariffs are being gradually lowered.

v) To external openness of the economy, foreign investment and foreign technology have been encouraged.

vi) Many steps have been taken to correct balance of payments deficit. Exports have been encouraged efforts are being made to increase India's share in world trade.

1. New Fiscal Policy

Fiscal Policy is related to income and expenditure of government. It is also known as budgetary policy of government. It deals with taxation, government expenditure, deficit-financing and public –debt. In this policy, government expenditure and revenue sources are managed so as to achieve some basic objectives. These basic objectives can be rapid economic development, increase in rate of capital formation, removal of poverty, removal of regional disparities. Globalisation means progressive integration of Indian Economy with the world economy.

In the new economic policy following measures have been taken with regard to fiscal policy.

- i) Reduction of Tax- rates.
- ii) Reduction in non-developmental expenditure.
- iii) Reduction in Subsidies.
- iv) Reducing dependence on external borrowings.
- v) To discourage deficit financing (meeting budgetary deficit through printing more notes by RBI) .
- vi) Simplification of tax- procedures and modification in indirect-tax structure so as to ensure better collection of indirect taxes.

2. New Monetary Policy

Monetary policy referred to policy related to money-supply and interest rate in the economy. This policy is formulated and executed by RBI. Achieving price-stability and adequate availability of credit are the key objectives of monetary-policy. In the new economic policy following measures have been taken with regard to monetary policy.

i) Reduction in bank-rate, statutory liquidity ratio and cash reserve ratio so as to increase the availability of credit in the economy. But recently cash reserve ratio has been increased to check inflation.

ii) Reduction in interest rates so as to make interest rate in line with international trends.

iii) To discourage Unproductive- Loans is that more funds are available for productive –loans.

iv) To make banks more competitive commercial banks are given certain flexibility in determining rate to interest on deposits and landings.

v) For improvements in accounting system of the bank, all banks should adopt a uniform system of accounting with regard to their borrowing and lending operations. Balance sheets should be systematically prepared so as to reflect the true economic status of the banks.

10.7 Achievement and Shortcomings of New Economic Policy

New Economic Policy has been in force for the last 17 years. Major indicators that have undergone a change in the last 17 years of the operation of new economic policy, and in pre-new economic policy year 1990-91, are clear from the following table.

Annual Percentage Changes in Major Economic Indicators

Years	Rate GNP	Growth Rate of Agriculture	Growth Rate of Industries	Inflation
1990-91	4.7	3	8.3	12
2000- 2001	4.4	-5.8	5.0	4.9
2001- 2002	5.6	-5.9	2.7	1.6
2002- 2003	4.2	-13.9	5.8	3.4

2003-2004	8.5	9.6	7.0	5.5
2004-2005	6.9	1.1	7.5	6.4
2005-2006	9.4	6.0	9.5	4.1
2006-2007	9.6	2.7	10.0	5.4
2007-2008	8.7	2.6	9.4	6.7

Source- Economic Survey 5, 2007-2008.

It is evident from above account that new economic policy is succeeding on all important front.

Achievements

i) With the introduction of new economic policy, our national income has increased for last many years it is growing at around 8 percent per annum.

ii) Main objectives of the new economic policy are to accelerate the growth rate of industrial production by adopting liberal industrial policy, privatization and globalization of the industries. Industries production has increased as a result of new economic policy. In year 2007-2008, industrial production increased by 9.4 percent.

iii) New Economic Policy has largely succeeded in bringing down the price level. In 1990-91, rate of increase in price level was 12 percent. But in 2007-2008 it decreased to 6.7 percent. Thus, new economic policy partially succeeded in checking the rise in price level.

As a result of new economic policy, exports of the country have increased substantially. In 2006-2007 export growth rate was 22.6 percent.

v) Most favourable impact of new economic policy has been on foreign currency reserve. In 1990-91, foreign currency reserves of India had fallen to the low level of Rs. 4,588 crore. In April, 2008 our foreign exchange

reserves are 311.9 billion U.S. dollars. Thus, foreign currency reserve have multiplied a greater deal due to new economic policy.

vi) Liberal approach of new economic policy has gradually given rise to direct foreign capital investment were sanctioned by the government. In year 2006-2007, foreign direct investment worth 19,531 million U.S. dollars was received. Undoubtedly, now economic policy has largely succeeded in attracting foreign direct investment.

vii) With the introduction of new economic policy, fiscal deficit has reduced. In the year 1990-91 fiscal deficit was 6.5 percent of GDP. In the year 2007-2008 fiscal-deficit has declined to 3.2 percent of GDP.

Shortcoming:-

- i. The new economic policy has failed to solve the problem of poverty which is a major economic problem of India.
- ii. The new economic policy has not benefited much to the agriculture sector.
- iii. The economic policy liberalized imports.
- iv. Under new economic policy, great importance has been given to investment made by multinational companies. However, these companies make extensive use of capital intensive technique, hence investment made by them in India has not resulted in any significant increase in employment opportunities.

It is evident from the above account that new economic policies have succeeded in achieving their objectives in some fields, viz., encouragement to foreign sector, fall in the level of prices, etc, but in other sectors, especially in poverty alleviation, employment, etc. it has failed completely.

10.8 Summary

New economic policy refers to various policy measures and changes undertaken since July, 1991 with a view to increase productivity and efficiency of the economy by creating an atmosphere of competition. Globalisation Liberalisation and privatization will provide competition. This increased competition will promote efficiency. New industrial policy, new foreign trade policy, new fiscal policy and new monetary policy are the major components of new economic policy. These components play a crucial role in economic development of Indian economy. New economic

policy has succeeded in achieving their objectives in some fields, but in other fields, especially in poverty all aviation, employment etc. it has failed completely.

10.9 Keywords:

Economic Policy: Economic Policy (M.P.C. Rangarajan), outgoing Governor, State Bank of India: “Since 1991, various policy measures and changes have been implemented and all these are included in economic policy. The objective of the new economic policy is to create a competitive environment and improve the productivity and efficiency of the economy. The new economic policy focused on liberalisation, privatisation and globalisation.

Liberalization: Liberalisation means free market economy. It marks a change from a restrictionist regime to a free regime.

Privatisation: Privatisation means allowing the entry of private sector into areas hitherto exclusively reserved for the public sector,

Globalization: Globalisation means progressive integration of Indian Economy with the world economy.

Fiscal policy: Fiscal Policy is related to income and expenditure of government. It is also known as budgetary policy of government. It deals with taxation, government expenditure, deficit-financing and public –debt. In this policy, government expenditure and revenue sources are managed so as to achieve some basic objectives. These basic objectives can be rapid economic development, increase in rate of capital formation, removal of poverty, removal of regional disparities.

Monetary policy: referred to policy related to money-supply and interest rate in the economy. This policy is formulated and executed by RBI. Achieving price-stability and adequate availability of credit are the key objectives of monetary-policy

Structural Policies

These policies relate to consolidating the supply of the economic system. These include the following:

- Industrial Policy-Privatization, Liberalization and Globalization.
- Foreign Trade Policy.

- Foreign Investment Policy.

Stabilization Policies: Stabilization Policies relate to consolidating the demand side of economic system. It includes: 1. Monetary Policy 2. Fiscal Policy

Market Friendly State: It is an important responsibility of the State to select certain market free areas and ensure smooth functioning of the market economy. Compared to earlier, ownership of some selected enterprises was handed over to the private sector.

Modernization: The new economic policy gave great importance to the modernization of technology. Its objective was to increase the growth of industries. For importing technology in India, the government decided to pass all foreign collaborations.

10.10 Check Your Progress

3. New economic policy was implemented in
4. The new economic policy focused on, privatization and globalization.
5. means the process of integration of all the economies of the world without hindering the flow of goods, services, technology, capital and human capital.
6. Fiscal policy is related to the income and expenditure of

10.11 Answers to Check Your Progress

1. 1991 2. Liberalisation 3. Globalisation 4. Government

10.12 Terminal Questions

1. What is meant by new economic policy? What are its main features?
- ii. Give arguments in favour and against the new economic policy..
- iii. What is new economic Policy? Discuss its impact on Indian economy?
- iv. Critically evaluate the new economic policy.
- v. Explain the Components of New Economic Policy.

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UNIT-11 ECONOMIC REFORMS IN INDIA PART -1

BLUE PRINT OF UNIT

- a. Introduction
- b. Economic Reforms- First Phases
- c. Features of Economic Reforms- First Phases
- d. Measures of Economic Reforms- First Phases
- e. Contribution of the New Economic Policy 1985 in Economic Reform
- f. Short Comings of Economic Reforms
- g. The rationale for economic reforms
- h. Summary
- i. Glossaries
- j. Comprehension Questions
- k. Answer to comprehension Questions
- l. Self Assessment Questions
- m. Book References

OBJECTIVES

After reading this unit you will be able to:

Understand economic reforms

Know about Economic Reforms- First Phases

Point out the feature of Reforms- First Phases

Appreciate the Contribution of Economic Reforms – First

Know Rationale for Economic Reforms – First Phase

11.1 INTRODUCTION

In the 1960s and 1970s, most industries in the construction sector of India required permits and were subjected to capacity control. There were particularly the following constraints or obstacles that affected the selection of works in this sector of construction:

- In 18 industries, the majority of the market share was reserved for the public sector, which included industries such as iron and steel (used in construction), heavy plants and machinery, telecom equipment, and petroleum. However, there are exceptions in every industry, such as 'Tata Steel' in the steel sector.
- When the list of murders is prepared, I also want it to be an interesting one. Randomly combining various types of murders, and going through their caused effects, would indeed be useful. This will also help in identifying garments that belong to these murders, and analyzing the behavior of the suspects.
- Most areas were within the scope of obtaining permits and restricted capabilities.
- Monopolies and Restrictive Trade Practices Act 1969 (Amendment in 1969) Invite objections and hold public hearings before allowing investment by industrial houses for production.
- The Foreign Exchange Regulation Act (FERA) 1973 allowed companies engaged in core activities, utilizing complex technologies, or fulfilling certain export commitments to operate outside the restrictions. All companies were required to keep foreign capital investment below 40% along with some other objections/restrictions. High import duties were imposed on capital goods and technology, compelling companies and firms to focus on research and development in the country and develop contemporary technologies. Its aim was also to discourage the import of capital goods.
- Legal Process
- Labor Laws
- Restrictions on Foreign Direct Investment.

In entire world economy has been experiencing dramatic and momentous changes during the decade of late 1980s and 1990' s. In the recent past, never have the economic reforms been as widespread as today. Economic reforms are being undertake

At such a pace that they are sweeping the entire Eastern Europe and a proud and wide spectrum of developing countries which includes India to Vietnam and from Peru to Morocco and even Cuba. These countries are gradually discarding old economic philosophies, grading their process of economic development, and are hunching ambition us reforms of their political and the economical policies.

Various countries of the world are now favouring economic reforms because it promises more rapid and more sustained economic growth.

Economic Reforms-The term ' economic reforms' broadly indicates necessary structures adjustments to extended events. W hile making such adjustments i t requires, fi rstly, reduction of country' s spending to the level parallel to i ts income and thereby reducing i ts fiscal deficit considerably. Secondly, such adjustment requires market oriented structured changes in under to make the economy more efficient and flexible and also for using both demotic and external resources in a most appropriate manner. This requires gradual reduction of import restrictions and also elimination of export restrictions.

As revealed by the studies made by the World Bank, three points are quite clear. First external assistance - either specific project based on meeting overall balance of payment crisis is more effective in realizing its goal who where reform is under way.

Secondly, effectiveness of economic reforms depends largely on the response of investments and institutions towards structural adjustments. Thus reforms, by it, are not enough but what is needed is a spontaneous response from the private sector to promote. Investments and institution building, to contribute towards poverty all aviation and environmental production programmes and simultaneously it also needs complementary action by the government concerned.

Finally, the success of economic reforms depends on the country's involvement in the reforms programme where broad consensus must be attained on the need for such reform or structural change. Thus, to become successful, it is quite essential that people sentiment should go in favour of reforms. Otherwise, it will be simply a futile exercise in the midst of darkness.

11.2 Economic Reform - The First Phase

With the change in the nature of markets and structures and social relation of production in various countries of the world, India has also started to respond to all these changes, particularly to the increasing globalization of economic processes.

The first phase of economic reforms that had its origin in 1985 when Mr. Rajiv Gandhi took over as the Prime Minister of the country. Just after that Mr. Gandhi declared the New Economic Policy where he put much emphasis on improvement in productivity, absorption of modern technology and fuller utilization of capacity and finally on the greater role for the private sector.

In order to provide greater scope to private sector, this new policy introduced various policy changes regarding industrial licensing, technology up gradation, elimination of controls and restriction, foreign equity capital, fiscal policy, rationalizing and simplifying the system of fiscal and administrative regulation and export- import policy. These policy changes were brought with the sole intention to create a favourable climate for getting a big boost in private sector investment which would, in turn user in rapid growth of the economy as well as pave the way for modernization of the economy. In this connection, Prof. K. M. Raj rightly observed that, “There has been, however, a general agreement that a very distinctive feature of those policy changes taken as a whole is the greater scope for unfettered expansion they offer to the private sector, particularly in the corporate sector of manufacturing industry and the opportunities opened up to multi- national enterprise.

11.3 Main Features of economics Reforms – First Phases

The economic reforms and policy adopted for the economic development of India prior to 1991, is called as old economic policy. This policy had the following features:

1. To reduce import duties on the import of capital goods with the aim of modernizing Indian industries and promoting exports.
2. To streamline the tax system to encourage growth.
3. . To bring leniency to government control over private sector industries. The

following were the features of this policy:

Private Economy- In the post independence period, mixed economy was adopted as a strategy to achieve the objectives of economic development. Under this strategy both public sector and private sector work together.

- **More Importance to Public Sector:**

In the old economy policy, more importance was given to public sector. Basic industries were to be set up by the public sector. It was the responsibility of this sector to develop economic and social infrastructure. Several restrictions were imposed on the private sector. For checking concentration of economic power in the private sector, monopolies and restrictive trade practices Act was enforced.

- **Protection against Foreign Competition:**

In order to protect domestic industries against foreign competition, several measures were adopted e.g. high rates of import duty on foreign goods, or quantitative restriction on imports.

- **Promotion of Exports and Substitution of Imports:**

To promote exports, exporters were provided with incentives and exemptions in taxes among other facilities. There was a strong emphasis on 'import substitution' for various types of products.

- **Restrictions on Foreign Capital:**

Several restrictions were imposed on foreign direct investment. In order to control foreign capital, Foreign Exchange Regulation Act (FERA) was enforced. Thus, foreign companies were discouraged to invest in India.

- **Fixed Rate of Exchange**

Policy of fixed rate of exchange was adopted. Under it, exchange rate of the rupee used to be fixed by the Reserve Bank of India. All the exporters had to sell foreign currencies earned by them to Reserve Bank of India at a fixed rate of exchange. Similarly, importers who needed foreign exchange had to purchase the same from the Reserve Bank at a fixed rate. There were many restrictions on the use of foreign exchange.

- **Fiscal Policy:**

Prior to 1991, on account of continuous rise in non - development expenditure of the government, fiscal deficit went on rising. Fiscal policy refers to revenue and expenditure policy of the government. In order to meet government expenditure - new taxes were imposed and rates of existing taxes were raised. Deficit financing was adopted and public borrowing and external borrowing were resorted to.

11.4 MEASURES OF ECONOMIC REFORM FIRST PHASE

Accordingly, the New Economic Policy or reforms stressed on removing unnecessary restriction in issuing licenses, in denying industrial licensing to MRTP companies and in making adjustment of output to administered prices. In the connection, the government introduced various measures in the following manner.

1. **Cement:** Cement was totally decontrolled and a number of private sector units were issued additional licensed capacities.
2. **Sugar:** The share of free sale of sugar in open market was enlarged.
3. **Asset Limit:** The ceiling of the assets limit of big business house was enhanced from ₹20 crore to ₹100 crore.
4. **Broad Bonding:** The scheme of "Bond bonding" of licenses was introduced to bring variety in the production of two wheelers which was later extended to 25 other categories of industries like, four wheelers, chemicals, petro - chemicals, pharmaceuticals, typewriters etc.
5. **Drug:** All drugs were completely relicensed and 27
6. rate in basic goods (non-durable goods) industry fell from 8.7% per year in 1980-85 industries were placed outside the purview of MRTP Act.
7. **Textile:** Introduction of new textile policy distinction between mill, power loom and handloom sectors and also between natural and synthetic fiber for licensing purposes.
8. **Electronics:** Electronics industry was liberalized from MRTP Act restriction. The entry of FERA Companies in the areas was also liberalized.
9. **Trade:** Export-import policy 1985 was announced in order to pave the way for easier and quicker access to imports, strengthening export production

base and for facilitating technological up gradation.

LTFP, money term fiscal policy, 1985 was announced for the implementation of the seventh plan in a smooth manner.

11.5 CONTRIBUTION OF NEW ECONOMIC POLICY 1985 in ECONOMIC REFORMS

Increase in National Income-With the introduction of economic reforms 1985, our national income has increase. In 1980 - 81 to 2002 - 2003 of increased to sq percent. In fact, during the planning (1981 - 2001) the average growth rate in national income at constant prices has been 4.4 percent.

1. Increase in Industrial Production-The main objective of economic reforms was to accelerate the pace of industrial production. During the economic reforms, the industrial production growth rate was 9.5%. From 1981 to 1985, the industrial growth rate was 6.4% per year, which increased to 8.5% per year during the seventh plan and then decreased to 8.3% per year in 1990-91. In 1981-85, there was a significant surge in the growth rate of capital goods industries, which was 6.2% per year, and it increased to 14.8% per year between 1985-90 and to 17.4% per year in 1990-01. During 1981-85, the growth rate in consumer goods (durable goods) industry was 5.1% per year, increasing to 7.3% in 1985-90. However, the growth to 7.4% in 1985-90. The growth rate in the intermediate goods industry (manufacturing of intermediate products) showed fluctuations. In 1980-85, the growth rate in this industry was 6%, which increased to 6.4% in 1985-90. Overall, we can say that the growth rate of industrial production, which was (-1.6%) per year in 1979-80, saw significant improvement in the 1980s.

11.6 Shortcoming of Economic Reforms

Following are the shortcoming failure of new economic reform of first phases.

- **Fiscal imbalance:** Prior to 1991, on account non- development expenditure of the government, fiscal deficit went on rising. In the year 1981 - 82, it was 5.4 percent of gross domestic product but in 1991- 92, of rose to 8.4 percent of GDP. In unde r to meet the fiscal deficit, the government had to raise loans and pay interest there on. Thus, due to rise in fiscal deficit there was correspond ing rise in public debt and inters payment. In 1980 - 81 inters payment on public

debt amounted to 10 percent of total government expenditure. In 1991, amount of interest payment uses to 36.4 percent of total expenditure of the central government international financial institution like world bank IMF etc had lost faith in the fiscal state of the government. It therefore becomes inevitable for the government to make social efforts to scale down fiscal deficit. This phase began with a terrible economic situation characterized by low economic growth, high inflation rates, and a continuous decline in the balance of payments due to rising prices of imported crude oil. The government aimed to address this fiscal deficit through a process of increasing taxes. A new tax system was implemented for the financial management of long-term plans. Provisions for tax exemptions were also introduced to encourage foreign capital inflow into India to tackle the balance of payments problem. To increase imports, boost government revenue, and protect domestic industries, custom duties were also raised. In 1985, the government announced a long-term fiscal policy for India, expressing concern over the decline in the country's fiscal position and identifying it as a key challenge. Moreover, specific goals were set to address or solve this issue, including changes in tax policy for growth and equitable distribution for the success of the plans. In order to reduce the adverse effects of taxation in the region, to quickly alleviate the burden of taxes, and to gradually increase it, the government implemented an improved Value Added Tax system in 1986. Reforms in customs duty were introduced, emphasizing reliance on taxes instead of imposing quantity-related restrictions on imports, which was meant to increase the revenue for the country. This phase was indeed a stage that generated the impact of tax reforms, but it was also essential for policymakers to pay attention to the following points: (a) The economic impacts of tax policy must ensure that resource allocation improves and consequently, economic growth increases. (b) The administrative implementation of tax policy or tax structure, as well as the practical aspects of tax administration and taxpayer behavior, should be examined before or during its creation.

- **Fragile balance of payment situation:** - The balance of payments situation was highly precarious in 1991, but this was not unexpected. The current account deficit which was \$27 billion 1.35 percent of GDP in 1980-81 rose to \$ 4.9 billion or 2.5 percent of GDP in 1985-86 and farther to 9.7 billion dollar or 3.69 percent of GDP in 1990-91. These continuously growing deficit low to be financed by borrowing from abroad and US a consequences India's external debts use from 12 percent of GDP at the end of 1980-81 to 23 percent

of GDP at ends of 1990 - 91. This study growing external debt lead to an increase in debt service burden from 10 percent of current account receipts and 15 percent of export earnings in 1980 - 81 to 22 percent of export earnings in 1990 - 91. These mounting strains during the 1980 stretched to the breaking point in 1991 due to the Gulf crisis. The balance of payment position was on the bank of disasters in mid - January 1991 and again in late 199 the level of foreign exchange reserves dropped to levels which were not sufficient to finance imports of even ten days.

- **Gulf Crisis:** - On account of Gulf was in 1990 - 91, prices of petrol shot up. Thus, India had to make huge payments of gulf counties so as to import petrol. Gulf crisis thus further worsened already adverse India's balance of payments position. This further increased balance of payments deficit.

- **Fall in foreign exchange reserves:** - in 1990- 91 India's foreign exchange reserves fell to such a low level that the same were not enough pay for an important bill for even 10 days. The situation grew so acute that in the year 1990 - 91 government had to mortgage country's gold to arrange necessary foreign exchange. In such a situation, government felt compelled to frame new economic policy.

- **In India prices continued to rates very high:** - average annual rate of inflation increased to 10.3 percent. In the year 1990- 91, despite monsoon from three consecutive years, price of food grains substantially. Because of increasing pressure of inflation, country's economic position deteriorated further. So, government realized the need for new economic policy.

- **Poor performance of public sector undertakings:** - in 1951 there were 5 enterprises in public sector in India but in 1990 - 91 their number rose to 246. Several thousand crore of public funds were invested therein. In the initial years their functioning was quite satisfactory but thereafter of these sufferance losses. Because of their poor performance. Public sector undertaking into liability. In such situation need of new economic policy was felt which provides more impetus to private sector as compared to public sector

11.7 RATIONALE FOR ECONOMIC REFORMS

Introduction of current economic reforms in India initiated process of structural adjustments in order to correct the distortion and weakness of economic policies

followed in the country since its inception of economic planning. The advocates of current economic reforms have justified such process of structural adjustments. The following are some of the important arguments advanced in favour of economic reforms:

1. In India wage fixation has no link with productivity. But rationality suggests that wages must be equal to marginal productivity of labour. Labour in India is having dual character, representing organized labourers enjoying securing and high wages and unorganized workers, on the other hand, which remain exploited, totally defenseless and poor. Thus in this context, economic reforms through its market mechanism will either improve productivity of workers or face closure or exit by the employer concerned. The public sector enterprises in India are facing the problem of low productivity and poor rates of return due to high overhead costs; overstaffing, wastage of raw materials and inputs, wrong pricing policies and loss of work culture among highly unionized workers. In order to make necessary remedy to these problems of PSEs, economic reforms will play a very important role.

2. The country is facing a huge growth of non plan expenditure, particularly due to its ever increasing expenditure on defense, subsidies and interest payment. The current economic reforms have made an attempt to reduce this increasing trend in non plan expenditure through withdrawal of subsidies on food, fertilizers, export and even on higher education.

3. The current economic reforms in India made provision for increased flow of foreign direct investment which would help the country to modernize its technology and also for increasing its productivity.

4. As the country becomes much dependent on domestic borrowing and deficit financing its expenditure, this has resulted in a huge debt burden as well as a high rate of inflation in the country. The current economic reforms have made sincere attempt to reduce the dependence on domestic borrowing and deficit financing.

5. India has been experiencing maintenance of persistent fiscal deficit in its annual budget, resulting inflationary pressure in the country. Economic reforms have made a sincere attempt to contain this fiscal deficit.

6. Economic reforms have saved the industrial sector from unnecessary

regulation and control of the government.

7. Economic reforms have Become successful to simplify and rationalize the entire tax structure of the country

11.8 SUMMARY

Economic reforms stressed on removing unnecessary restriction in issuing licenses, in denying industrial licensing to MRTP companies and in making adjustment of output to administered prices. In the connection, the government introduced various measures in the following manner.

Refers to all those measures which aim at rendering the economy more efficient competitive and developed. Main economic reforms are as in more importance to private sector in much emphasis an improvement in productivity, absorption of modern technology and fuller utilization of capacity. In nether to provide grater scope to private sector this new economic reforms introduce various policy changes regarding industrial licensing technological up gradation, elimination of controls and restrictions foreign equity capital fiscal policy, and simplifying the system of fisical and administrative regulating and export and import policy. Economic reforms of firs phase has many benefits and short comings short coming of reforms it became inevitable for the government to adopt new economic policy. The objective was to speed up economic growth and attract foreign capital.

11.9 Glossary

- **Economic Reforms:** The term ' economic reforms' broadly indicates necessary structures adjustments to extended events. W hile making such adjustments it requires, firstly, reduction of country' s spending to the level parallel to its income and thereby reducing its fiscal deficit considerably. Secondly, such adjustment requires market oriented structured changes in under to make the economy more efficient and flexible and also for using both demotic and external resources in a most appropriate manner. This requires gradual reduction of import restrictions and also elimination of export restrictions.

- **private economy:** Private economy, greater importance to the public sector,

encouragement of exports and import substitution, protection from foreign capital, restrictions on foreign capital, fixed exchange rates.

- **Measures of Economic Reforms:** In the connection, the government introduced various measures in the manner including- cement, sugar, asset limits, broad banding, drug, textile, electronic and trade.

- **Fiscal imbalance-** Prior to 1991, on account non-development expenditure of the government, fiscal deficit went on rising. In the year 1981 - 82, it was 5.4 percent of gross domestic product but in 1991 - 92, of rose to 8.4 percent of GDP. In order to meet the fiscal deficit, the government had to raise loans and pay interest there on. Thus, due to rise in fiscal deficit there was corresponding rise in public debt and interest payment. In 1980 - 81 interest payment on public debt amounted to 10 percent of total government expenditure. In 1991, amount of interest payment rises to 36.4 percent of total expenditure of the central government international financial institution like world bank IMF etc had lost faith in the fiscal state of the government. It therefore becomes inevitable for the government to make social efforts to scale down fiscal deficit.

- **Gulf Crisis:** On account of Gulf war in 1990 - 91, prices of petrol shot up. Thus India had to make huge payments of Gulf countries so as to import petrol. Gulf crisis thus further worsened already adverse India's balance of payments position. This further increased balance of payments deficit.

- **FERA-** In order to control foreign capital, Foreign Exchange Regulation Act (FERA) was enforced. Thus, foreign companies were discouraged to invest in India.

a) **Fixed exchange rate :** (mechanism of exchange rate stability and ensuring liquidity): The fixed exchange rate policy was adopted. Under this policy, the exchange rate of the Rupee is determined/fixed by the Reserve Bank of India. All exporters are required to deposit their earned foreign capital with the Reserve Bank at a predetermined exchange rate for one year.

11.10 Understanding question.

Fill in the blanks

1)..... In industries, most of the market share was reserved for the public sector

2). To prevent the centralization of economic rights in the private sector, ... was

created.

3) A fixed exchange rate policy was adopted. Under this policy, the exchange rate of the rupee is determined/fixed by

4) In 1990-91, India's had decreased so much that it could not make significant payments for even 10 days.

11.11 Answer of understanding questions

1). 18 2) Monopolies and Restrictive Trade Practices Act 1969 3). Reserve Bank of India 4). Foreign Exchange Management

11.12 SELF ASSESSMENT

1. What do you understand by economic reforms?
2. Describe the economic reforms of first phase?
3. What is the feature of economic reforms?
4. Describe the main component of economic reforms?
5. Critically evaluate the new economic reforms of first phase?
6. Explain the private economy and stable exchange rate?
7. Explain fiscal policy?

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UNIT-12 ECONOMIC REFORMS IN INDIA-II

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- 12.1 Introduction
- 12.2 Objectives of Economic Reforms-II
- 12.3 Features of Economic Reforms-II
- 12.4 Policy measures of economic reforms-II
- 12.5 Performance of economic reforms in Indian economy
- 12.6 Arguments in favour of economic reforms
- 12.7 Arguments against economic reforms
- 12.8 Summary
- 12.9 Glossary
- 12.10 Comprehension questions
- 12.11 Answer to comprehension questions
- 12.12 Self Assessment questions
- 12.13 Book References

OBJECTIVES

- b) After reading this unit you will be able to:
- c) Understand the economic reforms and its objectives,
- d) Know the Feature of Economic Reforms,
- e) Learn about the policy measures of second phase,
- f) Appreciate the role of economic reform in Indian economy,
- g) Point out the arguments in favour and against economic reforms.

12.1 INTRODUCTION

In 1980, a moderate path of liberalization was adopted in the Indian economy, but it was characterized by depth, breadth, and self-development. By the end of this decade, the Indian economy was in a deep crisis involving several macroeconomic crises,

initially leading to a foreign exchange crisis and later a problem with debt and interest payments. To resolve this crisis, India turned to the World Bank and the International Monetary Fund for large loans, and these institutions imposed various conditions along with permission to lend. India found itself in a predicament and accepted the conditions set by the World Bank and the IMF, and thus began efforts to revitalize the entire economy, which included fundamental changes through stabilization programs in the economy. With this in mind, India initiated the implementation of a new economic policy in July 1991.

In 1980, only policy decisions were reconsidered to boost the pace of economic prosperity, along with half-hearted economic reforms. It was implemented. After excellent performance by several countries in East Asia, the idea emerged that there was a need to rediscover India's economy. The Indian economic system was characterized by extensive government control over the private sector, price controls, high tax rates, quantitative restrictions on imports, and restricted foreign investment. This system made it difficult to conduct operations as needed, and there was a requirement for change. The control system was not completely changed in 1980; it existed but was being operated more liberally. In 1980, this process yielded good results, and economists also agreed that there was a need for broader and more structured changes. Therefore, recommendations for implementing liberalization began to emerge. Many of these recommendations were implemented in 1990.

In 1990, as soon as economic reforms were implemented, India experienced a severe balance of payments crisis in 1991. The new administration prepared a comprehensive framework for economic reforms that included the following facts: -

- Ending the effective role of the public sector and encouraging the role of the private sector as an engine of economic development.-
- Increasing competitiveness through a competitive environment and greater reliance on the market sector.-
- Opening up the economy for international trade, foreign investment, and foreign technology

During the first half of the period of economic reforms (1992-97), there were excellent signals with an average annual growth rate of 6.7 percent in domestic production; however, during the second half of this period (1998-03), this growth rate declined to 5.7 percent.

The first phase of economic reforms failed to yield the expected result on most of the grounds. More particularly, the deficit in balance of trade account gradually increased and thus the average deficit in balance of trade during the sixth plan which was the extent of ₹5,935 crore, suddenly rose to the tune of ₹10,841 crore during seventh plan. Moreover, receipts on invisible account have also declined. Thus the country has been plunged into a serious balance of payments crisis. In order to save the situation, the government approached the world bank and the international monetary fund (IMF) to extend loan to the tune of about 7 billion dollar. IMF finally decided to advance the loan but at the same time insisted that the government should put the economy again on right track. Accordingly, Dr. Manmohan Singh the then finance minister of India finally made a commitment by his letter dated August 27, 1991 to the IMF managing director Michel Camdessus that the government of India set certain macro-economic targets and also initiated certain policy measures in order to bring about structural readjustment of the economy.

In order to restore both internal and external confidence, the Narasimha Rao Government initiated a good number of stabilization measures in 1991-92. These measures include tightening monetary policy by raising interest rates, adjustment of the exchange rate of rupee by 22 percent, liberalization and simplification of foreign trade policy, reduction of fiscal deficit and introduction of other reforms in a new element of dynamism to the process of economic growth of the country. The memorandum submitted by the then finance minister observed that “The thrust will be to increase the efficiency and international competitiveness of individual industrial production, to utilize foreign investment and technology to much greater degree than in the past, to improve the performance and rationalize the scope of the public sector and to reform and modernize the financial sector so that it can more efficiently serve the needs of the economy.

12.2 OBJECTIVES OF REFORMS –II

The main economic objectives of macro-economic objectives of economic reforms in India include:-

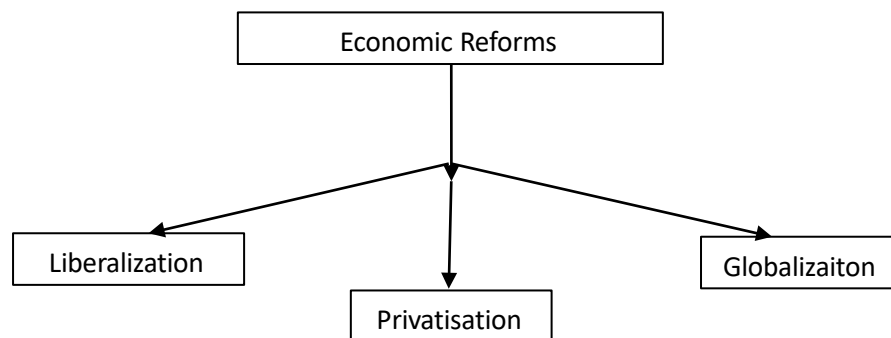
- 1) Attaining economic growth at the rate of 3 to 3.5 percent in 1991-92 and at 4 percent in 1992-93.
- 2) Reducing the annual rate of inflation by 9 percent in 1991-92 followed by 6 percent in 1992-93.
- 3) Relieving the critical balance of payment situation and rebuilding foreign exchange reserve to 2.2 billion dollar.
- 4) Reducing current account deficit in the budget from 2.5 percent of GDP in 1990-91 to 2.0 percent by 1992-93.

12.3 MAIN FEATURE OF ECONOMIC REFORM-II

1. Structural Economic Reforms- Since 1991, structural economic reforms were sector-wise. Different sectors were carefully selected for structural economic reforms, and the extent of these reforms in the chosen sectors was gradually increased over time.

The major structural economic reforms adopted in 1991 were primarily in the following areas: trade policy, external sector, industrial policy, policies related to infrastructure, privatization policies, financial sector, and policies to attract Indian investment. Emphasis was placed on economic reforms in all sectors, which opened the Indian economy to international competition. Exchange rate controls were abolished, access to foreign capital was liberalized, and it was also ensured that foreign investments were not penalized simply because they were foreign.

Main features of economic reforms are liberalization, Privatization and globalization. Since 1991, government of India has introduced diverse economic reforms to pull the country out of economic crisis and to accelerate the rate of growth.



2. Liberalization: Liberalization - An example of gradual liberalization due to economic reforms. External liberalization occurred around the end of 1970 when India faced a crisis of overvalued exchange rates due to strict import controls and high rates of import-export duties. There was consensus here that numerical controls on imports should be abolished. Liberalization - An example of gradual liberalization due to economic reforms. External liberalization occurred around the end of 1970 when India faced a crisis of overvalued exchange rates due to strict import controls and high rates of import-export duties. There was consensus here that numerical controls on imports should be abolished.

The economic reforms of 1990 brought about a planned transformation and were explored with good momentum. In 1991, a 25 percent devaluation of the stable exchange rate was carried out in two successful installments as import controls were now liberalized. Therefore, it was reasonable to implement a system that would achieve a more flexible exchange rate, which was done at two levels. In 1992, a dual exchange rate system was implemented, consisting of a flexible fixed rate that aided in payment for exports and a fluctuating rate for other transactions. This rate was determined by the supply and demand for foreign exchange. In 1993, the dual exchange rate system was replaced by a single exchange rate system which was fully dictated by market forces. The permitting system was abolished first and quickly applied to intermediaries and capital goods. However, the corporation continued to apply this to consumer goods. During this time, a significant step was also taken to reduce import-export duties.

The liberalization of the economy means freeing the economy from the direct and real invitations of the government. Before 1991, the government had implemented various types of controls on the Indian economy, such as industrial permits, price control, and registration of large investments by big industrialists. Later, the government realized that these controls were having a negative impact on the economy. This was discouraging industrialists from investing in their industries. These controls have given rise to diseases such as corruption, delays, and inefficiency, which have slowed the pace of economic growth. This has led to high costs in the economic system. Economic reforms aimed to reduce these controls imposed on the economy.

MEASURES TAKEN FOR LIBERALIZATION.

- 12 Abolition of industrial licensing and registration
- 13 Liberalizing the MRTP Act.
- 14 Freedom in expansion and production.
- 15 Increase in the investment limit of the small scale industries.
- 16 Freedom to import capital goods.
- 17 Freedom to import technology.
- 18 Free determination of interest rates.
- 19 Tax reforms

3. Privatization- In the context of economic reforms privatization means following the private sector to setup more and more of such industries as were previously reserved for the public sector. under i t, existing enterprises of the public sector are either wholly on partially sold to private sector. Privatization is the general process of involving the private sector in the ownership or operation of a state owned enterprise. Need for privatization was felt mainly because of the in- efficiency of the public sector. Most of the enterprise of the public sector was running into loss. The main reason behind it was that the managers of public sector enterprise were not free to take decision independently

In 1990, this process was adopted in a limited manner, which was appreciated. The need for this became serious when there was a necessity to increase resources from the budget, and this was done solely by selling the shares of public enterprises to minority investors. However, the primary objective was to increase government revenue. Yet, there was also a belief that bringing in private investors could advance the management of public enterprises beyond a commercial mindset.

In the context of economic reforms, privatization refers to the establishment of more and more enterprises by the private sector that were previously reserved for the public sector. Generally, privatization is a process through which private ownership and operations begin to take place in public sector enterprises. The need for privatization was felt due to the inefficiency of the public sector. Most public sector enterprises were operating at a loss. A major reason behind this was that managers of public sector enterprises did not have the freedom to make decisions.

The first two privatizations, which involved changes in management, were completed in 1999/2000 and sparked significant controversy. The company's workers took the matter to court, claiming that the privatization was illegal, and many non-governmental organizations opposed the government's decision to privatize, along with various other institutions and individuals. However, when the principles were established and some enterprises were privatized, the government faced internal opposition regarding the transfer of certain public sector petroleum enterprises into private hands.

The implementation of the second round of reforms faced specific challenges that were relatively complex. This was observed in India when privatization was allowed in the infrastructure sector, such as electricity generation and distribution, telecommunications, and roads. The year 1990 witnessed that there was a significant gap in India's infrastructure, and this gap could not be filled solely by investing in public sector enterprises. Infrastructure services were traditionally provided by state-owned suppliers, who charged very low fees. Therefore, they were unable to raise the necessary resources. The government's fiscal situation was such that it could not address the resource shortfall, making policy changes essential.

MEASURES ADOPTED FOR PRIVATIZATION:

Following are the measures adopted in the respect of privatization under

- a. Contraction of the public sector

- b. Disinvestment in current public sector enterprises
- c. Sale of shares of public sector enterprises.

GLOBALIZATION:-

Globalization refers to the integration of a country's economy with the economies of other countries through the free flow of trade and capital, along with the free movement of human capital. Globalization can be defined as a process related to promoting openness, increasing economic interdependence, and broad economic integration in the world economy.

In business and economics, marketing expert Theodore Levitt first used the term 'globalization' in his 1983 article titled 'Global Marketing'. Globalization has led to a significant use of currency and involves various stakeholders. It has occurred and will continue to be an effective force shaping the world economy. Its existence and importance have changed considerably. A general policy shift, which has a greater reliance on market forces, is a fundamental basis of contemporary globalization. Gradually, by the end of the 1980s, a remarkable reflection was seen in the world economy, characterized by rapid growth in multidimensional trade and global capital flows (including foreign direct investment). The long-term growth rate of foreign direct investment (FDI) was almost double that of multidimensional trade, which in turn was double the growth rate of the world GDP. In the current phase of globalization, the fields of multidimensional trade and financial services have become so developed and broadly integrated on a global scale as they had never been before. The characteristics of globalization are as follows:-

- Due to modern containerization and inexpensive air services (on an international level),
- transportation costs in international trade have continuously decreased.
- With a sharp increase in foreign direct investment, there has been significant growth in the activities of transnational enterprises.
- In response to globalization, there has been a drastic change in the behavior and production organization of companies of all sizes.
- There are completely new ways of conducting trade and production networks, etc.
- The novelty of information communication technology is a new driver of globalization that is responsible for the ongoing changes in the global economy.
- The radical improvements in value chain and supply chain management have

not only altered manufacturing processes but also resulted in a reduction in production costs

- In contemporary globalization, there has been an expansion in the types of goods and services that are tradeable.
- There is fierce competition among all industrial and business houses to go international, and due to political disruptions, there are no longer any obstacles in the field of trade.

MAIN COMPONENTS OF GLOBALIZATION OF INDIAN ECONOMY ARE AS UNDER: -

1. Increase in Equity limit of foreign investment
2. Partial convertibility of Indian rupee.
3. Long term Trade policy.
4. Reduction in tariffs.

12.4 POLICY MEASURES OF SECOND PHASE OF ECONOMIC REFORMS

Following are the Major Areas of the Second Phase of Economic Reforms in India:

5) Fiscal Policy Reforms: An assessment of sequences in economic reforms led to the conclusion that fiscal stability is a prerequisite for the success of economic reforms. The Indian economic reforms were built with exactly this thinking, and fiscal stability was prioritized in these programs. In the initial stage of reform, when the current account deficit was at its peak and inflation was in double digits.

Since the 1980s, the central government's fiscal deficit continued to widen and reached its peak at 8.4 percent of the Gross Domestic Product in 1990-91. If we account for the fiscal deficit of state governments, this government fiscal deficit was 10 percent, which was certainly not sustainable. It was necessary to reduce the central government's fiscal deficit to implement reforms. In the first year of the reforms, a significant reduction in the fiscal deficit was observed; in 1990-91, the deficit was 8.4 percent of GDP, which decreased to 5.9 percent in 1991-92 and further to 5.7 percent in 1992-93. The reduction in the fiscal deficit achieved in the first two years resulted from well-planned reforms that permanently strengthened the fiscal position. For example, in 1991-92, the export duty concession was abolished, and in 1992-93, the subsidy on fertilizer was reinstated. Other significant changes included

the announcement that enterprises running at a loss in the public sector would not receive any assistance/loans from the central government's budget. The improvement/growth in the fiscal situation in the first two years was also achieved by cutting/restricting development expenditures, which included spending on social and economic infrastructure. Despite these limitations, the success achieved in strengthening the fiscal condition in the first two years was remarkable, reducing the fiscal deficit to 2.7 percent of the gross product. In this context, the management of reforms in the first two years was as expected.

This process of strengthening the fiscal position continued in the third year of reforms, in which there was hope to reduce the fiscal deficit to 4.6 percent of the gross domestic product. However, in the third year, there were some fluctuations in this target, and in 1993-94, the fiscal deficit was 4.3 percent of the gross domestic product. Part of the fluctuations (approximately 1 percent of the gross domestic product) was due to a decrease in tax revenue when compared to the budget. Despite a significant reduction in import duties and leniency towards imports in structural adjustments, imports were significantly lower than expectations. As a result, the revenue received from import duties was significantly lower compared to the budget. Revenue from excise duties was also much lower than expected because industrial production did not grow as fast as hoped. The remaining fluctuations (approximately 1.7 percent of gross domestic product) occurred due to government spending exceeding targets. The prices of food grains in the public distribution system required the government to provide higher food grain subsidies due to delays in these adjustments, which were more than expected, and the expenditures made for development were also significantly higher than the targets. Some of this happened because there was a large flow of resources in the form of aid for state development at this time. To some extent, excessive spending caused pressures that lasted for two years while the fiscal situation was strengthening, making it difficult to extricate from this.

It is also true that the situation that existed in 1993-94 due to excessive spending became somewhat bearable in 1994-95 because the economy was struggling with underutilization of resources and full utilization of equity was not being achieved. The investment in the public sector, especially by the states, was withdrawn for fiscal reasons, and investments from the private sector were also curtailed to some extent. This was because corporations were readjusting their investment plans according to a new and competitive environment.

In 1993-94, the increase in the fiscal deficit, contrary to expectations, was certainly a reason that needed attention; the experiences of various developing countries provide numerous examples where reform methods were prematurely reversed due to fiscal conditions. The government was aware of this issue and indicated that the deviation from the process of strengthening the fiscal situation in 1993-94 was a stopgap measure and that we would return to the old process in 1994-95. Accordingly, the fiscal deficit target for 1994-95 was set at 6.9% of the gross domestic product, which was significant and corrective compared to the actual situation in 1993-94.

In the 1994-95 budget, another important initiative was announced that there would be a predetermined limit on the monetization of government deficits, which did not exist before, allowing the government to borrow from the Reserve Bank without any limits. It has now been proposed that the loans/borrowings taken by the government from the Reserve Bank...

There will be a limit to which the Reserve Bank can sell or auction treasury bills in the market. The government adopted various fiscal measures to reduce the fiscal deficit from 8.4 percent of GDP in 1990-91 to 5 percent in 1996-97 and to 3.7 percent in 2006-07. To achieve this goal, the government imposed various controls on public spending and made efforts in various ways to increase tax revenue and other income. Other measures included adherence to fiscal discipline by the state and central governments, reduction of subsidies, development of a more efficient spending system, encouraging state governments to improve the utility of state enterprises, especially state electricity boards and state transport corporations, eliminating budgetary support to public sector enterprises, and enhancing their profitability and efficiency.

6) Monetary Policy Reforms: The government pursued a restrictive monetary policy for reducing inflationary pressures and also for improving balance of payment position

Monetary policy refers to a policy that is directly related to the supply of money. Issues related to monetary policy include: objectives and goals of the policy, instruments of monetary control, its efficiency, implementation, medium-term goals of the policy, etc. India's monetary policy was 'controlled expansion' from the very first five-year plan. It was a policy that prioritized financial and price stability for economic development. Therefore, the Reserve Bank assisted in increasing the economy by supporting the expansion of money and lending, and in controlling inflation through monetary and other controls.

Economic reforms, which were expected to have a long-term impact on the economy, included fiscal, monetary, financial, industrial, and import-export policy reforms. The aim of reforms in monetary and lending policy was to reduce monetary expansion and thereby control inflation. The initiative for reforms in the financial sector was based on the recommendations of the Narasimham Committee. The reduction in the statutory liquidity ratio, the reduction in the cash reserve ratio (CRR), and giving banks the authority to determine interest rates on deposits marked the beginning of the first phase of economic reforms. The money market helps in the implementation of monetary policy in the country. Certain significant factors contributed to the development of the money market in India. First, it gradually allowed the cash reserve ratio to become insignificant as an instrument of monetary policy (CRR); second, the development of tools for indirect monetary control such as bank rate and liquidity adjustment facility (LAF); third, the growth of currency and foreign exchange markets. The shape of monetary policy is determined. Therefore, in the period following economic reforms, the economy restructures itself while implementing new programs and policies.

7) Pricing Policy Reforms: In order to reduce budgetary provision for subsidies and to promote a more flexible price structure, the government increased the administered prices of various commodities and inputs and gave greater freedom to public sector enterprise to set prices as per market forces.

The main areas of the pricing policy were as follows: - -

- To maintain a minimum support price for agricultural products. –
- To provide food security for the poor in the form of cheap food grains and supply other essential goods through public distribution system shops. - To gradually allow price determination according to the free market system for food grains and essential items. –
- To maintain less control over critical sectors such as cement, steel, and capital goods and gradually liberalize them. - Strict control over drug- prices.
- To encourage competition in the telecommunications sector.

Though late, a policy was implemented for the free market price determination system for petroleum products, which allowed enterprises to determine their prices without governmental intervention

In the new term, OMC was freed to determine retail prices based on the import parity pricing formula and under the supervision of the petroleum sector regulator.

Domestic refining and retail space were also opened up for the private sector. The aim was to ensure significant private sector participation in the retail sector in India, such as Reliance, LPG, and kerosene being important as cooking fuel and to assist the poor class of India, the provisions of subsidies in the government budget were restructured, though it was supposed to end by 2005 and 2007 (but it has still not ended). During the new pricing policy period, it was expected that there would be fluctuations in the retail prices of petroleum products.

8) External policy reforms:- The government introduced stabilization and import compression measures in order to reduce the current account deficit in balance of payments to

2.1 percent of GDP in 1991 - 92 and then to 2 percent of GDP in 1992 – 93

The following points illustrate the history of foreign exchange management by India:-

- 1947 (when India became a member of the International Monetary Fund) - the rate of rupees and pounds on October 28, 1945.-
- September 18, 1949: The pound was devalued and the rupee achieved parity with the pound.-
- June 6, 1966: The dollar was devalued; post-devaluation the rate was Rs 7.50 per \$1..
- On November 18, 1967, the UK devalued the pound and India did not devalue.
- August 1971: The rupee was linked to gold and the dollar. This period was marked by an international financial crisis.- December 18, 1971: The dollar was devalued.-
- December 20, 1971: The rupee was pegged to the pound sterling.-
- 1971-79: Due to India's import substitution policy, the rupee became overvalued
- June 23, 1972: India maintained a stable exchange rate with the pound.-
- 1975: India linked the rupee to a currency basket (of major trading partners). Although this basket underwent changes over time, this relationship remained until the devaluation in 1991.
- July 1991: The rupee was devalued by 18-19 percent. March 1992: The dual exchange rate liberalized exchange rate management system came into existence.

- March 1993: A single exchange rate was implemented, \$1 = 31.37.
- 1993-94: The rupee was freed for exchange for trade but not for investment.

9) Industrial Policy Reforms: In order to make necessary reforms in its industrial policy the government introduced its new industrial policy on July 24, 1991. Various measures under industrial policy reforms include –(a) abolition of the scheme of industrial licensing for all industrial projects excepting 18 industries related to security, strategies or environmental concerns etc. (b) dereservation of the area of public sector from 17 to 8 industries in order to open up area of investment for the private sector, (c) elimination of the system of pre-entry scrutiny of

investment decisions of the MRTP companies and controlling only “ unfair or restrictive business practices (d) liberalization of location policy (e) abolition of phased manufacturing programmes earlier enforced to increase the face of indigenization and removal of mandatory convertibility clause.

10) Foreign Investment Policy Reforms:- the new industrial policy, 1991 made provision for increased flow of foreign investment in connection with technology transform, marketing expertise and introduction of modern managerial techniques. Accordingly, the new policy included 34 priority industry in annexure ii i to give automatic permission for foreign divest investment up to 51 percent forging equity. In respect of foreign technology agreement, automatic permission will be provided in high priority industry for upto 5 percent on domestic sales, 8 percent on export sales or a maximum payment of ₹ 1 core. More over in under to promote exports of Indian commodities in international market foreign trading companies are also allowed to raise their foreign equity holdings upto 51 percent in export activities.

11) Public Sector Policy Reforms:- Considering the huge amount of losses incurred by a good number of public sector enterprises, the government has taken various policy measures of making necessary reforms of public sector. these policy measures include. (a) reservation of list of industries under public sector reduced to 8 as against 17 industries reserved earlier (b) review of those public investments be made in to avoid

those areas where social consideration are not so paramount and where private sector investment would be more efficient (c) enterprises earning higher profit and judged appropriate will be provided with much higher degree of management autonomy through the system of MOD (d) progressive reduction of budgetary support of public enterprise (e) inviting private sector participation to increase market competitiveness and also the competitive capacity of these public sector enterprises through disinvestment of part of equity of selected enterprises (f) referring the sick public enterprises part of to board for industrial and financial reconstruction (BIFR) for its rehabilitation, reconstruction or rationalization in the mean time, the government has taken decision to depressure the area of industries and thus reduced the number of industries reserved for public sector participation even in these 8 areas selectively. The government also allowed joint ventures with foreign companies. The government has also decided to invest 20 percent of the equity of public enterprises to selective private sector enterprises. Accordingly in 1991 - 92 and 1992 - 93 ₹ 3038 and ₹ 1866 crore respectively were through disinvestment of PSE shares in 1993 - 94 the government has plan to mobilize ₹229 crore against the targeted amount ₹3500 crore and in 1994 - 95, the government plans to mobilize ₹4000 crore through disinvestment of PSU shares but it realized ₹ 5237 crore. A national renewal fund has also been created for training and re-deployment of workers and also to provide voluntary retirement compensation.

12) Trade Policy Reforms:- In contexts globalization of the economy and also to Promote international integration of our country, phasing out of excessive and indiscriminate protection given to domestic industry become necessary. This would develop a vibrant export sector and create a regime of price based system. The main objective is to eliminate progressively the system of licenses and quantitative restrictions, particularly for capital goods and raw materials so that these items can be placed easily on open general license (OGL). The new policy made provision for reduction of the scope of the public sector monopoly sharply for most export items and also a good number of import items. In this context the government has introduced export import policy, 1992 - 97 and 1997 - 2002 for the coming five years and on 13th April 1998 the

government has further modified this new EXIM policy (1997 - 2002) and also announced its annual EXIM policy, 2000 - 01 and also in 2001-02, Again on 31 March 2002 the government announced its new EXIM policy 2002 -07 so as to achieve 1 percent share in global export by 2007.

13) Social Policy Reforms:- Social policy refers not to a single policy but to a network/group of policies related directly and indirectly to the development of the economy. It includes institutions, programs, and policies that monitor the social arrangement/status of economic activities. Broadly, it also includes the social relations of capital and labor. In developing countries, it is understood as the social relations of capital and labor for the management of development projects. However, towards the end of the twentieth century, it was defined as projects aimed at economic development and the physical welfare of citizens through governmental agencies. Many developing countries, including India, have not been completely successful in

14) achieving the goals of these projects. To meet the objective of poverty alleviation as a part of our adjustment process the government allocated a higher amount of outlays on elementary education, rural drinking water supply, assistance to small and marginal farmers, programmes for the welfare of scheduled caste and scheduled tribe and other weaker section for the society. Programme for women and children and also on introduced a national social assistance scheme in the form of housing assistance, old age person, maternity benefits, group insurance for schemes etc. for these living below the poverty line

12.5 PERFORMANCE OF INDIAN ECONOMY DURING ECONOMIC REFORMS- AN EVALUATION

Economic reforms have completed 18 years as on 31st March 2009. The performance of Indian economy during reforms can be reviewed as under:

1. Growth of GDP: The annual growth rates of GDP at factor cost was 5.3 percent in 1990 - 91 it fell down to 4.4 percent in 2000 - 01 and rose to 9.6 percent in 2006 - 07 growth rate of agriculture, during the same period was 4.5 percent, 0.0 percent and 4% of industry it was 6.7 percent, 6.8 percent and 11.5 percent and of services it was 7.7 percent, 5.7 percent and 11.2 percent respectively. In recent years, despite the recession caused by

the international financial crisis of 2008-09, the Indian economy responded robustly to fiscal and monetary stimuli, achieving growth rates of 8.6 percent and 9.3 percent in 2009-10 and 2010-11, respectively. However, inflationary trends were observed in the economy, and the Reserve Bank of India raised rates in March 2010. Increased rates and policy hurdles adversely affected investment, and in the following two years, the growth rates slowed to 6.2 percent and 5 percent in 2011-12 and 2012-13, respectively. Nevertheless, the compounded annual growth rate (CAGR) of factor costs for the decade ending in 2012-13 was 7.9 percent for Gross Domestic Product (GDP).

2. Foreign Direct Investment:- A significant indicator of the benefits/accomplishments gained from economic reforms is that the Indian economy attracted a considerable amount of global investment during the reforms, resulting in an increase in both Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) in India. During the 2000s, there was good growth in the flows of both types of investment. According to the economic survey by the Ministry of Finance, India attracted approximately 4 billion US dollars in Foreign Direct Investment in the year 2001-02. Most of this investment was in infrastructure sectors such as energy and telecommunications.

Economic reforms have led to rapid increase in foreign direct investment and foreign exchange rate. The foreign direct investment (FDI) has increased from about US \$ 107 million dollars in 1990-91 to US\$ 22 078 million dollar in 2006-07. There has been increase in foreign exchange reserve in India from 11,416 crores in 1990-91 to Rs 8, 68, 222 crore in 2006-07. Due to a decrease in total exports, there was pressure on India's balance of payments, with total capital flows reducing to 40 billion dollars in 2012-13, down from 43.5 billion dollars in 2011-12. The total foreign direct investment in India decreased or declined, but some portfolio flows, which included foreign institutional investments, increased. According to initial estimates, the internal flow in the third quarter was projected to be 9.9 billion dollars, compared to only 5.8 billion dollars in the second quarter.

1) Impact on Employment: in the field of employment the economic reforms have not generated sufficient employment opportunities in the country. The average daily number of workers at works in 1990-91 were 8,431 thousand this number came down to 7,870 thousand in 2003-04 in

selected industries. The increasing picture of employment today also indicates signs of improvement in the future. Some key points about the current situation of employment are as follows:

- In 1999-2000, 7.32 percent of workers were unemployed. Overall, the number of unemployed was 16.58 million. This number of unemployed included those whose labor time was not fully utilized or was underutilized, but did not include those underemployed workers who were engaged at low levels of productivity. The share of the poor in the employed population was as high as it was in the total population of the country, which indicated that employment generation was more significant at low and high-low levels.
- Only 8 percent of total employment was generated in the organized sector and more than approximately 90 percent from activities of the unorganized sector. Most workers were excluded from social security and could only receive limited amounts of institutional and other assistance.
- The skill and educational level of the present workers were extremely low.

4. Impact on agriculture: Economic reform have not proved beneficial to agriculture as expected, rather here growth rate has slowed down. The public investment in agriculture or has been reduce in the reform period, particularly in infrastructure like irrigation, power, roads, market linkages and research and extension (which played a pivotal role in the green Revolution). Again the removal of fertilizer subsidy has led to increase in the cost of production, which has severely affected to small and marginal formers. Further with the coming into picture of WTO agriculture sector has been facing a number of policy changes such as reduction in import duties in its production removal of minimum support price and lifting of quantitative restrictions on agriculture product. All these have adversely affected the Indian farmers as they have now to face increase global competition. Besides, this on account of export oriented policy strategy in agriculture, there has been a shift from production for the domestic market towards production for the export market emphasizing on cash crops in lieu of production of food grains. This puts pressure on the prices of food grains and it has actually happened now.

3) Impact on Industry :- Economic reforms, in industry too, have not shown encouraging results. Industrial growth has recorded a slow down.

This has happened on account of diminishing demand of industrial products due to various reasons such as cheaper import, inadequate investment in infrastructure particularly in supply of power etc. Due to globalization the under development countries are compelled to open up the doors of their economics to greater flow of goods and capital from developed countries rendering their industries un-safe to imported goods. Cheaper import has reduced the demand for domestic goods. The manufacturers in the domestic market are facing stiff competition from imports. The free movement of goods and services due to globalization from foreign countries has adversely affected the local industries and employment opportunities in under developed countries. Further the under developed country, like India, still does not have access to the market of developed countries due to high not tariff barriers. For instance, although quota restrictions on exports of textile and clothing have been removed from India's side, but U.S.A. has not removed their quota restrictions on import of textiles from India and china, which has resulted a decline in export.

4) Impact on Disinvestment:-In India, the government fixes a target for disinvestment of public sector undertaking (PSUS) every year. For example, in 1991- 92 the target was to mobilize ₹2,500 crore though disinvestment but the government was able to mobilize ₹3,038 crore than the target. In 2004 -05 it was targeted to mobilize ₹4,000 crore but actual realization was ₹2,765 crore. Critics are of the opinion that the assets of PSUs have undervalued or under estimated and sold to the private sector . This implies that there has been a substantial loss to the government. Moreover, it may be mentioned that money realized from disinvestment has been used to offset the shortage of government revenue rather than using it for the development of PSUs and building social infrastructure in the country.

7. Impact on Fiscal Policies: Economic reforms have also not shown encouraging result on the fiscal policy of country. These have placed limits on the growth of public expenditure, especially in social sectors. The objective of the reforms was to get larger revenue and curb tax evasion by tax reduction but has not resulted in increases in tax revenues for the government. The reform policies of the government involving tariff reduction, have also curtailed scope for raising revenue through custom duties. Tax incentives were provided to foreign investors so as to attract foreign investment in country. This step has further reduced the scope for raising tax revenues. All this has shown a negative impact on the development and welfare expenditures.

In short, economic reforms were initiated in July 1991. A period of 16 years have elapsed since then. During this period, several objectives of economic reforms have been achieved. However, these reforms could neither alleviate poverty nor reduce unemployment. The main idea behind adopting these reforms was

to reduced deep-rooted inequalities in India society, but externally guided and advised this new economic policy packa ge has further enhanced the inequalities. Further, it has increased the income and quality of consumption of only high income groups and the growth has been concentrated only in some selected areas in the service sector such as telecommunication, information technology, finance, entertainment travel and hospital services real estate and trade rather than vital sectors such as agriculture and industry which provide livelihood to millions of people in the country. It is therefore, imperative that policies relating to these reforms should be so modified into help eradicate poverty reduce inequality and minimize unemployment.

12.6 ARGUMENTS IN FAVORS OF ECONOMIC REFORMS:

Following are some of the important arguments advanced in favuor economic reforms:

12 In India ways fixation has no link with productivity suggested that ways must be equal to manageable productivity of labour. Lobour market in India is having dual character, representing organized labours enjoying securely and high ways and unorganized worker, on the other hand

which remained exploited, totally defenseless and poor. Thus, in this contest economic reforms through its market mechanism will either improve productivity of workers surface closure or exit by the employer concerned.

13 Public sector enterprises in India are facing the problem of how Inductivity and poor rates of return due to high overhead costs, over staffing, wastage of raw materials and inputs wrong pricing policies and loss of work culture among highly unionized workers. In order to make necessary remedy to these problems of PSEs, economic reforms will play a way important role.

14 The country is facing a huge growth of non- plan expenditure particularly due to its ever increasing expenditure on

Defense, subsidies and interest payment. The economic reforms have made an attempt to reduce this increasing trend is non- plan expenditure through withdrawals of subsidies on food, fertilizers, export and even on higher education.

15 The current economic reforms in ideally made provision for increased flow of foreign direct investment which would help the country to modernized its technology and also for increasing its productivity.

16 As the country become much dependent on domestic borrowing and deficit financing for financing its expenditure, this has resulted in a huge debt burden as well as a high rate of inflation in the country. The current economic reforms have made sincere attempt to reduce the dependence on domestic borrowing and deficit financing.

17 India has been experiencing maintenance of persistent fiscal deficit in its annual budget resulting in inflationary pressure in the country. The current economic reform have made a sincere attempt to contain fiscal deficit and thereby become successful in containing the inflationary spiral in the price level.

18 The new economic reforms have saved the industrial sector from unnecessary regulation and control of the government.

19 The current economic reforms have become successful to simplify and rationalize the entire tax structure of the country.

20 Foreign exchange is now flowing through legal channels in sample quantities instead of through howl transaction as earlier.

12.7 ARGUMENTS AGAINST ECONOMIC REFORMS:

- 1) The first important criticism raised by critics against new.
- 2) The fiscal deficit maintained in the budget yet been controlled.
- 3) In respect of cut on subsidies whatever success was achieved in early years that could not gain its momentum in the later two years i.e. In 1992 - 93 and 1993 - 94. Government has failed to formulate a fresh policy for redirecting the food subsidy from the creamy layer and urban middle class of the society to the poorer sections.
- 4) Another criticism raised against the economic reforms of unemployment arising out of large scale retrenchment of workers. Thus both the public sector, on the plea of over staffing and redundancy and private sector, on the plea of modernization and technological up gradation, workers are gradually being retrenched or forced to accept voluntary retirement scheme like 'Golden Handshake'
- 5) Another point of criticism raised by the critics against the policy reforms is that the new economic reforms are a complete surrender to the world bank IMF precepts and the government has surrendered its sovereignty in order to procure a huge amount of loan from such international agencies.
- 6) Another criticism connected with economic reforms is related to its organization reforms while implementing the reformers programmes whatever changes suggested by the finance minister can also be thwarted by R.B.I. nothings.

It has been observed that in India there are three weakest links in economic reforms of the country. Firstly, the government has failed to take into confidence the organised workers at any stage of the implementation of economic reforms. Economic reforms have failed to garner supports from the organized workers in general. Similarly, there are two areas i.e. agriculture and infrastructure which along with worker constitute a trinity of weakest links in the process of economic reforms of the country. Thus government should play due attention for handling these three weakest link the workers, agriculture and infrastructure so as to reap optimum benefits from economic reforms.

12.8 Summary

Economic reforms refer to all those measures which aim at rendering of economy more efficient, competitive and developed. This unit includes the various aspects of economic reforms of 2nd phases. This includes, objectives, features, measures, impact an in economy and Indian economy during the reform period –II phase's economic holdout important for the country's economy but it does not mean that each and every economic decision must be left completely to the freedom of market . Such a decision may face conflict in realizing the objectives of growth with equity. Thus the crusade of the problem is to attain a balance between conflicting objectives and to make necessary reconciliation between objectives of increasing competitiveness for efficiency and equity.

12.9 GLOSSORY

Economic Reforms: Economic reforms refer to all those measures which aim at rendering the economy more efficient, competitive and developed.

Liberalization: It means free the economy from direct or physical controls imposed by the government.

Privatization: Privatization in general process of living the private sector in the ownership and management of a public sectors enterprise.

Fiscal reforms: Fiscal reforms refer to increasing government revenue receipts and reducing public expenditure In such a manner as not to adversely affect production and economic welfare. Main objectives of reforms are to reduce fiscal deficit or government.

Globalization: Globalization means integrating the economy of a country with the economies of other counties under condition of free flow of trade and capital, and movement of persons across the border.

Financial Reforms: These refer to reforms in the monetary and banking policies of the country. Main objectives of financial reforms is to provide credit or loans to productive sector at low rate of interest.

taxes on individual incomes as it was felt that high rates of income tax were an important reason for tax evasion

12.10 COMPREHENSIVE QUESTIONS

Fill in the blanks:

- 1) In 1993, the dual exchange rate system was replaced by a single exchange rate system that was entirely determined by
- 2) due to inefficiency felt the need for privatization.
- 3) means the integration of a country's economy with other countries' economies under the conditions of free flow of trade and capital, and free flow of human capital.
- 4) refers to a policy that is directly related to the supply of currency.

12.11 ANSWER OF UNDERSTANDING QUESTIONS

1. Market forces 2. Public sector 3. Globalization 4. Monetary policy

12.12 SELF ASSESSMENT QUESTIONS

- What do you understand by GDP and FDI?
- What impact did economic reforms have on employment, agriculture, and industries?
- What was the state of the Indian economy during the era of economic reforms?
- Provide arguments in favor of economic reforms.
- Provide arguments against economic reforms.
- What do you understand by economic reforms?
- Highlight the role of liberalization, privatization, and globalization in the Indian economy.
- Explain the different types of economic reforms.
- Explain the objectives of economic reforms.

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UNIT-13 INDUSTRY POLICY & INDUSTRY LICENSING

BLUE PRINT OF UNIT

- 13.1 Introduction
- 13.2 Industrial Policy 1948
- 13.3 Industrial Policy 1956
- 13.4 Industrial Policy 1977
- 13.5 Industrial Policy 1980
- 13.6 Industrial Policy 1991
- 13.7 Industrial Licensing
- 13.8 Summary
- 13.9 Glossary
- 13.10 Comprehensive Questions
- 13.11 Answers to Comprehensive Questions
- 13.12 Self-Evaluation Questions
- 13.13 Book References

Objective

- After studying this unit, you will be able to –
- Explain industrial policy.-
- Explain the key points of various industrial policies.-
- Classify accounting information.-
- Describe industrial licensing.

13.1 INTRODUCTION:-

Industrial policy of any country reflects the growth and development of that country as the economic environment is largely influenced by the industrial production. The term 'industrial policy refers to all objectives, principles, rules, regulations and procedures concerning the industrial development, location and functioning of industrial

establishments, ownership pattern of industries, rate of growth of industries in the country. It also describes the government policy towards foreign capital, labour, tariff and other related aspect. It also indicates the respective area of large, small and medium scale sectors.

Industrial policy indicates the relationship between government and business and is therefore considered as the most important documents of the country. It gives clear guidelines for promoting and regulating industries. Therefore, it shapes, guides, fosters, regulates and controls the industrial development of that country. The industrial policy is not an act and hence the violation of it cannot be challenged in a court of law.

Meaning: Industrial policy is a statement which defines the role of government in industrial development. The place of the public and private sectors in industrialization of the country. The relative role of large and small industries. The role of foreign capital etc. In brief, it is a statement of objectives to be achieved in the area of industrial development and the measures to be adopted towards achieving these objectives. The industrial policy thus formally indicates the spheres of activity of the public and the private sectors. It lays down rules and procedures that would govern the growth and pattern of industrial activity. The industrial policy is neither fixed nor inflexible. It is amended, modified and redrafted according to the changed situations, requirements and perspectives of developments.

The main points of the industrial policy are as follows:-

- It encompasses the rules, regulations, principles, policies, and systems made by the government for the regulation and control of the country's industrial establishments.-
- It describes the role of public, private, joint, corporate, large, medium, and small scale sectors in the development of industries.-
- It includes fiscal and financial policies, tariff policy, labor policy, etc.-
- It not only reflects external assistance but also the government's attitude towards the public and private sectors.

The main objectives of industrial policy are as follows - -

1. To maintain sustainable growth in productivity. –
2. To promote profitable employment. –
3. To prevent undue concentration of economic powers. –
4. To ensure optimal utilization of human resources. –

5. To achieve international competitiveness, and - To establish India as a major partner and power in the global landscape.

13.2 INDUSTRIAL POLICY, 1948

The summary of the important points of the Industrial Policy Resolution 1948 is as follows –

-

(1) The Government of India has seriously considered the economic problems of the country. –

(2) Consideration has been given to improving the economic conditions of the nation and the development of national assets.

(3) Discussions have been held regarding the issues related to state participation in industries and the circumstances under which private enterprises should be allowed to participate. –

(4) Based on the aforementioned, the government has decided that the production of arms and ammunition, generation and control of nuclear energy, and ownership and management of railway traffic will remain completely under the monopoly of the central government. –

(5) The regulation of electricity generation and distribution will be conducted by the Government of India. This industry will be regulated through licensing. –

(6) In addition to the above, other sectors will generally be kept open for private sector enterprises, individuals, and cooperatives.

(7) There are some fundamental industries that are important and need to be planned and regulated by the central government in the interest of the nation.

i. Cottage and small industries play a significant role in the national economy. - The government understands that the goal of achieving maximum production cannot be

accomplished merely through the division of industries between the state and the private sector. –

(8) The Government of India agrees with this perspective of the industry conference that while foreign investment and enterprise participation should be particularly accepted in terms of industrial technology and knowledge for the country's rapid industrialization, it is also necessary to carefully regulate the conditions under which they are participating in the Indian industrial sector in the national interest. –

(9) The Government of India is also fully aware of its direct responsibilities towards those industries that are deemed necessary to be fully secured as state enterprises.

(10) The Government of India is hopeful that after clarifying its intentions regarding the fundamental aspects of industrial policy, all confusion will be resolved and the path for industrialization in the nation will be paved through joint and intensive efforts.

Classification

- Defence and strategic industries such as manufacture of arms and ammunition production and control of atomic energy and ownership and management of railways were to be the exclusive monopoly of Central Government.
- In the case of basic and key industries such as coal, iron and steel, aircraft manufacture, ship building etc. all new units were to be set-up by the state while the old units were to continue to be run by the private entrepreneurs for the next ten years when the question of their nationalization was to be decided.
- Some industries were to remain in private ownership but subject to overall regulation and control by the government. Such industries included automobiles and tractors, sugar, cement, cotton and woollen textiles etc.
- Rest of the industries were to remain with the private sector where government were to exercise only an overall general control.

The role of State enterprise vis-à-vis private enterprise. The basic principle embodied in the policy was that State must play a progressively active role in the development of industries. It was, however, duly recognised that in the circumstances

then prevailing in the country, it was not advisable for the State to take over existing units and it was, therefore, decided to concentrate on new units and existing units already under its control. The private sector was to be properly regulated and directed and was assigned an important role in the situation then obtaining in the country.

1. **Allocation of industries to private and public sectors :** Keeping in view the broad principles enunciated above, the Policy Resolution divided the industries into the following four categories for the purposes of their allocation as between private enterprise and State enterprise

i) **Strategic and basic industries :** The manufacture of arms and ammunition, production and control of atomic energy, and the ownership and management of railway transport were made the “exclusive monopoly of the State”. These industries were even earlier, wholly in the public sector.

ii) **Basic and key industries :** These included coal, iron and steel, aircraft manufacture, ship-building, manufacture of telephone, telegraph and wireless apparatus, etc. The existing units in these industries were to be allowed to continue in the private sector for a period of ten years at the end of which the position was to be reviewed and the question of nationalization was to be decided, if necessary. As for the new units it was laid down that the State would be exclusively responsible for their establishment.

iii) **Private sector industries subject to control and regulation by the Government :** In this category were placed twenty important industries of the country which were to continue in the private sector though they were to function subject to control and regulation by the Government. These industries included heavy chemicals, sugar, cotton and woollen textiles, cement, paper, salt, machine tools, etc., all of which were considered important in the national interest.

iv) **The private and co-operative sector industries:** The rest of the industries not covered by any of the categories mentioned above were to be private enterprise-individual as well as co-operative-though they were to be under the general control of State.

2. **The rule of small-scale and cottage industries :** The Policy Resolution afforded due recognition to the importance of small-scale and cottage industries in the economy of the

country. It was visualized that they would be organised on co-operative lines and would be integrated and coordinated with large industries.

3. **Steps toward better Industrial relations :** In keeping with the recommendations of the Industries Conference of 1948, the Industrial Policy Resolution of 1948 accepted profit-sharing and other schemes meant to associate labour with the management of industry as steps in the direction of more cordial Industrial relations in the country.

The Industrial Policy resolution of 1948 laid down some guidelines for small –scale and cottage industries and foreign capital.

(i) **Roll of small-scale and Cottage Industries :-**

The Industrial Policy Resolution of 1948 emphasized on the development of small-scale and cottage industries because through the development of these, the development of the masses is possible. The development of small-scale and cottage industries will help to bring about decentralization of industries and of economic power.

(ii) **Attitude towards foreign capital :-** For making rapid industrial growth possible, the resolution of 1948 favoured foreign capital and enterprises. But the entrance of foreign enterprises was to be carefully regulated in the national interest. It was decided that the major interest, ownership and effective control of industrial establishment will be kept in Indian hands. The Industrial Policy Resolution 1948, thus, proposed a mixed economy and emphasized the entrepreneurial, promotional, regulatory and planning roles of the state in the industrialization of the country.

(iii) **Other important features of the industrial policy:-** The role of foreign capital in industrial development of the economy was recognized but the need for regulation and controlling it according to needs of the domestic economy was deemed essential. Therefore, it was stated that in those industries where foreign investment was to be done, Indians should have a major say in the ownership and management. The Resolution called for harmonious relations between the management and labour since this was necessary for industrial development. For this purpose, the Resolution enunciated a policy of just labour conditions wherein workers would be given fair wages. For purposes of maintaining industrial peace, labour participation in management was also stressed.

13.3 INDUSTRIAL POLICY, 1956

The industrial policy proposal of 1956 gave importance to various significant new topics.

- These proposals emphasize the economy to ensure continuous growth in production and its equitable distribution, and state that the government must play an active role in the development of industries.
- The government will have to take full responsibility for the establishment of new ventures in six fundamental industries. Planning has been initiated in an organized manner, and the first five-year plan has been completed.
- Parliament has adopted a socialist social order as the objective of social and economic policy.
- After Parliament accepted the objective of social and economic policy as a socialist social order in December 1954, these fundamental and general principles gained special emphasis. Like other policies, industrial policy will also be guided by these principles and directives.
- For the development of industrialization, especially heavy industries and machine manufacturing industries, it is essential to increase the rate of economic growth to expand the public sector and develop a large and developing cooperative sector.
- It is necessary to keep all industries of fundamental and strategic importance or public utility services in the public sector for the planned and rapid development of the nation and the establishment of a socialist society. In the classification of industries, first-class industries are those for which the future development will be fully the responsibility of the government.
- Second-class industries are those that will progressively come under government ownership.
- Industrial establishments in the private sector must necessarily align with the country's social and economic policy framework and will be subject to the control and regulation of the Industrial (Development and Regulation) Act and other related laws.
- While measures will be adopted to make industrialization beneficial for the country's overall economy, importance will also be given to gradually reducing various regional imbalances. —
- A managerial and technical class will be established in public services. An apprenticeship scheme will be implemented for large-scale training in public and private

sector enterprises, and business management training will be provided in universities and other institutions.-

- Measures will be implemented to improve the living and working conditions of workers and increase their efficiency.
- With the growing participation of public industry and trade, the way these activities are conducted and managed has increased their significance. Decentralization of rights and their management will be done according to the needs of trade.-
- The division of responsibilities between the central and state governments has been legally formalized.

The setting was favorable for the Industrial Policy, 1956. The country gave itself a Constitution which set out certain Directive Principles. Planning began to be implemented on an organized basis and the First Five Year Plan was already completed. Parliament accepted the socialist pattern of society as the objective of social and economic policy. The country's resources also increased and the governments drive in expanding the public sector as a means for rapid economic development to countervail economic concentration and removal of regional economic disparities gained momentum. These changes and developments necessitated a policy and then it was announced on 30th April, 1956.

Industrial Policy Resolution – 1956 The Industrial Policy Resolution - 1956 was shaped by the Mahalanobis Model of growth, which suggested that emphasis on heavy industries would lead the economy towards a long term higher growth path. The Resolution widened the scope of the public sector. The objective was to accelerate economic growth and boost the process of industrialization as a means to achieving a socialistic pattern of society. Given the scarce capital and inadequate entrepreneurial base, the Resolution accorded a predominant role to the State to assume direct responsibility for industrial development. All industries of basic and strategic importance and those in the nature of public utility services besides those requiring large scale investments were reserved for the public sector.

The Industrial Policy Resolution - 1956 classified industries into three categories. The first category comprised 17 industries (included in Schedule A of the Resolution) exclusively under the domain of the Government. These included *inter alia*, railways, air transport, arms and ammunition, iron and steel and atomic energy. The second

category comprised 12 industries (included in Schedule B of the Resolution), which were envisaged to be progressively State owned but private sector was expected to supplement the efforts of the State. The third category contained all the remaining industries and it was expected that private sector would initiate development of these industries but they would remain open for the State as well. It was envisaged that the State would facilitate and encourage development of these industries in the private sector, in accordance with the programmes formulated under the Five Year Plans, by appropriate fiscal measures and ensuring adequate infrastructure. Despite the demarcation of industries into separate categories, the Resolution was flexible enough to allow the required adjustments and modifications in the national interest.

Another objective spelt out in the Industrial Policy Resolution – 1956 was the removal of regional disparities through development of regions with low industrial base. Accordingly, adequate infrastructure for industrial development of such regions was duly emphasized. Given the potential to provide large-scale employment, the Resolution reiterated the Government's determination to provide all sorts of assistance to small and cottage industries for wider dispersal of the industrial base and more equitable distribution of income. The Resolution, in fact, reflected the prevalent value system of India in the early 1950s, which was centered around self sufficiency in industrial production. The Industrial Policy Resolution – 1956 was a landmark policy statement and it formed the basis of subsequent policy announcements. The main features of this Industrial Policy Resolution of 1956 were as follows:

1. Categorization of Industries :-

- In the first category will be industries the future development of which will be the exclusive responsibility of the State.

- The second category will consist of industries which will be progressively state owned and in which the State will, therefore, generally take the initiative in establishing new undertakings, but in which private enterprise will also be expected to supplement the efforts of the State.

- The third category will include all the remaining industries, and their future development will, in general, be left to the initiative and enterprise of the private sector.

2. **ROLE OF FOREIGN CAPITAL:-**

The industrial Policy, 1956 recognized the important role of the foreign capital in country's development. The foreign capital supplements domestic savings. Provides more resources for investment and relieves pressure on Balance of payments. The

country therefore welcomed inflow of foreign capital. But the 'Policy' made it clear that inflow of foreign capital will be permitted subject to the condition that major share in management, ownership and control should be in the hand of Indians.

3. INCENTIVES TO LABOUR :-

The Industrial Policy, 1956 recognized the important role of labour as a partner in the tasks of development. The 'policy' therefore put emphasis on the provision of adequate incentives to workers and improvement in their working and service conditions. It laid down that wherever possible the workers should be progressively associated with the management so that they are enthusiastically involved in the development progress.

4. IMPORTANT PLACE OF SMALL-SCALE AND VILLAGE INDUSTRIES:-

Since small-scale and village or cottage industries have an important place in the national economy, the state has reserved production of some goods exclusively for the small-scale industries. Small scale industries were also encouraged by providing direct subsidy and suitable taxation relief.

13.4 INDUSTRIAL POLICY, 1977

The industrial policy of 1977 can be understood with the help of the following key points: -

13 The growth rate of Gross Domestic Product (GDP) was insufficient to meet the needs of a developing economy. –

14 Unemployment increased, inequality between villages and cities grew, and the rate of real investment became stagnant. Incidents of industrial sickness rose, and some large industries were severely affected by this. –

15 The structure of industrial costs and prices had become distorted, and the expansion of industrial activities outside of major urban centers slowed down considerably. –

16 It was necessary to remove the previous obstacles to the new industrial policy in such a way that public aspirations could be fulfilled through a timely economic development program.

17 The deep interdependence between the agricultural and industrial sectors of our economy cannot be overly emphasized. –

18 The new industrial policy primarily focused on the extensive spread of cottage and small-scale industries in rural areas and towns. - Although the current definition of small-scale industries will remain, small-scale industries will particularly include very

small

19 The government will consider bringing special laws to protect the interests of cottage and small-scale industries.-

20 There will be an agency in each district to address all the needs of small and rural industries. This will be called the District Industry Center.-

21 To effectively provide economic support for the development of small rural and cottage industries, the Industrial Development Bank of India (IDBI) has taken steps to establish a separate division to meet the credit requirements of this sector.-

22 In the above sector, marketing of goods along with product standardization and quality control will be prioritized.

23 .

24 Khadi and village industries will develop comprehensive plans adopting modern management techniques for the development of these rural industries.-

25 Through Khadi, the needs of the people regarding textiles can be continuously fulfilled while developing the handloom sector.- The development and use of technology suitable for our socio-economic conditions will be an integral part of the policy.-

26 There will also be a clear role for large-scale industries in India. The role of large-scale industries will be linked to programs that meet the minimum needs of the public through the extensive distribution of small and rural industries and the empowerment of the agricultural sector.-

27 The growth of large corporations has been inconsistent compared to the size of internally generated resources and loans from public financial institutions and banks. This process must be reversed.-

28 In its licensing policy, the government will regulate the activities of large corporations in accordance with the nation's socio-economic goals.-

29 The role of the public sector will be expanded across various sections.- The future

industrial development of India will be orderly.

30 In the process of increasing technological self-reliance, the government will emphasize the continuous flow of specific and high-priority areas of technology.

31 The government's priority will be to acquire the best available technology and adapt it to the country's needs. Adequate research and development facilities need to be established so that imported technology can be adopted and assimilated.

32 Investment and acquisition of foreign technology essential for India's industrial development will only be permitted under conditions deemed necessary in the national interest by the Indian government.

33 Numerous industries have been established by Indian entrepreneurs in joint ventures with local partners in other developing countries. Given the current state of industrial development in the country, it is neither appropriate nor desirable to export capital from India. Therefore, joint ventures abroad should primarily be in the form of machinery and equipment, infrastructure, and technical knowledge and management expertise.

34 Self-reliance should be kept as a primary objective in the country's industrial and economic policies.

35 The changes that have occurred in our foreign exchange conditions and the progress we have made in the industrial sector have made the selective distribution of export quotas and quantitative restrictions feasible, while we need to continue the protections afforded by tariffs.

36 The government will positively consider proposals with export-oriented manufacturing capacity in internationally competitive investment sectors. When approving new industrial capacity, mandatory export obligations have been enforced in various cases, so that the payment for the import of raw materials and capital goods necessary for the project can be met from future exports. Acknowledging the importance of balanced regional development across the nation, the government has seriously recognized that any industrial development in our country since independence has been

concentrated in metropolitan areas and major cities. Requests will be made to state governments and financial institutions not to support new industries in these areas. Additionally, support will also be requested for existing large industries that wish to relocate from crowded metropolitan areas to designated locations in backward regions.

37 A robust price policy will be formulated aimed at achieving stability at appropriate levels of prices and establishing equality of prices for agricultural and industrial products.-

38 Family control over trade, especially in large industries, is a malpractise, and the government's policy must implement professional behavior in management.-

39 Cooperation in equality from shop level to large scale and active participation of labor in decision-making will provide a necessary environment for worker participation in industrial management.-

40 A persistent issue in the industrial sector in recent years has been the increasing impact of the malaise of large and small industries. Sick units that have been taken over but are still harmful need to be financed through public funds. This trend cannot be sustained continuously. In the future, management acquisition of units will be based on selection criteria and will only be undertaken after careful testing of the necessary measures to revive them.-

41 The government is making efforts to remove obstacles that arise in the process of industrial approval.

In March, 1977, the Janta Party comes into power replacing the congress Party at the center. According to the Janta Party Government, the Industrial Policy Resolution of 1956 which remained in operation for more than two decades has failed in many respects. Therefore, The Janta Party government announced its Industrial Policy Statement in December 1977 in the Parliament. The Janta Party Government was of the view that the Resolution of 1956 has failed in the development of small-scale industries. Large-scale Industrial uses were allowed to expand their business with the found of public-sector financial institution. Multinational companies were allowed to enter India and they took advantage of sheltered and protected markets of India. The Janta Party

government also maintained that the rural-urban disparities have widened, unemployment has increased, industrial sickness has become widespread and the rate of real investment has stagnated.

On the other hand, this statement emphasized decentralization of industrial sector with increased role for small scale, tiny and cottage industries. It also provided for close interaction between industrial and agricultural sectors. Highest priority was accorded to power generation and transmission. It expanded the list of items reserved for exclusive production in the small scale sector from 180 to more than 500. For the first time, within the small scale sector, a tiny unit was defined as a unit with investment in machinery and equipment up to Rs.0.1 million and situated in towns or villages with a population of less than 50,000 (as per 1971 census). Basic goods, capital goods, high technology industries important for development of small scale and agriculture sectors were clearly delineated for large scale sector. It was also stated that foreign companies that diluted their foreign equity up to 40 per cent under Foreign Exchange Regulation Act (FERA) 1973 were to be treated at par with the Indian companies. The Policy Statement of 1977 also issued a list of industries where no foreign collaboration of financial or technical nature was allowed as indigenous technology was already available. Fully owned foreign companies were allowed only in highly export oriented sectors or sophisticated technology areas. For all approved foreign investments, companies were completely free to repatriate capital and

remit profits, dividends, royalties, etc. Further, in order to ensure balanced regional development, it was decided not to issue fresh licenses for setting up new industrial units within certain limits of large metropolitan cities (more than 1 million population) and urban areas (more than 0.5 million population).

The main elements of this policy are discussed below:

ROLE OF LARGE SCALE OF INDUSTRIES :-

The Industrial Policy 1977 recognized the important role of large scale industries in economic development of the country and prescribed the following areas for their operation:

- i) Basic industries essential for building up infrastructure for industrial development of both large and small industries.
- ii) Capital goods industries for meeting the requirements of machinery of large as well a small industry.

iii) High technology industries where production has necessarily to be on a large scale and which help agricultural and industrial development such as fertilizers, petrochemical industries etc.

iv) Other industries not covered under the list items reserved exclusively for small scale sector.

2. EXPANDING ROLE OF THE PUBLIC SECTOR INDUSTRIES

The role of the public sector in the industrial development of the country was established in the policy. Public sector industries were trusted not only with the production of basic and strategic goods but also essential consumer goods. The public sector industries would be encouraged to develop ancillary industries and contribute expertise to small-scale industries.

3. FOREIGN CAPITAL INVESTMENT

Government has clarified in this connection that "In areas where foreign technological know-how is not needed, existing collaborations will not be renewed and foreign companies operating in such fields will have to modify their character and activities in conformity with national priorities within the framework of the Foreign Exchange Regulation Act."

13.5 INDUSTRIAL POLICY, 1980

The Congress (I) out geared the Janta Party in the General Elections of 1980 and assumed power at the center. The Congress (I) government announced its Industrial Policy on 23rd July, 1980. This policy is mainly based upon the 1956 Industrial Policy Resolution. The industrial Policy Statement of 1980 placed accent on promotion of competition in the domestic market, technological up gradation and modernization of industries. Some of the socio-economic objectives spelt out in the Statement were i) optimum utilization of installed capacity, ii) higher productivity, iii) higher employment levels, iv) removal of regional disparities, v) strengthening of agricultural base, vi) promotion of export oriented industries and vi) consumer protection against high prices and poor quality. Policy measures were announced to revive the efficiency of public sector undertakings (PSUs) by developing the management cadres in functional fields viz., operations, finance, marketing and information system. An automatic expansion of

capacity up to five per cent per annum was allowed, particularly in the core sector and in industries with long-term export potential. Special incentives were granted to

industrial units which were engaged in industrial processes and technologies aiming at optimum utilization of energy and the exploitation of alternative sources of energy. In order to boost the development of small scale industries, the investment limit was raised to Rs.2 million in small scale units and Rs.2.5 million in ancillary units. In the case of tiny units, investment limit was raised to Rs.0.2 million.

MAIN FEATURES OF INDUSTRIAL POLICY STATEMENT, 1980-

1. REVITALIZING OF PUBLIC SECTOR INDUSTRIES :- In the Industrial Policy Statement of 1980, the Government proposed to revitalize the public sector industrial units so that they could make a substantial contribution to the creation of the employment and financial surplus for the further growth of the economy. The Government also proposed to strengthen their management by developing management cadres in the fields of the finance, marketing, operations and information systems. Revival of loss-making public sector units by restructuring the system and by providing dynamic and competent management was also stressed by the government.

2. ROLE OF PRIVATE SECTOR:- Although the Statement stated that the growth of monopolistic tendencies or concentration of economic power and wealth in a few hands would be prevented, but even then the private sector was assigned an important role. The Policy Statement proposed that the private sector would be allowed to develop in consonance with targets and objectives of national plans and policies.

13.6 INDUSTRIAL POLICY 1991

The Government of India announced the New Industrial Policy on 24th July, 1991. The Industrial Policy Statement of 1991 stated that "The Government will continue to pursue a sound policy framework encompassing encouragement of entrepreneurship, development of indigenous technology through investment in research and development, bringing in new technology, dismantling of the regulatory system, development of the capital markets and increased competitiveness for the benefit of common man". It further added that "the spread of industrialization to backward areas of the country will be actively promoted through appropriate incentives, institutions and infrastructure investments. The objective of the Industrial Policy Statement - 1991 was to maintain sustained growth in productivity, enhance gainful employment and achieve optimal utilization of human resources, to attain international competitiveness, and to transform India into a major partner and player in the global arena. Quite clearly, the

focus of the policy was to unshackle the Indian industry from bureaucratic controls. This called for a number of far-reaching reforms:

- A substantial modification of Industry Licensing Policy was deemed necessary with a view to ease restraints on capacity creation, respond to emerging domestic and global opportunities by improving productivity. Accordingly, the Policy Statement included abolition of industrial licensing for most industries, barring a handful of industries for reasons of security and strategic concerns, social and environmental issues. Compulsory licensing was required only in respect of 18 industries. These included, *inter alia*, coal and lignite, distillation and brewing of alcoholic drinks, cigars and cigarettes, drugs and pharmaceuticals, white goods, hazardous chemicals. The small scale sector continued to be reserved. Norms for setting up industries (except for industries subject to compulsory licensing) in cities with more than one million population were further liberalized.

- Recognizing the complementarity of domestic and foreign investment, foreign direct investment was accorded a significant role in policy announcements of 1991. Foreign direct investment (FDI) up to 51 per cent foreign equity in high priority industries requiring large investments and advanced technology was permitted. Foreign equity up to 51 per cent was also allowed in trading companies primarily engaged in export activities. These important initiatives were expected to provide a boost to investment besides enabling access to high technology and marketing expertise of foreign companies.

- With a view to inject technological dynamism in the Indian industry, the Government provided automatic approval for technological agreements related to high priority industries and eased procedures for hiring of foreign technical expertise.

- Major initiatives towards restructuring of public sector units (PSUs) were initiated, in view of their low productivity, over staffing, lack of technological upgradation and low rate of return. In order to raise resources and ensure wider public participation PSUs, it was decided to offer its shareholding stake to mutual funds, financial institutions, general public and workers. Similarly, in order to revive and rehabilitate chronically sick PSUs, it was decided to refer them to the Board for Industrial and Financial Reconstruction (BIFR). The Policy also provided for greater managerial autonomy to the Boards of PSUs.

- The Industrial Policy Statement of 1991 recognized that the Government's intervention in investment decisions of large companies through MRTP Act had proved

to be deleterious for industrial growth. Accordingly, pre-entry scrutiny of investment decisions of MRTP companies was abolished. The thrust of policy was more on controlling unfair and restrictive trade practices. The provisions restricting mergers, amalgamations and takeovers were also repealed.

IMPORTANT POINTS OF INDUSTRIAL POLICY 1991

a. In the earlier industrial policy, industries were subjected to tight regulation through the licensing system. Through some liberalization measures were introduced during 1980's that positively affected the growth of industry. Still industrial development remained constrained to a considerable extent.

b. The new industrial policy abolishes the system of industrial licensing for most of the industries under this policy no licenses are required for setting up new industrial units or for substantial expansion in the capacity of the existing units, except for a short list of industries relating to country's security and strategic concerns, hazardous industries and industries causing environmental degradation. Through later amendment to the policy, this list was reduced. It now covers only five industries relating to health security and strategic concerns that require compulsory licensing. Thus the industry has been almost completely made free of the licensing provisions and the constraints attached with it.

1. CHANGES IN THE MRTP ACT:- According to the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, all big companies and large business houses (which had assets of Rs. 100 crores or more, according to the 1985 amendment to the Act) were required to obtain clearance from the MRTP Commission for setting up any new industrial unit, because such companies (called MRTP companies) were allowed to invest only in some selected industries. Thus, besides obtaining license they were also required to get MRTP clearance. This was a big impediment for industrial development as the big business firms which had the resources for development could not grow and diversify their activities. The Industrial Policy, 1991 has put these industries on par with others by abolishing those provisions of the MRTP Commission for their new projects. Under the amended Act, the MRTP Commission will concern itself only with the control of Monopolies and Restrictive Trade Practices that are unfair and restrict competition to the detriment of consumer's interests. No prior approval of or clearance from the MRTP

Commission is now required for setting up industrial units by the large business houses.

2. **FOREIGN INVESTMENT:-** From the very beginning, foreign investment in India was regulated by the Government. Thus for any foreign investment, prior approval of the Government was necessary. All these were resulting in unnecessary delays and thus hampered the decision-making in business. The new industrial policy thus prepared a specific list of high technology and high investment priority industries (Annexure III) in which automatic permission will be available for direct-foreign investment up to 51 percent foreign equity. The Annexure III included 34 priority industries, such as, metallurgy, boiler and steam generating plants, electrical equipment, telecommunication equipments, transportation, industrial and agricultural machinery, industrial investment, chemical, food processing, hotel and tourism industry.

13.7 INDUSTRIAL LICENSING

The Industrial Policy Resolution of 1948 emphasized that, "allowing private enterprise to play an important role in the industrialization of the country if should be properly directed and regulated." It was to vest the Government with necessary power to regulate and control the existing and new undertakings. The Industries (Development and Regulation) Bill was introduced in the Parliament in April 1949, which was finally passed as the Industries (Development and Regulation) Act, 1951.

The Act provided for a compulsory registration of all scheduled undertakings with the government within a specified period. The licenses should be obtained from the government by all new undertakings and by undertakings contemplating substantial expansion; that the government could order an investigation in respect of case of failure to carry out the directions issued after such investigation, the Government could take over the management of such industries of undertakings.

The five types of licenses provided in the act are:

- i. new undertakings,
- ii. substantial expansion,
- iii. the production of new articles
- iv. change in the location either part or whole of the undertaking,
- v. carrying on business.

The Act further provided for the establishment of the Licensing Committee, the Central Advisory Council and the Development Councils. The Licensing Committee had been set up with representatives of the ministries concerned and the Planning Commission.

It was an advisory body expected to make such investigations in respect of any application and make a report to the Government.

The Central Advisory Council had been set up for industries for consultation in regard to problems relating to the administration of the Act and other matters pertaining to the development of industry. The sub-committee of the Central Advisory Council undertakes periodical review of the working of licensing system and reports the same to the Central Advisory Council.

Other important institutions that come into existence under the Act were Development Councils for individual industries. The consisted of representatives from industrial undertakings, employees and consumers. The main objective of these councils is to act as liaison between the public and private sectors and to ensure that private industry conforms more and more to the planned pattern of development.

OBJECTIVES OF LICENSING:- A license is a written permission issued by the Central Government to an industrial undertaking stating such detail as the location, the article to be manufactures, production capacity and other relevant particulars.

It also subject to a validity period within which the license capacity should be implemented. The main objectives of licensing are:-

- to limit industrial capacity with the targets set by the plans;
- to direct investment in industries according to plan priorities;
- to regulate the location of industrial units so as the secure a balanced regional development ;
- to prevent both monopoly and concentration of wealth;
- to protect small-scale industries against undue competition from large-scale industries;
- to faster technology and economic improvements in industries by ensuring units of economic size and adopting modern processes; and
- to encourage new entrepreneurs to start industrial units, thus broadening the entrepreneurial base.

The major objective of licensing is to give effect to the industrial policy of the Government. Any change in the industrial policy, therefore, will have its repercussions on the licensing system.

13.7 LICENSING POLICY

Direct Industrial Licences are granted by the Government, against applications except for those items which are exclusively reserved for the small scale sector. For cases involving SSI items, initially a Letter of Intent is issued to the applicant subject to certain conditions like obtaining pollution clearance. On fulfillment of conditions stipulated in the LOI, etc, Letter of Intent is converted into an Industrial License.

CRITICISM OF LICENSING POLICY:-

The following were some of the general points of criticism:

1. Cumbersome and Time Consuming Process : The most common points of criticism is that the licensing policy created a very cumbersome and time-consuming procedure involving too many agencies and Ministries of Government, e.g. Ministries of Company Affairs, Economic Affairs, Science and Technology, etc. each one concerned with specific aspect of industrial development. Then, there are specialized agencies like the DGTD. Nearly a dozen or so ministries were involved in the licensing process specially when a large industrial house was involved or questions of foreign technical and financial collaboration came. All this took much time and led to inordinate delays.

2. Plethora of Controls: Government emanated too many controls from which a project had to secure clearance, such as the Capital Goods Committee, the Controller of Capital Issues, MRTP Act, (Sec. 21-22). The Chief Controller of Exports and Imports, the RBI, etc. and the licensing was also one of them. To procure the letter of intent was not the end, but the beginning of the process for various approvals and clearance. In this plethora of controls, the total package of procuring various licenses and approvals unavoidably led to delays and frustration.

3. The issue of licenses tends to give an exaggerated picture of industrial capacity which sometimes scores away genuine entrepreneurs who might be chronologically late, at the sometime, as it encourages foreclosure of licensed capacity by influential groups and sitting tight on unimplemented licenses.

4. Licenses are normally, in most cases, issued for a capacity 10 to 25 percent above the target for the end-plan year and that too, mostly around the beginning of the plan period. An excessive-through quantitatively un-variable-pressure is thus exerted on the available foreign exchange and possible collaborators and also on domestic suppliers. This leads to bottlenecks and delays, apart from adversely affecting the terms of negotiation with foreign and domestic suppliers and creditors.

13.8 SUMMARY

The Industrial Policy of 1948 was aimed at clearing the foggy and uncertain environment so that investment in industry does not become a casualty. The basic aim of the Industrial Policy (1948) was to bring economic stability and establish the mixed economy framework in India. The Industrial Policy of 1956 was motivated by considerations of rapid Industrialisation within the framework of the socialist pattern of society accepted as the goal of economic and social policy. Industrial Policy Statement, 1977 - Policy drafted by the Ghanaians in the Janata Party. The main aim of the policy was to correct the distortions in the implementation of the Industrial Policy (1956). Major distortions: (a) Unemployment has increased; (b) rural-urban disparities have widened; and (c) rate of real investment has stagnated. The Industrial Policy of 1980 has been criticized for its internal inconsistency. While swearing by Industrial Policy of 1956, the 1980 policy proclaims that the interest of the small and large sector is not essentially conflicting. This is a totally untenable proposition because the IPR 1956 intended to support small and village industries (a) by restricting the volume of production in the large scale sector, (b) by differential taxation or (c) by direct subsidies. The Government of India announced the New Industrial Policy on 24th July, 1991. The Industrial Policy Statement of 1991 stated that "The Government will continue to pursue a sound policy framework encompassing encouragement of entrepreneurship, development of indigenous technology through investment in research and development, bringing in new technology, dismantling of the regulatory system, development of the capital markets and increased competitiveness for the benefit of common man". It further added that "the spread of industrialization to backward areas of the country will be actively promoted through appropriate incentives, institutions and infrastructure investments. Licensing Policy is a compulsory registration of all scheduled undertakings with the government within a specified period. The licenses should be obtained from the government by all new undertakings and by undertakings contemplating substantial expansion; that the government could order in investigation in respect of case of failure to carry out the directions issued after such investigation, the Government could take over the management of such industries of undertakings.

13.9 GLOSSARY

- **Mixed Economy:** An economic system in which both the public and private sector coexist and complement each other in the task of economic development.
- **Nationalization:** Take-over of ownership and management of private sector company/industry by the state.
- **Subsidies:** The grants of assistance by the State to encourage the production of a commodity or a service in a certain industry or sector of the economy.
- **Regional Disparities:** Differences in the level of development attained by different regions.

13.10 COMPREHENSIVE QUESTIONS

Fill in the blanks.

- 1.) refers to all the objectives, principles, rules, regulations, and methods related to industrial development, establishment and implementation of industrial enterprises, ownership of industries, and growth rates in the country.
- 2.) Defense and strategic industries such as - the production of weapons and ammunition (explosives), the production and control of nuclear energy, and the ownership and management of railways, will be completely..... under the monopoly of the government
- 3.) includes coal, iron and steel, aircraft manufacturing and shipbuilding, telephone, telegraph, and wireless devices
- 4.) The industrial policy proposal of 1956 classified industries into categories.
- 5.) The Government of India announced the new industrial policy on

13.11 ANSWER OF UNDERSTANDING QUESTIONS

1. Industrial policy, 2. Center, 3. Basic and major industries, 4. Three,
5. July 24, 1991

13.12 SELF ASSESSMENT QUESTIONS

- i) Give a brief introduction of industrial policy and industrial licensing.
- ii) Explain industrial policy 1948 and analyse the features of industrial policy, 1948.

- iii) State and analyse the features of industrial policy resolution 1956.
- iv) Write an essay on industrial policy, 1977.
- v) Write a short note on industrial policy, 1980.
- vi) Discuss in detail the industrial policy, 1991.
- vii) Explain the features of industrial policy, 1991.
- viii) Explain the meaning of industrial licensing and its various objectives.

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UNIT-14 PUBLIC SECTOR ENTERPRISES AND SMALL MEDIUM ENTERPRISES

- 14.1 Introduction
- 14.2 Types of Organizations in Public Sector Enterprises
- 14.3 Role of Public Sector Enterprises
- 14.4 Evaluation of Public Sector Enterprises
- 14.5 Development of Public Sector Enterprises
- 14.6 Small and Medium Enterprises
- 14.7 Importance of Small Scale Industries
- 14.8 Role of Small Scale Enterprises in India
- 14.9 Problems of Small Scale Industries
- 14.10 Summary
- 14.11 Glossary
- 14.12 Comprehension Questions
- 14.13 Answers to Comprehension Questions
- 14.14 Self-Assessment Questions
- 14.15 Reference Books

OBJECTIVES:

After studying this unit, you will be able to –

Understand the organization, role, and issues of public sector enterprises.

Comprehend the redistribution of income and wealth.

Explain employment opportunities

Explain balanced regional development.

Know effective means to face competition from private sector establishments.

14.1 INTRODUCTION:

Prior to 1947, there was virtually no "public sector" in India. The only instances worthy of mention were the Railways, the Post of Telegraphs, the Port Trusts, the Ordnance and Aircrafts Factories and a few state managed undertakings like the

Government Salt factories, Quinine factories etc. The idea that economic development should be promoted by the State actually managing industrial concerns did not take root in India before 1947, even though the concept of planning was very much discussed by Congress Governments in the India provinces as far back as 1931. However, in the post independence period, the expansion of public sector was undertaken as an integral part of the Industrial Policy 1956.

Since the time of its establishment, Central Public Sector Enterprises (CPSUs) have become the cornerstone of the Indian economy and they were initiated with the following mandate - (a) the broad economic objectives of high economic growth. To work for the purpose of attainment, (b) to achieve self-reliance in the production of goods and services, (c) to achieve long-term balance in the payment balance, and (d) to ensure stability in prices and establish appropriate standards for the prices of essential commodities. Historically, central public sector enterprises (CPSUs) have gained significant importance in the Indian economy before and after independence. Before independence, public sector enterprises were limited to certain specific areas such as railways, post and telegraph, port trusts, and ordnance factories

After gaining independence, the country's economic identity was that of an agriculture-based economy with a weak industrial foundation. There were regional disparities in economic development, savings were low, and structural facilities were inadequate. In the absence of private sector capital, the development of the public sector was considered the key to self-reliant economic growth. Consequently, the industrial policy resolutions of 1948 and 1956 emphasized the establishment of public enterprises in the basic sector by the central government.

As a result of the steps taken in the five-year plans, the role of CPSUs (Central Public Sector Undertakings) in the Indian economy increased manifold. Thus, the number of CPSUs, which was 5 at the beginning of the first five-year plan with an investment of Rs. 29 crores, increased to 246 by March 31, 2009, with an investment of approximately Rs. 5.3 lakh

In the year 1991, after the arrival of economic reforms, the government initiated a planned shift towards an open economy, aligning with market forces and providing a significant role to the private sector, including foreign investment. As a result, it became inevitable for central public sector enterprises to face competition not only

from the domestic private sector but also from large multinational companies. In the

competitive environment, public enterprises also made efforts to upgrade their technology and capabilities so that they could operate on the same level as their competitively equivalent companies in the liberalized economy. As a result of continuous focused efforts, many CPSEs have become self-reliant and are playing a crucial role in strengthening the Indian economy.

DEFINITION: In simple terms a public sector enterprise in an industrial, commercial or other economic activity owned and managed by the Central or State Government or Jointly by both. A comprehensive definition of a public sector unit is given by experts at the International Centre for Public Enterprise (ICPE), Yugoslavia. To quote the Centre:

"A public enterprise is an organization which is:

1. owned by public authorities including Central, State or local authorities to the extent of 50 percent or more ;
2. is under the top managerial control of the owning public authorities, such public control including inter-alia, the right to appoint top management and to formulate critical policy decisions;
3. is established for the achievement of a define_ set of public purpose, which may be multi-dimensional in character;
4. and is consequently placed under a system of public accountability;
5. is engaged in activities of a business character;
6. involves the basic idea of investment and returns
7. and which markets its outputs in the shape of good and services".

OBJECTIVES OF PUBLIC ENTERPRISES: The following are the objectives of public enterprises:

- Help in the rapid economic growth and industrialization of the country and create the necessary infrastructure for economic development;
- Earn return on investment and thus generate resources for development;

- Promote redistribution of income and wealth;
- i) Create employment opportunities;
- ii) Promote balanced regional development;
- iii) Assist the development of small-scale and ancillary industries;
- iv) Promote import substitution, save and earn foreign exchange for the economy;
- v) Act as a countervailing force to put up with effective competition to undertakings in the private sector and
- vi) Gain control over the commanding height of the economy.

14.2 FORMS OF ORGANISATION OF PUBLIC SECTOR ENTERPRISES:

1. There are three different forms of organisation used for the public sector enterprises in India. These are

- (a) Departmental Undertaking;
- (b) Statutory (or Public) Corporation
- (c) Government Company.

1) DEPARTMENTAL UNDERTAKING: This form of organisation is primarily used for provision of essential services such as railways, postal services, broadcasting etc. Such organisations function under the overall control of a ministry of the Government and are financed and controlled in the same way as any other government department. This form is considered suitable for activities where the government desires to have control over them in view of the public interest.

Example:

14 Posts & Telegraph

15 Railways

16 All India Radio (AIR)

17 Door Darshan (TV)

18 Ordnance Factories

Features Of Departmental Undertaking:

The main features of departmental undertakings are as follows:

- It is established by the government and its overall control rests with the minister.

- It is a part of the government and is managed like any other government department. It is financed through government funds.
- It is subject to budgetary, accounting and audit control.
- Its policy is laid down by the government and it is accountable to the legislature.

Merits Of Departmental Undertakings:

The following are the merits of departmental undertakings:-

1. **Fulfillment of Social Objectives:** The government has total control over these undertakings. As such it can fulfill its social and economic objectives. For example, opening of post offices in far off places, broadcasting and telecasting programmes, which may lead to the social, economic and intellectual development of the people are the social objectives that the departmental undertakings try to fulfill.
2. **Responsible to Legislature:** Questions may be asked about the working of departmental undertaking in the parliament and the concerned minister has to satisfy the public with his replies. As such they cannot take any step, which may harm the interest of any particular group of public. These undertakings are responsible to the public through the parliament.
3. **Control Over Economic Activities:** It helps the government to exercise control over the specialized economic activities and can act as instrument of making social and economic policy.
4. **Contribution to Government Revenue:** The surplus, if any, of the departmental undertakings belong to the government. This leads to increase in government income. Similarly, if there is deficiency, it is to be met by the government.
5. **Little Scope for Misuse of Funds:** Since such undertakings are subject to budgetary accounting and audit control, the possibilities of misuse of their funds are considerably reduced.

LIMITATIONS OF DEPARTMENTAL UNDERTAKINGS:

Departmental undertakings suffer from the following limitations:

- (a) **The Influence of Bureaucracy:** On account of government control, a departmental undertaking suffers from all the ills of bureaucratic functioning. For instance, government permission is required for each expenditure, observance of government decisions regarding appointment and promotion of the employees and so on. Because of

these reasons important decisions get delayed, employees cannot be given instant promotion or punishment. On account of these reasons some difficulties come in the way of working of departmental undertakings.

(b) **Excessive Parliamentary Control:** On account of the Parliamentary control difficulties come in the way of day-to-day administration. This is also because questions are repeatedly asked in the parliament about the working of the undertaking.

(c) **Lack of Professional Expertise:** The administrative officers who manage the affairs of the departmental undertakings do not generally have the business experience as well as expertise. Hence, these undertakings are not managed in a professional manner and suffer from deficiency leading to excessive drainage of public funds.

(d) **Lack of Flexibility:** Flexibility is necessary for a successful business so that the demand of the changing times may be fulfilled. But departmental undertakings lack flexibility because its policies cannot be changed instantly.

(e) **Inefficient Functioning:** Such organizations suffer from inefficiency on account of incompetent staff and lack of adequate incentives to improve efficiency of the employees.

2) Statutory Corporation:

refers to a corporate body created by the Parliament or State Legislature by a special Act which defines its powers, functions and pattern of management. Statutory Corporation is also known as public corporation. Its capital is wholly provided by the government. Examples of such organizations are Life Insurance Corporation of India, State Trading Corporation etc.

Example

- (a) Food Corporation of India
- (b) Industrial Finance Corporation of India
- (c) Life Insurance Corporation of India
- (d) Unit Trust of India
- (e) State Trading Corporation

Features of Statutory Corporation:

The main features of Statutory Corporations are as follows:

- It is incorporated under a special Act of Parliament or State Legislative Assembly.

- It is an autonomous body and is free from government control in respect of its internal management. However, it is accountable to parliament and state legislature.
- It has a separate legal existence. Its capital is wholly provided by the government.
- It is managed by Board of Directors, which is composed of individuals who are trained and experienced in business management. The members of the board of Directors are nominated by the government.
- It is supposed to be self sufficient in financial matters. However, in case of necessity it may take loan and/or seek assistance from the government.

Merits of Statutory Corporations:

Statutory Corporation as a form of organization for public enterprises has certain advantages that can be summarized as follows:

1. **Expert Management:** It has the advantages of both the departmental and private undertakings. These enterprises are run on business principles under the guidance of expert and experienced Directors.
2. **Internal Autonomy:** Government has no direct interference in the day-to-day management of these corporations. Decisions can be taken promptly without any hindrance.
3. **Responsible to Parliament:** Statutory organizations are responsible to Parliament. Their activities are watched by the press and the public. As such they have to maintain a high level of efficiency and accountability.
4. **Flexibility:** As these are independent in matters of management and finance, they enjoy adequate flexibility in their operation. This helps in ensuring good performance and operational results.
5. **Promotion of National Interests:** Statutory Corporations protect and promote national interests. The government is authorised to give policy directions to the statutory corporations under the provisions of the Acts governing them.
6. **Easy to Raise Funds:** Being government owned statutory bodies, they can easily get the required funds by issuing bonds etc.

limitations Of Statutory Corporations:

Having studied the merits of statutory corporations we may now look to its limitations also. The following limitations are observed in statutory corporations.

Government Interference: It is true that the greatest advantage of statutory

corporation is its independence and flexibility, but it is found only on paper. In reality, there is excessive government interference in most of the matters.

(a) **Rigidity:** The amendments to their activities and rights can be made only by the Parliament. This results in several impediments in business of the corporations to respond to the changing conditions and take bold decisions.

(b) **Ignoring Commercial Approach:** The statutory corporations usually face little competition and lack motivation for good performance. Hence, they suffer from ignorance of commercial principles in managing their affairs.

3. Government Company :

refers to the company in which 51 percent or more of the paid up capital is held by the government. It is registered under the Companies Act and is fully governed by the provisions of the Act. Most business units owned and managed by government fall in this category.

Example

- (a) Hindustan Machine Tools Limited
- (b) Steel Authority of India Limited
- (c) Hindustan Shipyard Limited

Features Of Government Companies:

The main features of Government companies are as follows:

- It is registered under the Companies Act, 1956.
- It has a separate legal entity. It can sue and be sued, and can acquire property in its own name.
- The annual reports of the government companies are required to be presented in Parliament.
- The capital is wholly or partially provided by the government. In case of partially owned company the capital is provided both by the government and private investors. But in such a case the central or state government must own at least 51% shares of the company.
- It is managed by the Board of Directors. All the Directors or the majority of Directors are appointed by the government, depending upon the extent of private participation.
- Its accounting and audit practices are more like those of private enterprises and its auditors are Chartered Accountants appointed by the government.
- Its employees are not civil servants. It regulates its personnel policies according to its

articles of associations.

Merits of Government Companies:

The merits of government company form of organising a public enterprise are as follows:

1. **Simple Procedure of Establishment:** A government company, as compared to other public enterprises, can be easily formed as there is no need to get a bill passed by the parliament or state legislature. It can be formed simply by following the procedure laid down by the Companies Act.
2. **Efficient Working on Business Lines:** The government company can be run on business principles. It is fully independent in financial and administrative matters. Its Board of Directors usually consists of some professionals and independent persons of repute.
3. **Efficient Management:** As the Annual Report of the government company is placed before both the house of Parliament for discussion; its management is cautious in carrying out its activities and ensures efficiency in managing the business.
4. **Healthy Competition:** These companies usually offer a healthy competition to private sector and thus, ensure availability of goods and services at reasonable prices without compromising on the quality.

Limitations of Government Companies

The government companies suffer from the following limitations:

- (a) **Lack of Initiative:** The management of government companies always have the fear of public accountability. As a result, they lack initiative in taking right decisions at the right time. Moreover, some directors may not take real interest in business for fear of public criticism.
- (b) **Lack of Business Experience:** In practice, the management of these companies is generally put into the hands of administrative service officers who often lack experience in managing the business organisation on professional lines. So, in most cases, they fail to achieve the required efficiency levels.
- (c) **Change in Policies and Management:** The policies and management of these companies generally keep on changing with the change of government. Frequent change of rules, policies and procedures leads to an unhealthy situation of the business enterprises.

Characteristics of Public Sector Enterprises:

Looking at the nature of the public enterprises their basic characteristics can be summarized as follows:

(a) **Government Ownership and Management:** The public enterprises are owned and managed by the central or state government, or by the local authority. The government may either wholly own the public enterprises or the ownership may partly be with the government and partly with the private industrialists and the public. In any case the control, management and ownership remain primarily with the government. For example, National Thermal Power Corporation (NTPC) is an industrial organization established by the Central Government and part of its share capital is provided by the public. So is the case with Oil and Natural Gas Corporation Ltd. (ONGC).

(b) **Financed from Government Funds:** The public enterprises get their capital from Government Funds and the government has to make provision for their capital in its budget.

(c) **Public Welfare:** Public enterprises are not guided by profit motive. Their major focus is on providing the service or commodity at reasonable prices. Take the case of Indian Oil Corporation or Gas Authority of India Limited (GAIL). They provide petroleum and gas at subsidised prices to the public.

(d) **Public Utility Services:** Public sector enterprises concentrate on providing public utility services like transport, electricity, telecommunication etc.

(e) **Public Accountability:** Public enterprises are governed by public policies formulated by the government and are accountable to the legislature.

(f) **Excessive Formalities:** The government rules and regulations force the public enterprises to observe excessive formalities in their operations. This makes the task of management very sensitive and cumbersome.

14.3 ROLE OF PUBLIC SECTOR ENTERPRISES:

After the attainment of independence and the advent of Planning, there has been a progressive expansion in the scope of the Public Sector. The passage of Industrial Policy

Resolution of 1956 and the adoption of the Socialist Pattern of Society as our national goal, further led to deliberate enlargement of the role of public sector.

To understand the role of the Public Sector, we must have an idea about its size in the

context of the Indian economy. For a comprehensive view of the entire Public Sector, we should cover besides autonomous corporations, the departmental enterprises. While doing so, not only the enterprises owned and run by the Central Government be covered but the enterprises run by the State Governments and local bodies should also be included.

Secondly, it would not be appropriate to use any single measuring to estimate the size of the public sector, rather it would be desirable to use quite a few indicators, e.g. employment, investment, value of output, national income generated, savings, capital formation and capital stock.

14.4 EVOLUTION OF THE PUBLIC SECTOR ENTERPRISES:

Though the public sector was started with greater vigor only after 1947, the idea of State-owned undertakings was there long before. In South India, great dams and anicuts were built across the river Cauvery by the Chala Kings of the 11th and 12th centuries. They are magnificent testimonials to the wisdom and foresight of the Cholas. That is repeated in very many parts of the country. India was not merely a country of temples. There was a good deal of economic development by the State, directed towards sustaining the life of the community. And these dams and anicuts which were set-up by the State for the benefit of the people are testimony enough to acknowledge the evolution of the public sector. Started by the great Chola Kings, the public sector went through periods of steady expansion until our country become a free nation. After 1947, the public sector become investable as the government realized the rapid economic development could be achieved only through State intervention in economic activities. The Industrial Policy Resolution of 1948 and 1956 clearly reflect the need for expanding the public sector. The public sector has now grown tremendously and has become a leading light of our economic.

a. DEVELOPMENT OF PUBLIC SECTOR ENTERPRISE:-

Share in National Income: An important contribution to the National Income is Public Sector. During the period 1960 to 1999, the public sector has doubled its share in the national income in real terms and account for 25 percent of the total income of the economy. This is, undoubtedly, a significant change in the structure of economy in terms of the increased importance of the public sector in domestic activity.

Balanced Regional Development: India is a vast country with wide variations in climate, demography' resource availability, fertility and topography. At a given time,

some parts of the country will be reeling under floods, at the same time there will be severe droughts in other parts. One can also witness vast barren lands with sparse inhabitation by people, juxtaposed with thickly populated areas. Industrialization has high potential in leveling such differences. The severe draughts being faced by Orissa, Rajasthan, Maharashtra and Madhya Pradesh are a case in consideration.

Recognizing the existence of disparities in economic development of different regions, the Industrial Policy Resolutions of 1956, 1977, and 1980, emphasized the need for accelerated role of growth in the economy and speedy industrialization and removal of the regional imbalanced. In this context, PUS,s have a vital role to play since the setting up of large industries

in public sector help eliminate regional disparities through such spin-offs as employment opportunities, growth of small and ancillary industries and development of infrastructural facilities. While deciding the location of PSUs, due considerations are given to the backwardness of various regions, subjects to the over-riding consideration of techno-economic feasibility.

Resource Mobilization: PSUs have contributed enormously to the resources of the Central Government through dividends, interest payments on loans, income tax and excise and other duties.

In addition, PSEs have generated internal resources for themselves in the form of depreciation provision and retained profits including deferred revenue expenditure written off during the year. It may be stated that only commercial enterprises are allowed to generate internal resources. Enterprises engaged in development and promotional activities are not expected to build up sizable surpluses.

Thus, PSUs have occupied the commanding heights of the economy and have been regarded as the temples of modern India. Without them, India could not have stood in the comity of nations with the self assurance that has characterized its stature. PSUs have been in the vanguard of the industrialization process, supplying infrastructure, steel and capital goods essential for a rapidly evolving economy.

Suggestions to improve the Performance of Public Sector Enterprises (PSEs) :

- Controlling the cost at every level of public sector enterprises.
- Increase the productions.

- Reforms in capital base.
 - Increase the standard of public sector enterprises to manage the competition from both domestic and foreign competitors.
- iv) Identifying redundant manpower and dealing with it through means a retraining, redeployment and encouraging self-employment etc.

14.6 SMALL AND MEDIUM Enterprises Introduction:-

The small scale industries (SSIs) have a crucial role in a developing economy like India. They play a strategic role in the progress of the country. These industries by and large represent a stage in economic transition from tradition segments to modern segments. The traditional nature of this process is reflected in the diversity of these industries. Some SSIs employ simple skills and mechanism while many other units use modern and sophisticated technology. Now our economy is facing a challenge of economic growth. It has to accelerate the productivity of many important area like agriculture and industry by improving their techniques of production. SSIs have been assigned to fulfill these expectations in more economic and diversified way.

SSIs constitute an important part of the India economic structure. They integrate a continuing element in the scheme of national planning. They are strategic part of the Indian economy as well as a progressive and effective decentralized sector which is closely related with agriculture and medium and large scale industries. The whole scheme of a socialistic pattern of society with employment for all rests on the decentralization and wide distribution of economic activity, entrepreneurship and economic advantages. The basic social philosophy underlying Indian planning is that to develop medium and large scale sector only to take advantage of modern technology. Over the rest of the field, SSIs will be encouraged to play their active role, if there is change in scale that has to be developed with the help of mutual co-operation -both horizontal and vertical.

In 1951, with the beginning of the planned economy implemented by the government and subsequent industrial policies, planners and the government marked a specific role for small and medium-sized industries in the Indian economy. Both sectors, especially small industries, were given special protection from 1951 until the adoption of liberalization and globalization policies in 1991. Some products were reserved exclusively for small industries for a long time, although this list of products has consistently shrunk based on changing industrial policies and environments.

Small and medium enterprises have always represented the government's socio-economic policies, which include prudent use of foreign exchange for the import of capital goods, a labor-based production system, job creation, decentralizing and dispersing economic powers (as was the case with large industrial houses), discouraging monopolistic practices in production and marketing, and ultimately ensuring substantial support for the foreign exchange earned by the country through minimal import-centric activities. This also included the policy of decentralizing industrial activities from any particular geographical area. It has been found that small and medium enterprises have always met the government's expectations. The development of small and medium enterprises has been such that they have also fulfilled the following objectives –

- i) High contribution in domestic production-
- ii) Abundant income from exports-
- iii) Low investment requirement- Operational flexibility-
- iv) Location-based viability-
- v) Low imports-
- vi) Potential for development of indigenous technology-
- vii) Import substitution-
- viii) Contribution to defense products-
- ix) Technology-driven industry-

x) Competitiveness in domestic and export markets

Along with the above, it would also be appropriate to know some limitations of small and medium enterprises, which are as follows:-

- xi) Limited capital base-
- xii) Work processes concentrated on one or two individuals
- xiii) Insufficient experience of the international environment-
- xiv) Inability to cope with the impacts of the World Trade Organization (WTO) era
- xv) Inadequate contribution to research and development-

xvi) Lack of professional competence

Despite the above limitations, small and medium enterprises have made significant contributions to technical development and exports.

xvii) Small and medium enterprises have been established in almost all important sectors of the Indian industrial landscape. Such as:- Agricultural investment- Chemicals

and pharmaceuticals-

xviii) Engineering, electricals, and electronics-

xix) Electro-medical devices-

xx) Clothing and sewn textiles-

xxi) Leather and leather goods-

xxii) Production of meat- Bio-engineering-

xxiii) Sports equipment-

xxiv) Plastic products-

xxv) Computer software, etc.

Due to the effects of globalization and liberalization in the WTO era, Indian small and medium enterprises are currently going through a transitional phase. Many units are facing tough times due to the economic downturn in India and abroad, especially in the United States and the European Union, as well as increased competition from China and some other low-cost foreign production centers. In facing the current challenge, only those small and medium enterprises (SMEs) that have a strong technical foundation, an international business perspective, a competitive spirit, and a willingness to restructure themselves will achieve high success through their contribution to the Indian economy.

DEFINITION OF MSMEs:-

The Central Government, in exercise of the power conferred by sub-section (1) of section 7 of Micro, Small and Medium Enterprises Development Act, 2006 after having obtained the recommendations of the Advisory Committee under sub-section (4) of section 7 of the Act in this regard, hereby notifies the following enterprises, whether proprietorship, Hindu undivided family, association of persons, co-operative society, partnership or undertaking or any other legal entity, by whatever name called:-

In case of enterprises engaged in the manufacturing or productions of goods pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951 as -

(a) For a micro enterprise, where the investment in plant and machinery does not exceed twenty five lakh rupees;

(b) A small enterprise, where the investment in plant and machinery in more than

twenty five lakh rupees but does not exceed five crore rupees; or

(c) A medium enterprise, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees.

14.7 SIGNIFICANCE OF SMALL SCALE INDUSTRIES -

As we said in the beginning of this chapter, the small-scale sector has a high potential for providing employment, dispersal of industries, promoting entrepreneurship and exchange to the county. The following points further demonstrate the importance of small-scale industries.

.6 Small is Beautiful: 'Small is beautiful', said E.F. Schumacher. He maintains that man's current pursuit of profit and progress, which promotes giant organizations and increased specialization, has infect resulted in gross inefficiency, environmental pollution and inhuman working conditions. Schumacher emphasizes or small working units, communal ownership and regional work places utilizing local labour and resources. For him, emphasis should be on the person and not an the product.

.7 Innovative and Productive : It is the small units which are highly innovative, through they do not maintain their own research and development wings." *a disproportionate share of innovation and success in business seems to come from 'Skunk works' tiny groups that tend to outperform the much larger lobs that often have a cost of hundreds. We have now, several score examples of effective skunk works.*

.8 Individual Tastes, Fashions and Personalized service: Small firms are quick in studying changes in tastes and the fashion of consumers and in adjusting the production process and production accordingly.

Small firms seem to have an edge in industries that call for personalized service, attention to detail and the flexibility to adopt quickly to changes in the business or technological environment. For instance, in the government and electronic fields, the small units have ruled the roost, a change of government and TV industry voices says that big companies delegate responsibility down the line and cannot swiftly change the trace when necessary. Says a garment export." *the garment business is personalized oriented to changing fashion and has to*

be controlled. Professional managers do not have the motivation for all this. And most people in the electronic business agree that big firms have so far had limited success because of their lack of flexibility.

.9 Symbols of National Identity:- Small enterprises are almost always locally owned and controlled, only they can strengthen rather than destroy the extended family and other social systems and cultural traditions that are perceived as valuable in their own right as well as symbols of national identity."

14.8 ROLE OF SMALL SCALE ENTERPRISES IN INDIA: -

The role of this sector cannot be underestimated in India economy. The SSI sector is playing an important role in terms of employment generation and growth. Total value of production of SSI production accounts for 40 percent of the total value of industrial output of the country. The generation of employment is 5 times by the small scale sector in comparison to large scale sector. The important role played by small sector in India is summarized as below:

a) **Number of Units:** The total number of small scale units has been increasing rapidly. It has increased from 4.20 lakhs in 1973-74 to 115.22 lakhs in 2003-04. The reserved list of the small scale units has been increased from 177 in 1972 to 873 in 1984. These units produce over 7500 commodities. According to a survey carried out by CSO in 1994-95, regarding manufacturing enterprises, 72.4 percent of the registered units were located in rural area and only

27.6 percent were in urban area.

b) **Employment Generation:** Small scale industries are labour intensive and thus are generating a large number of employment opportunities. Total number of employment generated by these small scale industries has increased from 39.7 lakhs in 1973-74 to 273.97 lakhs in 2003-

04. According to Planning Commission, 519 persons are getting employment from small and cottage industries. In 2002-03, 120 lakh persons in handloom industry, 15 lakh in Khadi, 55 lakh in silk industry, 36 lakh in village industry and 64 lakh in handicraft industry were employed. These industries help to improve partial employment opportunities. In their slack season, farmers can supplement their income by engaging themselves in cottage industries.

c) **Artistic Goods:** Small and cottage industries alone are producing artistic goods in India. These artistic goods include Banarsi Sarees, ivory work, carpets, designed pots and utensils, studded ornaments, etc. These goods have ready market in foreign countries. In 2001-02, handicrafts worth Rs. 4,406 crore and gems and jewellery worth Rs. 34,845

crore were exported to foreign countries. Thus, these industries help in earning good deal of foreign currency.

d) **Regional Dispersal of Industries:** Small scale industries are also playing an important role in dispersing the industrial units of the country in the various parts of the country. Besides, small-scale industries avoid evils of urbanization like, house shortage in cities, high prices, etc.

e) **Industrial Peace:** The industrial relations in these industries are direct and cordial and thus the small scale industries are maintaining a better industrial relation. This has lessened the frequency of industrial disputes and thus industrial peace is maintained to be advantage of the entire society.

f) **Equitable Distribution National Income :** The main arguments put forward in support of the small-scale and cottage industries are that they ensure a more equitable distribution of national income and wealth. This happens because of the following two considerations:

1. The ownership of small-scale industries is more widespread than the ownership of large scale industries, and
2. They possess a much larger employment potential as compared to the large industries.

g) **Less Industrial Disputes:** A number of supporter of small-scale and cottage industries have argued that as compared with large-scale units, these industries have less industrial disputes. While there are frequent strikes and lock-outs in large industries, small-scale and cottage industries do not face such problem. Therefore, there is no loss of output in small-scale and cottage industries. However, this point of view is not totally correct. The fact is that workers in large scale units are organized and thus the strikes and lock-outs in large industries, small-scale and cottage industries do not face such problem. Therefore, there is no loss of output in small scale and cottage industries. However, this point of view is not totally correct. The fact is that workers in large scale units are organized and thus the strikes are well reported in media. As against these workers in small scale units are unorganized and cannot resort to strike. Any worker who shows his resentment is immediately thrown out. Therefore, while in a small-scale units relations between the employer and employees appear to be normal on the surface but in fact they may be not.

14.9 PROBLEMS OF SMALL SCALE INDUSTRIES:

i) **Problem of Raw Material and Power:** These industries do not get sufficient quantity of raw material at proper prices. Non-availability of proper quality is another hindrance in production of high quality goods by these industries. Simultaneously the goods produced by these units bear the high costs of production and thus they are not able to compete with large industries. These industries also suffer from shortage of power and coal.

ii) **Marketing Problems :** Generally the small scale units have to face lot of difficulties in selling their goods at fair prices. Small entrepreneurs generally lack in resources and expertise to market their products effectively. The entrepreneurs are not in a position of offer attractive credit terms due to financial constraints. Through the government has initiated some steps in this regard but these are still inadequate to remove the marketing problems of SSI units.

iii) **Lack of Able Entrepreneurs :** The industries are generally situated in rural area and are run by incompetent entrepreneurs. Workers are mostly illiterate, ignorant and orthodox. Due to lack of education, the entrepreneurs are ignorant of new equipments and modern techniques of production. According to a report by State Bank of India, one of the reasons of failure of these industries is the lack of able and efficient entrepreneurs.

iv) **Lack of Advertisements :** As stated earlier, these industries lack in financial resources and therefore these enterprises cannot afford high advertisement cost. Due to lack of advertisement, demand for goods is low.

v) **Finance :** Finance is one of the most important problem confronting small scale industries. Finance is the life blood of an organization and no organization can function properly in the absence of adequate funds. The scarcity of capital and inadequate availability of credit facilities are the major causes of this problem. *Firstly*, adequate funds are not available and *secondly*, entrepreneurs due to their weak economic base, have lower credit worthiness. Neither they are having their own resources nor are others prepared to lend them. Entrepreneurs are forced to borrow money from money lenders at exorbitant rate of interest and this upsets all their calculations. After nationalization, banks have started financing this sector. These enterprises are still struggling with the problem of inadequate availability of high cost funds. These

enterprises are promoting various social objectives and in order to facilitate their working adequate credit on easier terms and conditions must be provided to them.

vi) **Technology:** Small Scale entrepreneurs are not fully exposed to the latest technology. Moreover, they lack requisite resources to update or modernize their plant and machinery. Due to obsolete methods of production, they are confronted with the problems of less production in inferior quality and that too at higher cost. They are in no position to compete with their better equipped rivals operating modern large scale units.

vii) **Project Planning:** Another important problem faced by small scale entrepreneurs is poor project planning. These entrepreneurs do not attach much significance to viability studies

i.e. both technical and economical and plunge into entrepreneurial activity out of mere enthusiasm and excitement. They do not bother to study the demand aspect, marketing problems, sources of raw material and even availability to proper infrastructure before starting their enterprises. Project feasibility analysis covering all these aspects in addition to technical and financial viability of the project, is not at all given due weight age. Inexperienced and incomplete documents, which invariably results in delays in completing promotional formalities. Small entrepreneurs often submit unrealistic feasibility reports and incompetent entrepreneurs do not fully understand projects details. Moreover, due to limited financial resources they cannot afford to avail services of project consultants. This result is poor project planning and execution. There is both time and cost overrun which adversely affect interest of these small scale enterprises.

14.10 SUMMARY

Simple terms a public sector enterprise in an industrial, commercial or other economic activity owned and managed by the Central or State Government or Jointly by both. There are three different forms of organisation used for the public sector enterprises in India. These are (1) Departmental Undertaking; (2) Statutory (or Public) Corporation and (3) Government Company. The public sector was started with greater vigor only after 1947, the idea of State-owned undertakings was there long before. In South India, great dams and anicuts were built across the river Cauvery by the Chala Kings of the 11th and 12th centuries. They are magnificent testimonials to the wisdom and foresight of the Cholas. The small scale industries (SSIs) have a crucial role in a developing economy like India. They play a strategic role in the progress of the country. These

industries by and large represent a stage in economic transition from tradition segments to modern segments. The traditional nature of this process is reflected in the diversity of these industries. Some SSIs employ simple skills and mechanism while many other units use modern and sophisticated technology. Now our economy is facing a challenge of economic growth. The small-scale sector has a high potential for providing employment, dispersal of industries, promoting entrepreneurship and exchange to the county. The role of this sector cannot be underestimated in India economy. The SSI sector is playing an important role in terms of employment generation and growth. Total value of production of SSI production accounts for 40 percent of the total value of industrial output of the country.

14.11 GLOSSARY

Public Sector Enterprise: It is an industrial, commercial, or any other economic activity owned and managed by the central or state government or jointly by both.

Constitutional Corporation: These are corporate bodies formed by a special act in Parliament or the state legislature.

14.12 COMPREHENSIVE QUESTIONS

Fill in the blanks

- A public enterprise is an organization that is owned by the central, state or local government or holds more than one ownership
- The nature of public enterprises is generally found in organizations where essential services are to be provided, such as railways, postal services, broadcasting services, etc.
- Small enterprises in which the investment in plant and machinery is more than Rs. but less than five crores.
- A percentage of the total industrial production value of the country is obtained from the category of small industries.

14.13 ANSWER OF UNDERSTANDING QUESTIONS

1. 50 percent 2. Departmental undertaking 3. Five lakh 4. 40

14.14 SELF ASSESSMENT QUESTIONS:

- What is meant by public sector enterprises and its objectives?
- Describe the various form of organisation in details.

- Explain departmental undertaking. Also explain its features and merits.
- What do understand by statutory corporation? Define its features and limitation.
- What are characteristics of the public sector enterprises?
- Write a note on small scale industries and problem related to them.

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UNIT-15 MICRO- FINANCE

BLUE PRINT OF UNIT

- 15.1 Introduction
- 15.2 Meaning of Microfinance
- 15.3 Need for Microfinance
- 15.4 Features and Characteristics of Microfinance
- 15.5 Major Features of Microfinance Programs
- 15.6 Principles of Microfinance
- 15.7 Channels of Microfinance
- 15.8 Microfinance Movement in India
- 15.9 Summary
- 15.10 Glossary
- 15.11 Comprehension Questions
- 15.12 Answers to Comprehension Questions
- 15.13 Self-Assessment Questions
- 15.14 Reference Books

OBJECTIVES:

After studying this unit, you will be able to –

1. Describe the needs of microfinance.
2. Describe the features of microfinance-
3. Describe the principles of microfinance.
4. Describe the channels of microfinance.
5. Explain the microfinance movement in India.

15.1 INTRODUCTION

Microfinance is the provision of a broad range of financial services such as – deposits, loans, payment services, money transfers and insurance products – to the

poor and low-income households, for their microenterprises and small businesses, to enable them to raise their income levels and improve their living standards.

The first step in conducting an evaluation of a microfinance program is, perhaps surprisingly, to ensure that you are conducting an evaluation of a microfinance program. This seems obvious, but is not, since the definition of “microfinance” is less than clear. Broadly speaking, microfinance for loans (i.e., microcredit) is the provision of small scale financial services to people who lack access to traditional banking services. The term microfinance usually implies very small loans to low-income clients for self employment, often with the simultaneous collection of small amounts of savings. How we define “small” and “poor” affects what does and does not constitute microfinance. “Microfinance” by its name clearly is about more than just credit, otherwise we should always call it microcredit. Many programs offer stand-alone savings products, and remittances and insurance are becoming popular innovations in the suite of services offered by financial institutions for the poor. In fact, it is no longer exclusively institutions for the poor that offer microfinance services. Commercial banks and insurance companies are beginning to go downscale to reach new markets, consumer durables companies are targeting the poor with microcredit schemes, and even Wal-Mart is offering remittances services. Hence, not all programs labelled as “microfinance” will fit everybody’s perception of the term, depending on model, target group, and services offered.

- 75 percent of the population lives in rural areas where geographical access is difficult.

- Informal Activities - Assessment of needs according to the variability of time.
- Illiteracy: Difficulties in dealing with traditional services.
- Decrease in the value of deals.
- Lack of collateral security.
- Lack of trained staff.
- Low morale among staff.
- Difficulties related to staff motivation.

Since the end of the 19th century, there has been a tradition of providing financial services to the poor class in India, while it was common for moneylenders to forcibly take control of the lands of villagers. One of the major steps taken by the British

government was to form an alternative institution that provided loans through cooperatives. In independent India, providing loan facilities to the poor was viewed differently, and loan was considered an essential part of fighting poverty, which

included the following parameters –

- Expansion of institutional structure
- Targeted loans for backward borrowers and communities
- Interest rates assisted by grants
- Institutional vehicles: cooperatives, commercial banks, and regional rural banks (RRBs)

Over time, many measures have undergone changes. From 1950 to 1969, emphasis was placed on the development of cooperatives. With the nationalization of large commercial banks in 1969, the branches of commercial banks were expanded into rural and semi-urban areas. In 1975, regional rural banks were developed as low-cost institutions that could reach the poorest individuals in underdeveloped areas with regard to loans. During this period, the Reserve Bank of India maintained necessary interventions for grant-based loans in rural areas (the concept of priority sector).

Financial reforms in rural financial institutions were carried out to fulfill the following objectives:

- Expansion of the area of commercial freedom
- Increase in the reach of banks to the poor
- Increase in the flow of loans to this sector
- Liberalization of interest rates in cooperatives and regional rural banks - Reducing controls on where, in which area, and to whom regional financial institutions can provide loans in the priority sector.
- Initiation of visionary principles.

■ In the year 1969, there was an increase from 1,833 to 32,538 rural branches currently. 49% of all scheduled commercial banks' rural branches are in rural areas.

■ The population per rural branch per bank has decreased from 201,854 in 1969 to the current level of 16,000.

- The share of institutional credit per family in rural areas has increased from 7% in 1951 to over 60% currently.

- The importance of rural finance can be assessed through the following facts: 31% of total deposit accounts (131.1 million) come from rural India.

- 43% of total loan accounts (22.4 million) come from rural India.

- There has been a positive impact on the level of the poor

The shortcomings of this system were as follows:-

- Shortcomings in policy formulation.-

- Weaknesses in implementation.-

- Failure to avoid programs like loan waivers by governments.- Excessive defaulting.-

- The banking system provided loans to the poor not as a viable activity but as a social responsibility.

- It is extremely difficult for commercial banks to believe that lending to the poor could be a profitable activity. Issues that need to be addressed include large pending gaps:

- 500 million people are deprived of banking services against a rural population of 741 million.

- The current population per branch is 22,793.

- Less than 18 percent of savings accounts were opened in urban and semi-urban areas compared to 104 percent.

- The number of villages per branch is 19.

- High dependency on informal means.

- 36 percent of rural finance comes from informal sectors.- Dependency among the lower-income group is even greater (78 percent). Three main models related to microfinance and micro-loans are found:

- Self-help group and bank linkage model.

ICICI Partnership Model With the expansion of microfinance, the role of technology has also become significant.

- i. Key features include:-
- ii. Management Information System (MIS)-
- iii. Cash Operations-
- iv. Aggregation of Accounts and Subsequent Management.

To address the above, it is necessary to establish new microfinance institutions by adopting the following diverse systems-

- 1. Venture capitalized system (Venture capitalist model)
- 2. Alternative vehicles-
 - a. Agency system-
 - i. Model of Life Insurance Corporation
 - ii. Challenges: Fraud control
 - b. Internet connectivity-
 - i. BSNL: If a wireless system is established in the current established rural exchanges, 80-85 percent of villages can be connected.
 - ii. Various devices that can be connected to the internet system: Low-cost biometric ATMs.
 - iii. Facilitates fraud control.

3. Expansion of microfinance services:

- 1. Personal loan services
- 2. Insurance
- 3. Health insurance
- 4. Livestock insurance
- 5. Weather insurance
- 6. Commodity price derivatives
- 7. Savings and investment products
- 8. Remittances

4. Key points for measuring and maximizing impact

- 1. Credit bureaus
- 2. Unique identifiers
- 3. Technological platforms

4. Rural infrastructure
5. Changes in regulations (interest rates, etc.)
6. Training institutes
7. Research

The economics of micro enterprises According to many scholars, micro finance refers to providing small loans (generally without collateral) and accepting small savings.

It is a collection of banking behaviors. There is no mention of revolution or change in behaviors. Some others believe that microfinance has yet to fully develop and withstand the test of time. Some may disagree, but microfinance has shaken the world of international development. The most important element is that this new model has emerged from the experiences of low-income countries, not from the standard banking models of wealthy countries. Entrepreneurs, scholars, social activists, and development experts worldwide are inclined towards microbanks and non-governmental organizations (NGOs).

They are attracted by the retail banking experiences through microfinance, as well as the promises held by microfinance institutions for the underserved to obtain the much-needed resources. Some importance has been given to certain non-traditional agreements to protect small borrowers from risks and to address the information problem. Microfinance aims to understand the nature of markets with low-income economies and government. The potential outcomes of insurance, water, and electricity supply were emphasized through the market, instead of the incompetent companies. Additionally, it was also emphasized that microfinance addresses poverty, reduces gender inequality, and strengthens societies.

The concept of microfinance provides a hope. At a time when the effectiveness of foreign aid to alleviate the burden of the poor worldwide is facing fundamental questions, banks and non-governmental organizations (microfinance institutions) are developing rapidly. Governments around the world are often facing criticism for being

corrupt, tainted, and reluctant to reform. Against this backdrop, banks and NGOs are providing innovative and low-cost ways for poverty alleviation and social change.

Microfinance presents a range of possibilities in emerging markets, poverty alleviation measures, and social issues. It can be debated whether the poorest individuals can be served through loans or other savings methods, whether grants provide assistance or create obstacles, whether merely providing loans without any training or support is sufficient, and which loaning system has been most successful. There is also a need to understand the many myths that come in the way of understanding microfinance. The first myth is that microfinance is necessarily related to providing loans. The second myth is that the secret of high repayment rates on loans is related to group lending contracts, innovations in contracts, and banking practices that are distinct from group loans. The third myth is that microfinance is associated with social impacts and is a useful tool for poverty alleviation and gender empowerment. The final myth is that most micro-lenders serve the poor. And are earning profits.

The important aspects of microfinance are as follows - - Metrics, validation, and barriers of micro enterprises - Market chain

This unit will elaborate on all the above aspects in detail. Microfinance provides financial services to the poor and low-income people for their micro-enterprises and small businesses, such as a wide range of products including savings, loans, payment services, money transfers, and insurance products, in order to enhance their income and living standards. The first step to evaluate the microfinance program is surprisingly that you are assessing microfinance. It seems natural, but it is not because the definition of microfinance is not entirely clear. Generally speaking, microfinance (micro loans) refers to providing small financial services to people who do not have access to traditional banking services. Microfinance generally includes loans for self-employment to low-income individuals as well as small savings. How the terms 'small' and 'poor' are defined determines whether it is microfinance or not. Microfinance, as the name suggests, is distinct from regular loans. Otherwise, it is referred to as micro credit. Many programs only offer savings-based products, and services like money transfers and insurance have been included as innovative financial services provided by financial institutions for the

poor. In fact, there is no institution that provides microfinancial services exclusively to the extremely poor. Commercial banks and insurance companies are also turning towards the lower class in search of new markets, consumer durable goods manufacturers are targeting the poor for micro loans, and companies like Walmart are also providing services such as money transfers. Thus, all programs that are included in microfinance cannot be the same based on the expectations of all people, models, target groups, and the services provided.

15.2 MEANING OF MICRO FINANCE:

Micro finance defined as the provision of thrift, credit and other financial services and products in very small amounts to the poor for enabling them to raise their income levels and improve living standards. It is the provision of very small loans that are rapid within short periods and is essentially used by low-income individuals and households. Micro finance is enabling, empowering, and bottom up tool to poverty alleviation that has provided considerable economic and noneconomic externalities to low income households in developing countries.

The Micro Financial Sector (Development and Regulation) Bill, (2007) defines microfinance as the provision of financial assistance and insurance services to an individual or an eligible client either directly or through a group mechanism for an amount, not exceeding rupees fifty thousand in aggregate per individual for small and tiny enterprise, agriculture, allied activities (including for consumption purposes of such individual); or an amount not exceeding rupees one lakh fifty thousand in aggregate per individual for housing or other prescribed purposes. The eligible clients which may get financial assistance under this scheme may be landless labourers and migrant labourers; artisans and micro-entrepreneurs; disadvantaged cultivators of agricultural land including oral lessees, tenants, and share croppers; and farmers owning not more than two hectares of agricultural land.

15.3 NEED FOR MICRO-FINANCE

In developing countries, financing to the rural poor through formal financial services failed to meet the credit requirements of the rural poor people. The main reason of failure was absence of any recognised employment and hence absence of

collateral with the poor. The high risk and the high transaction costs of banks associated with small loans and savings deposits are other factors which make them non-bankable. The lack of loans from formal institutions leaves the poor with no other option but to borrow money from local money-lenders on huge interest rates. In different countries including India, efforts have been made by their governments to deliver formal credit to rural areas by setting up special agricultural banks/rural banks or directing commercial banks to provide loans to rural borrowers. However, these programmes have also not worked well due to various reasons. The common reasons found by many researchers are the political difficulty for governments to enforce loan repayment and the selection of relatively wealthy and influential people, rather than the poor.

Thus, the inability of formal credit institutions to deal with the credit requirements of poor effectively has led to emergence of microfinance as an alternative credit system for the poor. Microfinance scheme provides a wide range of financial services to people who have little or nothing in the way of traditional collateral. It helps them to build up assets, survive crises and to establish small business to come out of poverty. Except extending small loans (micro-credit), microfinance programme provides various other financial and non-financial services such as savings, insurance, guidance, skill development training, capacity building and motivation to start income generating activities to enhance the productivity of credit.

15.4 CHARACTERISTICS AND FEATURES OF MICRO-FINANCE

	Distinguishing Features
Type of client	1. Low Income 2. Employment in informal sector; low wage bracket 3. Lack of physical collateral 4. Closely interlinked household/business activities
Lending Technology	▪ Prompt approval and disbursement of micro loans ▪ Lack of extensive loan records ▪ Collateral substitutes; group-based guarantees ▪ Conditional access to further micro-credits ▪ Information-intensive character-based lending linked to ▪ cash flow analysis and group-based borrower selection

Loan Portfolio	▪ Highly volatile ▪ Risk heavily dependent on portfolio management skills
Organizational Ideology	▪ Remote from/non-dependent on government ▪ Cost recovery objective vs. profit maximizing
Institutional Structure	▪ Decentralized ▪ Insufficient external control and regulation ▪ Capital base is quasi-equity (grants, soft loans)

It is debatable which of these characteristics, if any, are necessary conditions for a program to be considered microfinance. The first feature, small loans, is likely the most necessary, though lending itself is not essential; some microfinance programs focus on mobilizing savings (although few focus entirely on savings without engaging in any lending). Although MFIs often target micro entrepreneurs, they

differ as to whether they require this as a condition for a loan. Some MFIs visit borrowers' places of business to verify that loans were used for entrepreneurial activities while other MFIs disburse loans with few questions asked operating more like consumer credit lenders. In addition, some MFIs require collateral or "collateral substitutes" such as household assets that are valuable to the borrower but less than the value of the loan. Group lending, too, while common practice among MFIs is certainly not the only method of providing micro-loans. Many MFIs offer individual loans to their established clients and even to first-time borrowers. Grameen Bank, one of the pioneers of the microfinance movement and of the group lending model has since shifted to individual lending. The focus on "poor" clients is almost universal, with varying definitions of the word "poor." This issue has been made more important recently due to legislation from the United States Congress that requires USAID to restrict funding to programs that focus on the poor. Some argue that microfinance should focus on the "economically active poor," or those just at or below the poverty level (Robinson 2001). Others, on the other hand, suggest that microfinance institutions should try to reach the indigent (Daley-Harris 2005). Most, but not all, microfinance programs focus on women. Women have been shown to repay their loans more often and to direct a higher share of enterprise proceeds to their families. Worldwide, the Microcredit Summit Campaign reports that 80% of microfinance clients are female. However, the percentage of female

clients varies considerably by region, with the highest percentages in Asia, followed by Africa and Latin

America, with the fewest women served by microfinance institutions (MFIs) in the Middle East and North Africa.

This focus on the poor, and on women, along with the simple application process and the provision of financial services in clients' communities together form financial access, that is, the provision of financial services to the unbanked—those who have been excluded from financial services because they are poor, illiterate, or live in rural areas. Finally, microcredit loans are designed to be offered at market rates of interest such that the MFIs can recover their costs but not so high that they make supernormal profits off the poor. This is an important concept because institutions that charge high interest rates can be scarcely cheaper than the moneylenders they intended to replace, and institutions that charge subsidized rates can distort markets by undercutting other lenders that are attempting to recover their costs. This has implications for impact assessments because the less clients must pay in interest the more they could be expected to show in increased income. If we compare the impact of institutions that fall outside of “normal” microfinance interest rates, we could end up drawing unreasonable conclusions about the effectiveness of one program versus another, since each type of program attracts different clients and imposes different costs on their borrowers. Note that sustainability of an organization (as defined roughly by de facto World Bank policy) does not require each and every product or target market is sustainable but rather that the organization as a whole is sustainable. Thus organizations could charge lower interest rates for indigent or particularly poor individuals, as long as there were sufficient profits from lending to the not-so-poor to be able to cross-subsidize such program. Such programs may, in the long run, be sustainable (if the initially-subsidized program leads to client loyalty and a long-term relationship with the MFI).

15.5 MAJOR FEATURES OF MICRO- FINANCE PROGRAMMES

Under the Scheme of Micro-Finance Programme, the following activities would be undertaken.

1) Arranging Fixed Deposits for MFIs/NGOs: The SIDBI is already running a Micro-Credit Programme with a network of capacity assessed rated MFIs/NGOs. The scheme of Micro-Finance Programme has been tied-up with SIDBI by way of contributing towards security deposits required from the MFIs/NGOs to get loans from SIDBI as per details given under:

- The Government of India will provide funds for Micro-Finance Programme to SIDBI, which shall be called 'Portfolio Risk Fund' (PRF). This fund would be used for security deposit requirement of the loan amount from the MFIs/NGOs and to meet the cost of interest loss. At present, SIDBI takes fixed deposit equal to 10% of the loan amount. The share of MFIs/NGOs would be 2.5% of the loan amount (i.e. 25% of security deposit) and balance 7.5% (i.e. 75% of security deposit) would be adjusted from the funds provided by the Government of India. The MFIs/NGOs may avail the loan from the SIDBI for further on lending on the support of the security deposit.
- The Government would provide the needed fund in four years of the Xth Plan and release the fund on half-yearly basis based on demands for security deposit. By

contributing an amount of Rs.6 crore during the Xth Plan under Micro-Finance Programme, SIDBI can provide loan of Rs.80.00 crore to MFIs/NGOs. This would benefit approximately 1.60 lakhs beneficiaries, assuming an average loan of Rs. 5,000/- per beneficiary.

- The SIDBI will pay interest to the Govt. on the fixed deposit made available by the Government at the same rate as allowed to NGOs. Other terms and conditions will be fixed mutually by SIDBI and GOI.
- The recovery of loan/interests will be the sole responsibility of the SIDBI. In case of non recovery of loan, SIDBI would first adjust fixed deposit and interest accrued thereon for 2.5% security deposit of the loan pledged by the MFIs / NGOs and thereafter adjusts 7.5% security deposit of the loan amount provided by the Government of India and the interest accrued thereon with the approval of

Committee of Govt. of India.

- **Training and Studies on Micro-Finance Programme:** The Government of India would help SIDBI in meeting the training needs of NGOs, SHGs, intermediaries and entrepreneurs and also in enhancing awareness about the programme. This task would be performed through National Level Entrepreneurship Development Institutes (EDIs) and Small Industries Service Institutes (SISIs). The Research Studies would also be arranged through reputed agencies.

- **Institution Building for ‘Intermediaries ’ for identification of viable projects :** The Government of India would help in institution building through identification and development of ‘intermediary organization’, which would help the NGOs/SHGs in identification of product, preparation of project report, working out forward and backward linkages and in fixing marketing/ technology tie-ups. The SISIs would help in the identification of such intermediaries in different areas.

15.6 PRINCIPLES OF MICRO-FINANCE

1. **The poor need a variety of financial services, not just loans:** Just like everyone else, poor people need a wide range of financial services that are convenient, flexible, and reasonably priced. Depending on their circumstances, poor people need not only credit, but also savings, cash transfers, and insurance.

2. **Microfinance is a powerful instrument against poverty:** Access to sustainable financial services enables the poor to increase incomes, build assets, and reduce their vulnerability to external shocks. Microfinance allows poor households to move from everyday survival to planning for the future, investing in better nutrition, improved living conditions, and children’s health and education.

3. **Microfinance means building financial systems that serve the poor:** Poor people constitute the vast majority of the population in most developing countries. Yet, an overwhelming number of the poor continue to lack access to basic financial services. In many countries, microfinance continues to be seen as a marginal sector and primarily a development concern for donors, governments, and socially-responsible investors. In order to achieve its full potential of reaching a large number of the poor, microfinance should become an integral part of the financial sector.

4. Financial sustainability is necessary to reach significant numbers of poor people: Most poor people are not able to access financial services because of the lack of strong retail financial intermediaries. Building financially sustainable institutions is not an end in itself. It is the only way to reach significant scale and impact far beyond what donor agencies can fund. Sustainability is the ability of a microfinance provider to cover all of its costs. It allows the continued operation of the microfinance provider and the ongoing provision of financial services to the poor. Achieving financial sustainability means reducing transaction costs, offering better products and services that meet client needs, and finding new ways to reach the unbanked poor.

5. Microfinance is about building permanent local financial institutions: Building financial systems for the poor means building sound domestic financial intermediaries that can provide financial services to poor people on a permanent basis. Such institutions should be able to mobilize and recycle domestic savings, extend credit, and provide a range of services. Dependence on funding from donors and governments—including government-financed development banks—will gradually diminish as local financial institutions and private capital markets mature.

6. Microcredit is not always the answer: Microcredit is not appropriate for everyone or every situation. The destitute and hungry who have no income or means of repayment need other forms of support before they can make use of loans. In many cases, small grants, infrastructure improvements, employment and training programs, and other non-financial services may be more appropriate tools for poverty alleviation. Wherever possible, such non-financial services should be coupled with building savings.

7. Interest rate ceilings can damage poor people's access to financial services: It costs much more to make many small loans than a few large loans. Unless micro lenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs, and their growth and sustainability will be limited by the scarce and uncertain supply of subsidized funding. When governments regulate interest rates, they usually set them at levels too low to permit sustainable microcredit. At the same time, micro lenders should not pass on operational inefficiencies to clients in the form of prices (interest rates and other fees) that are

far higher than they need to be.

8. **The government's role is as an enabler, not as a direct provider of financial services:** National governments play an important role in setting a supportive policy environment that stimulates the development of financial services while protecting poor people's savings. The key things that a government can do for microfinance are to maintain macroeconomic stability, avoid interest-rate caps, and refrain from distorting the market with unsustainable subsidized, high-delinquency loan programs. Governments can also support financial services for the poor by improving the business environment for entrepreneurs, clamping down on corruption, and improving access to markets and infrastructure. In special situations, government funding for sound and independent microfinance institutions may be warranted when other funds are lacking.

9. **Donor subsidies should complement, not compete with private sector capital:** Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop supporting infrastructure (like rating agencies, credit bureaus, audit capacity, etc.), and support experimental services and products.

In some cases, longer-term donor subsidies may be required to reach sparsely populated and otherwise difficult-to-reach populations. To be effective, donor funding must seek to integrate financial services for the poor into local financial markets; apply specialist expertise to the design and implementation of projects; require that financial institutions and other partners meet minimum performance standards as a condition for continued support; and plan for exit from the outset.

10. **The lack of institutional and human capacity is the key constraint:** Microfinance is a specialized field that combines banking with social goals, and capacity needs to be built at all levels, from financial institutions through the regulatory and supervisory bodies and information systems, to government development entities and donor agencies. Most investments in the sector, both public and private, should focus on this capacity building.

11. **The importance of financial and outreach transparency:** Accurate, standardized, and comparable information on the financial and social performance of financial institutions providing services to the poor is imperative. Bank supervisors and regulators, donors, investors, and more importantly, the poor who

are clients of microfinance need this information to adequately assess risk and returns.

15.7 CHANNELS OF MICRO-FINANCE

In India microfinance operates through two channels:

1. SHG – Bank Linkage Programme (SBLP)

2. Micro- Finance Institutions (MFIs)

1. SHG- Bank Linkage Programme: This is the bank-led microfinance channel which was initiated by NABARD in 1992. Under the SHG model the members, usually women in villages are encouraged to form groups of around 10-15. The members contribute their savings in the group periodically and from these savings small loans are provided to the members. In the later period these SHGs are provided with bank loans generally for income generation purpose. The group's members meet periodically when the new savings come in, recovery of past loans are made from the members and also new loans are disbursed. This model has been very much successful in the past and with time it is becoming more popular. The SHGs are self-sustaining and once the group becomes stable it starts working on its own with some support from NGOs.

2. Micro-Finance Institutions: Those institutions which have microfinance as their main operation are known as micro finance institutions. A number of organizations with varied size and legal forms offer microfinance service. These institutions lend through the concept of Joint Liability Group (JLG). A JLG is an informal group comprising of 5 to 10 individual members who come together for the purpose of availing bank loans either individually or through the group mechanism against a mutual guarantee. The reason for existence of separate institutions i.e. MFIs for offering microfinance are as follows:

- High transaction cost – generally micro credits fall below the break-even point of providing loans by banks
- Absence of collaterals – the poor usually are not in a state to offer collaterals to secure the credit
- Loans are generally taken for very short duration periods

- Higher frequency of repayment of installments and higher rate of Default

Delivery Models of Micro-finance:

The concept of microfinance involves informal and flexible approach to the credit needs of the poor. There is no single approach or model that fits in all the circumstances. Therefore, a number of microfinance models emerged in different countries/states according to the suitability to their local conditions. Broadly, the microfinance delivery methods can be classified into six groups as follows:

1. **Grameen Bank Model:** Grameen Bank model is one of the oldest and most successful models of microfinance. This model was developed in Bangladesh. In this model microfinance programme participants are organised into groups of five members. They make mandatory contribution to group savings and insurance fund. Each member maintains her individual saving and loan account with the bank and after contributing to the savings fund for a fixed time the group members receive individual loans from the bank. But the group is not required to give any guarantee for the loan repayment by its member. Repayment responsibility solely rests on the individual borrower and there is no form of joint liability, i.e. group members are not responsible to pay on behalf of a defaulting member. Loans are provided for six months to one year duration but repayments are made weekly. Bank staff makes periodic visits to the groups, maintain individual records of group members and facilitate all the financial transactions. This creates ease in working but hindrance in the empowerment of members. The members remain dependent on field officers regarding their all group related activities. Grameen model has been replicated in more than 40 countries in Asia, Africa, and Latin America with modifications to suit local conditions and cultures. The programme of BancoSol in Bolivia and most of the solidarity groups in Latin America follow this methodology. Many MFIs in India have also replicated this model.

2. **Joint Liability Group Model:** In this model, 4 to 10 individuals are organised in a group known as a Joint Liability Group (JLG). The group members can avail bank loans against mutual guarantee and there is no condition of their own saving fund. All members sign a joint liability contract, making each one jointly liable for

repayment of all loans taken by all individuals in the group. Thus, only social collateral is provided to the lending institution. The JLGs are intended primarily to be credit groups and regular savings by the JLG members are not mandatory. The group exists only because its individual members are legally bound to one another. In this model, the progress of empowerment of group members remains very limited. In India these type of groups are generally made by most of the MFIs because such groups are easy to make as

there are very less restrictions regarding the utilisation of loan. NABARD is using this model for providing credit to the tenant farmers, cultivating land either as oral lessees or share croppers, and small farmers who do not have proper title of their land holding. Many other countries are also using this model. There were segments within the poor, such as share croppers/oral lessees/ tenant farmers, who were left out and whose loan requirements were much larger but who had no collaterals to fit into the traditional financing approaches of the banking system. To service such clients, Joint Liability Groups (JLGs), an upgradation of SHG model could be an effective way.

3. **Individual Lending Model:** In this method, individuals can get loans without any membership of a group. This is a straightforward credit lending model in which micro-loans are given directly to the borrowers. In this model, the financial institutions have to make frequent and close contact with individual clients to provide credit products customised to the specific needs of the individual. It is most successful for larger, urban-based, production-oriented businesses. The model is followed by many financial institutions like the Association for the Development of Micro-Enterprises (ADEMI) in Dominican Republic, Bank Rakyat Indonesia, Senegal Egypt, Self-Employment Women's Association in India, etc.

4. **The Group Approach:** The group approach delegates the entire financial process to the group rather than to the financial institutions. All financial activities like savings, getting loans, repayment of loans and record keeping are managed at the group level. In this method, 10-20 members are organised to form a group. These group members make regular savings of fixed amount in a common fund. The amount and frequency of savings is mutually decided by the group members. After the successful working of such a group for some months the group is linked to a financial institution for getting credit. The financial institutions issue loan in the

name of group and whole group is considered responsible for repayment. The amount of loan depends upon the total accumulated amount of saving of the group. Group members themselves decide about the criteria of dividing the loan among the group members. With this loan the whole group may jointly start a microenterprise or the members may start their individual businesses. An individual may also use his loan for consumptive purpose or meeting other priority needs. The peer pressure in the group helps the timely repayment of loan. These type of group based credit delivery methods help to empower the group members because they remain involved in various group activities. They visit the bank, market and hold group meetings which help them to increase self-confidence. In India, the group based credit delivery method known as SHG-BLP is a predominant method of providing microfinance. Programme Hubungan Bank Danksam (PHBK) project in Indonesia and the Chikola groups of K-REP in Kenya are also using such group based credit delivery models.

5. **Village Banking Model:** This village banking model is an expansion of the group approach. This model was developed in Bolivia during the mid 1980s by the Foundation for International Community Assistance (FINCA), a non-profit microfinance organisation. In this model, a Village Bank is

developed by grouping 30 to 100 low-income individuals who seek to improve their lives through self-employment activities. The bank is financed by internal mobilisation of members' saving fund as well as loans provided by the sponsoring MFIs. The MFIs lend capital to the bank, which then lends the money to its members. Members themselves run the village bank; they choose their members, elect their own officers, establish their own by-laws, distribute loans to individuals and collect savings and payments. Loan amounts are linked to the aggregate amount saved by individual bank members. Loans are repaid weekly in small instalments. Thus, village banks have a high degree of democratic control and independence. The model is used by various MFIs like Co-operative for Assistance and Relief Everywhere (CARE) in Guatemala; Save the Children in El Salvador; Burkina Faso in Bolivia, Mali, and Ghana; Freedom from Hunger and Catholic Relief Services in Thailand and Benin, Opportunity International, Consultative Group for Assisting the Poor (CGAP), etc.

6. **Credit Unions and Co-operatives:** A credit union is a democratic, not-for-

profit financial co-operative. It is owned and governed by its members, who are at the same time the owners and the customers of their co-operative society. Co-operatives are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operatives generally provide their members with a wide range of banking and financial services. Members participate in all the major decisions and democratically elect officers from among themselves to monitor the administration of the co-operative. Loans are granted only to the members. SANASA Development Bank of Sri Lanka is an example of rural credit co-operative which is successfully working as a microfinance service provider.

15.8 MICRO-FINANCE MOVEMENT IN INDIA

The micro finance movement in India was formally launched on a pilot basis by the National Bank for Agriculture and Rural Development (NABARD) in 1992. The formal financial institutions in India have not reached the poor households, particularly the women in the unorganised sector. Rigidities in the structure and overheads lead to high cost of making small loans. Further, the poor were not regarded as credit worthy. Low level of influence of the poor about either credit worthiness or their demand for saving services further aggravated the problem of the poor.

Micro credit is a financial innovation that originated with the Grameen Bank in Bangladesh. It has successfully enabled extremely impoverished people of Bangladesh to engage in self-employment projects that allow them to generate an

income and, in many cases, begin to build wealth and exit poverty. Due to the success of microcredit, many in the traditional banking industry have begun to realize that these microcredit borrowers should more correctly be categorized as pre-bankable; thus, microcredit is increasingly gaining credibility in the mainstream finance industry. Many traditional large finance organizations are contemplating microcredit projects as a source of future growth, even though almost everyone in larger development organizations discounted the likelihood of success of microcredit when it first

began. A multi agency rural credit delivery structure comprising of Commercial banks, Regional Rural Banks and Cooperative banks was established across the

country, but it was difficult for this structure to meet the credit requirements (small, frequent) of the poor. Complicated systems and procedures of banks also resulted in large section of poor keeping away from the formal banking sector. On the other hand, rapid expansion of bank network threatened its viability and at the same time they cannot keep the poor outside their fold. The need for alternate mechanism for catering the financial service needs of the poor has emerged.

Definition of Microfinance loans:

Microfinancing loans are small loans granted to the basic sectors, on the basis of the borrower's cash flow and other loans granted to the poor and low-income households for their microenterprises and small businesses to enable them to raise their income levels and improve their living standards. These loans are typically unsecured but may also be secured in some cases.

Level of Microfinance Loan:

Average microfinance loan of an NGO microfinance institution or of a cooperative bank or credit union in the Philippine case is about P25,000 (from a low of P2,000 to P5,000). To be realistic, the maximum principal amount of a microfinance loan can be pegged at P150,000. This is equivalent to the maximum capitalization of a microenterprise under R.A. 8425.

Collateralization of Microfinance Loan:

A microfinance borrower is not likely to be able to borrow from a large commercial, thrift or rural bank but from an NGO microfinance institution or perhaps from a small rural or cooperative bank. Thus, microfinance loans are typically unsecured, for relatively short periods of time (180 days) with monthly (or more frequent) amortizations of interest and principal, and often featuring a joint and several guarantees of one or more persons and, certainly, seldom with tangible collateral. But in some cases, they can also be secured, depending on the capacity of the borrower to offer collaterals acceptable to the lending institution.

Interest on Microfinance Loans:

1)Old Approach: The old (and by now highly discredited as ineffective) approach to loans for low-income borrowers emphasized subsidized interest rates. It did not

recognize that subsidized below- market interest rates do not necessarily result in opening up access to financial services for low- income households and microenterprises.

2)New Approach: The new approach which has been demonstrated by global experience is characterized by a market-based interest rate regime which permits the institution providing microfinance services to cover administrative costs, provisions for loan losses and intermediation/funding costs. This basis is consistent with financially sustainable rural finance and microfinance. Invariably, the

global experience continues to validate the proposition that what matters most to the poor and undeserved segments is access to financial services rather than their interest-rate cost – most especially because microenterprise and small business borrowers will take a microfinance loan whose repayment periods match the additional cash flows they hope to generate. Therefore, interest on such microfinance loans shall be reasonable but shall not be lower than the prevailing market rates. This is to enable the lending institution not only to recover the financial and operational costs incidental to this type of microfinance lending but also to realize some bottom line gains.

Segments of Demand for Micro-credit:

- The landless who are engaged in agricultural work on a seasonal basis and manual labourers in forestry, mining, household industries, construction and transport; requires credit for consumption needs and also for acquiring small productive assets, such as livestock.

- Small and marginal farmers, rural artisans, weavers and those self employed. in the urban informal sector as hawkers, vendors and workers in household micro-enterprises: requires credit for working capital, including a small part for consumption needs. This segment largely comprises the poor but not the poorest.

- Medium farmers/small entrepreneurs who have gone in for commercial crops and others engaged in dairy, poultry Among non-farm activities, this segment includes those in villages and slums engaged in processing or manufacturing activity. These persons live barely above the poverty line and also suffer from inadequate access to formal credit.

15.9 SUMMARY:

Microfinance is the provision of a broad range of financial services such as – deposits, loans, payment services, money transfers and insurance products – to the poor and low-income households, for their microenterprises and small businesses, to enable them to raise their income levels and improve their living standards. The term microfinance usually implies very small loans to low-income clients for self employment, often with the simultaneous collection of small amounts of savings. Micro finance defined as the provision of thrift, credit and other financial services and products in very small amounts to the poor for enabling them to raise their income levels and improve living standards. In India microfinance operates through two channels: (a) SHG – Bank Linkage Programme (SBLP) (b) Micro Finance Institutions (MFIs). The micro finance movement in India was formally launched on a pilot basis by the National Bank for Agriculture and Rural Development (NABARD) in 1992. The formal financial institutions in India have not reached the poor households, particularly the women in the unorganised sector. Micro credit is a financial innovation that originated with the Grameen Bank in Bangladesh. Microfinance loan of an NGO microfinance institution or of a cooperative bank or credit union in the Philippine case is about P25,000 (from a low of P2,000 to P5,000).

There are two kind of approaches of Microfinance Loans e.i.

- Old Approach,
- New Approach

15.10 GLOSSARY

Microfinance or small finance: refers to providing small loans to the poor class, lending in groups, and providing financial services for social/public welfare activities.

15.11 COMPREHENSIVE QUESTION

Fill in the blanks.

- In the year 1975, ... was developed as a low-cost institution that could reach the poorest individuals in backward areas in terms of loans
- 2. SHG (Self Help Group) is a bank-led microfinance vehicle that was started by

NABARD in

3. Microfinance is a financial innovation that started with rural banks.

15.12 ANSWER TO COMPREHENSIVE QUESTIONS

1. Regional Rural Banks 2. 1992 3. Bangladesh

15.13 SELF ASSESSMENT QUESTIONS

- 1) What is meant by Microfinance?
- 2) Discuss the various characteristics and features of Microfinance.
- 3) Explain the various Principles of Microfinance in details.
- 4) State and analyse of microfinance and its channels.
- 5) Define the silent features of Microfinance Programme.
- 6) Explain various delivery models of Microfinance.
- 7) Write an essay on Microfinance loan.

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UNIT-16 FINANCIAL INSTITUTIONS (IDBI, IFCI, ICICI, UTI AND SIDBI)

BLUE PRINT OF UNIT

- 16.1 Introduction
- 16.2 Financial Institutions: Meaning and Functions
- 16.3 Types of Financial Institutions
- 16.4 Regulation of Financial Institutions
- 16.5 Financial Institutions in India
- 16.6 Industrial Development Bank of India (IDBI)
- 16.7 Unit Trust of India (UTI)
- 16.8 Industrial Finance Corporation of India (IFCI)
- 16.9 Industrial Credit and Investment Corporation of India (ICICI)
- 16.10 Small Industries Development Bank of India (SIDBI)
- 16.11 Summary
- 16.12 Glossary
- 16.13 Comprehensive Questions
- 16.14 Answers to Comprehensive Questions
- 16.15 Self-Test Questions
- 16.16 Reference Books

OBJECTIVES:

After studying this unit, you will be able to –

- Describe the meaning and functions of financial institutions.
- Know the types of financial institutions.
- Explain the regulation of financial institutions.
- Obtain information about financial institutions in India.

16.1 INTRODUCTION

Financial institutions are those organizations that are involved in providing various types of financial services to their customers. The financial institutions are controlled and supervised by the rules and regulations delineated by government authorities. Some of the financial institutions also function as mediators in share markets and debt security markets. There the principal function of financial institutions is to collect funds from the investors and direct the funds to various financial services providers in search for those funds. Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management, and many other types of related functions. With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario. For carrying out their business operations, financial institutions implement different types of economic models. They assist their clients and investors to maximize their profits by rendering appropriate guidance. Financial institutions also impart a wide range of educational programs to educate the investors on the fundamentals of investment and also regarding the valuation of stock, bonds, assets, foreign exchanges, and commodities. Thus, it can be concluded that a financial institution is that type of an institution, which performs the collection of funds from private investors and public investors and utilizes those funds in financial assets. The functions of financial institutions are not limited to a particular country, instead they have also become popular in abroad due to the growing impact of globalization.

Financial institutions include banks, credit unions, asset management firms, building societies, and stock brokerages, among others. These institutions are responsible for distributing financial resources in a planned way to the potential users. There are a number of institutions that collect and provide funds for the necessary sector or individual. On the other hand, there are several institutions that act as the middleman and join the deficit and surplus units. Investing money on behalf of the client is another of the variety of functions of financial institutions.

Financial institutions can be categorized as follows:

- (1) Deposit Taking Institutions

- (2) Finance and Insurance Institutions
- (3) Investment Institutions
- (4) Pension Providing Institutions
- (5) Risk Management Institutions

At the same time, there are several governmental financial institutions assigned with regulatory and supervisory functions. These institutions have played a distinct role in fulfilling the financial and management needs of different industries, and have also shaped the national economic scene. Deposits taking financial organizations are known as commercial banks, mutual savings banks, savings associations, loan associations and so on.

The primary functions of financial institutions of this nature are as follows:

- (6) Accepting Deposits
- (7) Providing Commercial Loans
- (8) Providing Real Estate Loans
- (9) Providing Mortgage Loans
- (10) Issuing Share Certificates

Finance companies provide loans, business inventory financing and indirect consumer loans. These companies get their funds by issuing bonds and other obligations. These companies operate in a number of countries. On the other hand, there are insurance companies that provide coverage for a variety of risk factors and they also provide several investment options. Insurance companies provide loans for a number of purposes and create investment products. The functions of financial institutions, such as stock exchanges, commodity markets, futures, currency, and options exchanges are very important for the economy. These institutions are involved in creating and providing ownership for financial claims. These institutions are also responsible for maintaining liquidity in the market and managing price change risks. As part of their various services, these institutions provide investment opportunities and help businesses to generate funds for various purposes.

The functions of financial institutions like investment banks are also vital and related to the investment sector. These companies are involved in a number of financial

activities, such as underwriting securities, selling securities to investors, providing brokerage services, and fund raising advice. Financial institutions are the firms that provide financial services and advice to their clients. The financial institutions are generally regulated by the financial laws of the government authority.

15.3 TYPES OF FINANCIAL INSTITUTION

There are basically two types of Financial Institutions with respect to the Government; those that fall under direct state authority and those that are private. Another basis of classification would be based on the institutions that are mainly involved in traditional banking activities related to deposits and the issuance of loans and those that are concerned primarily with loans, insurance, finance and credit, mortgage, stock and other functions related to the World of finance.

The major difference in the above mentioned institutions is their modus operandi in the issuance of loans or the way in which finance is generated. State run institutions generate the resources from deposits and sale of shares; while private institutions generally act as intermediaries in generating finance by offering investment opportunities to people or establishments with excess capital and thus making it easy for companies and businesses to obtain the necessary funds.

The financial institutions based on the service that they offer may be broadly classified as follows

- Banks
- Credit Unions
- Insurance Companies
- Finance Companies
- Mortgage Companies
- Trust Companies
- Savings and Loan Associations

Financial institutions help the people in providing funds/money according to the needs and for the establishment purpose of small and large businesses or in other words, we can say that it is an agent providing financial service to the business. There are different types of such institutions like banks, credit unions etc. Their responsibility is to transfer the funds from specific investors to the different companies.

In India Financial Institution are classified into two Categories.

1. Banking Financial Institution.
2. **Non Banking Financial Institution.**

1. Banking financial institution are those which allow to receive money from the public, Like Banks i.e. allow to deal with public under the RBI guidelines.

2. Non banking Financial Institution are those institutions which are not allow to receive money from the public directly as deposit. But they will provide other financial support survives, Like Project financing, Hire purchase Finance, Bill Discounting, generally they deal with organization and their services are Enterprise oriented. They give financial support, advice and other service to Industry.

There are various types of financial institutions depending upon the services they offer like Banks, Credit Unions, Insurance Companies, Savings and Loan Associations, Finance Companies, Trust Companies and Mortgage Companies. On the basis of their assets and liabilities financial institutions are classified into three categories. First category of financial

institutions includes Depository institutions which include Commercial banks, Savings and loans associations, mutual saving funds and credit unions. Second category of financial institutions include Contractual saving institutions which are Life insurance companies, fire and casualty insurance companies, pension funds and government retirement funds. Third category of financial institution is Investment intermediaries. These institutions include finance companies, mutual funds and money market mutual funds.

Role of Financial Institutions

- The various financial institutions generally act as an intermediary between the capital market and debt market. But the service provided by a particular institution depends on its type.
- The financial institutions are also responsible to transfer funds from investors to the companies.
- Typically, these are the key entities that control the flow of money in the economy.

16.4 REGULATION OF FINANCIAL INSTITUTIONS

Regulations of financial institutions differ from one country to another. The financial

institution regulations are delineated by the government authorities of different countries. The principal objective of these government authorities is to regulate the financial activities going on in the country. The financial regulatory bodies control the stock markets, bond markets, foreign exchange markets, and various other segments of financial markets. The financial regulations are laid out for the purpose of creating a fair and customer-friendly environment in the financial market of a particular country, which is conducive for economic growth. Some of the examples of financial regulatory bodies are the Federal Reserve Bank (United States), Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), the Financial Services Authority (FSA) in the United Kingdom, the Securities and Exchange Commission (SEC) in the United States and many others.

The statutory objectives of the regulatory bodies of financial institutions include the following:

- **Market confidence:** Sustaining confidence in the financial markets is one of the most important objectives of the financial regulatory bodies
- **Consumer protection:** Ensuring the most suitable level of customer protection
- **Public awareness:** Encouraging public awareness about the financial market through imparting educational programs
- **Eliminating financial crime:** The financial regulations are designed for the purpose of reducing financial crimes and frauds

The regulatory principles that are followed by the regulators of financial institutions include the following:

- **Role of management:** Regulatory measures on the senior management of the financial institutions so that they do not take decisions that are detrimental to the financial market
- **Innovation:** Innovation should be facilitated with restriction so that the financial products and services launched are compliant to the rules and regulations
- **International aspects:** Strict monitoring should be there to see whether the international standards are maintained or not
- **Efficiency and economy:** The financial resources of a country should be used in the most prudent and effective way
- **Proportionality:** The financial regulations that are imposed should be proportional

to the advantages that are anticipated from the regulations

- **Competition:** There should be strict supervision on the financial market for the purpose of minimizing harmful effects of competition.

16.5 FINANCIAL INSTITUTION IN INDIA

Financial Institutions in India are divided in two categories. The first type refers to the regulatory institutions and the second type refers to the intermediaries. The regulators are assigned with the job of governing all the divisions of the Indian financial system. These regulatory institutions are responsible for maintaining the transparency and the national interest in the operations of the institutions under their supervision.

The regulatory bodies of the financial institutions in India are as follows:

- Industrial Development Bank of India (IDBI)
- Unit Trust of India (UTI)
- Indian Financial Corporation of India (IFCI)
- Industrial Credit Investment and Corporation of India (ICICI)
- Small Industrial Development Board of India (SIDBI)

16.6 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

Industrial Development Bank of India (IDBI) established under Industrial Development Bank of India Act, 1964 is the principal financial institution for providing credit and other facilities for developing industries and assisting development institutions. Till 1976, IDBI was a subsidiary bank of RBI. In 1976 it was separated from RBI and the ownership was transferred to Government of India. IDBI is the tenth largest bank in the world in terms of development. The National Stock Exchange (NSE), the National Securities Depository Services Ltd. (NSDL), Stock Holding Corporation of India (HCIL) are some of the Institutions which has been built by IDBI.

Organization and Management: IDBI consist of a Board of Directors, consisting of a chairman and Managing Director appointed by the Government of India, a Deputy Governor of the RBI nominated by that Central Government. The board had constituted on Executive Committee consisting of 10 Directors, including the Chairman and Managing Director. The executive committee is empowered to sanction financial assistance.

The Head office of IDBI is located in Mumbai. The bank has five regional offices, one each in Kolkata, Guwahati, New Delhi, Chennai and Mumbai. Besides the bank have 21 branch offices.

Function of IDBI: The main function of IDBI are discussed below:-

1. To provide financial assistance to industrial enterprises.
2. To promote institutions engaged in industrial development.
3. To provide technical and administrative assistance for promotion management or expansion of industry.
4. To undertake market and investment research and surveys in connection with development of industry.

IDBI Assistance:- The IDBI provides financial assistance either directly or through some specified financial institutions :-

1) **Direct Assistance:** The IDBI grants loans and advances to industrial concerns. There is no restriction on the upper or lower limits for assistance to any concern itself. The bank guarantees loans raised by industrial concerns in the open market from the State Co-operative Banks, the Scheduled Banks, the Industrial Finance Cooperation of India (IFCI) and other 'notified' financial institutions.

2) **Indirect Assistance:** The IDBI can refinance terms loans to industrial concerns repayable within 3 to 25 years given by the IFCI, the State Financial Corporation and some other financial institutions and to SIDCs (State Industrial Development Corporations), Commercial banks and co-operative banks which extend term loans not exceeding 10 years to industrial concerns. IDBI subscribes to the shares and bonds of the financial institutions and thereby provide supplementary resources.

DEVELOPMENT ACTIVITIES OF IDBI:-

1. **Promotion Activities:** In fulfillment of its developmental role, the bank continues to perform a wide range of promotional activities relating to development programmes for new entrepreneurs, consultancy services for small and medium enterprises and programmes designed for accredited voluntary agencies for the economic upliftment of the underprivileged. These include entrepreneurship development, self-employment and wage employment in the industrial sector for the weaker sections of society through voluntary agencies, support to Science and Technology Entrepreneurs' Parks, Energy

Conservation, Common Quality Testing Centers for small industries.

2. Technical Consultancy Organizations: With a view to making available at a reasonable cost, consultancy and advisory services to entrepreneurs, particularly to new and small entrepreneurs, IDBI, in collaboration with other All-India Financial Institutions, has set up a network of Technical Consultancy Organizations (TCOs) covering the entire country. TCOs offer diversified services to small and medium enterprise in the selection, formulation and appraisal of projects, their implementation and review.

3. Entrepreneurship Development Institute: Realizing that entrepreneurship development is the key to industrial development, IDBI played a prime role in setting up of the Entrepreneurship Development Institute of India for fostering entrepreneurship in the country. It has also established similar institutes in Bihar, Orissa, Madhya Pradesh and Uttar Pradesh. IDBI also extends financial support to various organizations is conducting studies or surveys of relevance to industrial development.

16.7 UNIT TRUST OF INDIA (UTI)

Unit Trust of India (UTI) is statutory public sector investment institution which was set up in February 1964 under the Unit Trust of India Act, 1963. UTI began operations in July 1964. It provides opportunity for small-savers to invest in areas where their risk is diversified. The Unit-holders, if necessary, can sell their units to UTI at the prices determined by UTI. One of the attractions is that the investment in UTI has an income-tax rebate and the income from the UTI's exempted from income tax subject to certain limits.

OBJECTIVES:

The primary objectives of the UTI are:-

1. To encourage and pool the saving of the middle and low income groups.
2. To enable them to share the benefits and prosperity of the industrial development in the country.

ORGANIZATION AND MANAGEMENT:-

UTI was established with an initial capital of Rs. 5crores, contributed by the RBI, LIC, SBI and its subsidiaries and scheduled banks and financial institutions. The initial

capital of Rs. 5 Crores was divided into 1,000 certificate of Rs. 50,000 each. To supplement its financial resources, the trust can borrow from the Reserve Bank of India, the amount being repayable on demand or with a period of 18 months.

UTI is managed by a Board of Trustees, consisting of a chairman and four members nominated by Reserve Bank of India, one member nominated by LIC, one member nominated by the State Bank of India, and two member elected by the contributing institutions.

Functions of UTI:

The UTI functions are discussed below:

- i) to accept discount, purchase or sell bills or exchange, promissory note, bill of lading, warehouse receipt, documents of title to goods etc.,
- ii) To grant loans and advances.
- iii) To provide merchant banking and investment advisory service.
- iv) To provide leasing and hire purchase business.
- v) To extent portfolio management ser service to persons residing outside India.
- vi) To buy or sell or deal in foreign exchange dealings.
- vii) To formulate unit scheme or insurance plan in association with or as agent of GIC.
- viii) To invest in any security floated by the Central Government, RBI or foreign bank.

Activities of UTI: The UTI can sell and purchase the units issued by it, investing, acquire, hold or dispose off securities. Keep money or deposit with the scheduled banks and undertake related functions incidental or consequential to that. All the units issued by the UTT are of the value of Rs. 10 each. These unties were put on sale at face value and thereafter at prices fixed daily by the UTI. Units can be purchase in ten or multiples of ten.

Scheme of UTI

The familiar schemes of UTI are given below:-

- Unit scheme- 1964.

- Unit Linked Insurance Plan- 1971.
- Children Gift Growth Fund Unit Scheme - 1986.
- Rajyalakhmi Unit Scheme - 1992.
- Senior Citizen's Unit Plan- 1993.
- Monthly Income Unit Scheme-.
- Master Equity Plan - 1995.
- Money Market Mutual Fund - 1997.
- UTI growth Sector Fund - 1999.
- Growth and Income Unit Schemes.

Advantages of Unit Trust

The advantages of unit trust are:-

- i) The investment is safe and the risk is spread over a wide range of securities.
- ii) The Unit-holders will be getting regular and good income, as 90 percent of its income will be distributed.
- iii) Dividends up-to Rs. 1,000 received by the individual are exempt from income tax.
- iv) There is a high degree of liquidity of investment as the units can be sold back to the trust at any time at prices fixed by trust.

16.8 INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)

Government of India set up the Industrial Finance Corporation of India (IFCI) in July 1948 under a special Act. This is the first financial institution set up in India with the main object of making medium and long term credit to industrial needs.

The Industrial Development Bank of India, Scheduled banks, insurance companies, investment trusts and co-operative banks are the shareholders of IFCI. The Union Government has guaranteed the repayment of capital and the payment of a minimum annual dividend. The corporation is authorised to issue bonds and debentures in the open market, to borrow foreign currency from the World Bank and other organizations, accept deposits from the public and also borrow from the Reserve Bank.

The authorised share capital of the IFCI was Rs. 10 crore at the initial stage, According to the Industrial Finance Corporation (Amendment) Act, 1986, the authorized capital of the corporation has been raised from Rs. 100 crore to Rs. 250 crore (the authorized capital may be fixed by the government of India by notification from time to time).

Functions:

The functions of the IFCI base as follows:

- i) The corporation grants loans and advances to industrial concerns.
- ii) Granting of loans both in rupees and foreign currencies.
- iii) The corporation underwrites the issue of stocks, bonds, shares etc.
- iv) The corporation can grant loans only to public limited companies and co-operatives but not to private limited companies or partnership firms.

Organization and Management:

The Head Office of the IFCI is in New Delhi. It has also established its Regional offices in Bombay, Chennai, Kolkata, Chandigarh, Hyderabad, Kanpur and Guwahati. The branch offices of IFCI are located in Bhopal, Pune, Jaipur, Cochin, Bhubaneswar, Patna, Ahmedabad and Bangalore.

The IFCI is managed by a Board of Directors, headed by a Chairman, who is appointed by the Government of India, in consultation with RBI. The chairman holds his position for a period of 3 years, subject to extension. Of the 12 directors, 4 are nominated by the IDBI, three of whom are experts in the fields of industry, labour and economics and the fourth is the General Manager of the IDBI. The remaining 8 directors are nominated. Two directors are nominated for a term of 4 years by each of the following- scheduled banks, co-operative banks, insurance companies and investment companies, making up eight directors.

Activities of the IFCI:

The promotional activities of IFCI are explained below:

1. **Soft Loan Assistance:** The scheme provides soft loan assistance to existing industries in small and medium sector for developing technology through in- house research and development.
2. **Entrepreneur Development:** IFCI provides financial support to EDPs

(Entrepreneur Development Programmes) conducted by several agencies all-over India. In co-operation with Entrepreneurship Development Institute of India.

3. **Industrial Development in Backward Areas:** IFCI also take measures to promote industrial development in backward areas through a scheme of concessional finance.

4. **Subsidised Consultancy:** The IFCI give subsidised consultancy for:

- Small Entrepreneurs for Meeting the Cost of Project.
- Promotion Ancillary Industries
- To do the Market Research
- Reviving Sick Units.
- Implementing Modernisation.
- Controlling Pollution in Factories.

5. **Management Development:** To improve the professional management the IFCI sponsored the Management Development Institute in 1973. It established the Development banks.

Working of the IFCI:

The working of the IFCI came in for a large measure of criticism. In the first place, the rate of interest which the corporation charged was extremely high. Secondly, there was a great delay in sanctioning loans and in making the amount of the loans available. Thirdly, the 'corporation's insistence on the personal guarantee of managing directors in addition to the mortgage of property was considered wrong.

In the last two decades the corporation has entered into new lines of activity, viz, underwriting debentures and shares and guaranteeing of deferred payment in respect of imports from abroad of plant and equipment by industrial concerns and subscribing to stocks and shares of industrial concerns directly. Besides, the performance of IFCI together with the work of other public sector financial institutions has been extremely credit worthy in the last two decades.

16.9 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)

Industrial Credit and Investment Corporation of India (ICICI) was established in 1955 as public limited company under Indian Company Act, for developing medium and small industries of private sector. Initially its equity capital was owned by companies, institutions and individuals but at present its equity capital has been owned by public

sector institutions like- Banks, LIC, GIC and its associate companies. In March 2002, the ICICI was merged with the ICICI Bank and created a first universal bank in India. With this merger, ICICI does not exist any more as a development financial institution.

Objectives:

The important objectives of the ICICI are as follows:

1. To provide loans to industrial projects in private sector.
2. To stimulate the promotion of new industries.
3. To assist the expansion and modernisation of existing industries.
4. To provide Technical and managerial aid to increase production.

Financial Assistance of ICICI:

To achieve its objectives, ICICI provides financial assistance in various forms such as:

1. Long term and medium term loans both in terms of rupee and foreign currency.
2. Participating in equity capital and in debentures.
3. Underwriting new issues of shares and debentures.
4. Guarantee to suppliers of equipment and foreign loaners.

The ICICI has recently set up a Merchant Banking Division which is working very creditably. It has also set up ICICI Asset Management Company Ltd. in June 1993 to operate the schemes of the ICICI Mutual Fund. Yet another subsidiary called ICICI Investors Services Ltd. (March 1994) and ICICI Banking Corporation Ltd. (January 1994) have started operations.

Activities of ICICI:

The activities of ICICI are discussed below:

1. **Project Finance:** The project finance is provided to industries for the cost of establishment, modernisation or expansion of manufacturing and processing activities in the form of rupee and foreign loans, underwriting, subscription to shares and debentures and guarantees to supply of equipment and foreign donors. The rupee loan is given for the purchase of equipment and machinery, construction and preliminary expenses. The foreign currency loans are provided for the purchase of imported capital equipment.

2. **Leasing:** The leasing operations of the ICICI commenced in 1983. Leasing assistance is given for computerisation, modernisation/ replacement, equipment of energy conservation, export orientation, pollution control etc.

3. **Project Advisory Services:** The Project advisory services are provided to the Central and State Governments and public sector and private sector companies. Advice to the government is provided on policy reforms and on value chain analysis and to private sector companies on strategic management.

4. **Facilities for Non-resident Indians:** The information regarding on facilities and incentives given by the Government of India to the non-resident Indians for judicious investing in India are offered.

5. **Provision of Foreign Currency Loans:** The ICICI has provision of foreign currency loans and advances to enable Indian Industrial concerns to secure essential capital goods from foreign countries.

6. Other Institutions Promoted:

- ICICI promoted the housing Development Finance Corporation (HDFC) to provide long term finance to individuals in middle and lower income groups, co-operations, etc., for the construction and purchase on ownership basis of residential houses all over the country.

- Credit Rating Information Services of India Ltd. (CRISIL) set up by ICICI in association with Unit Trust of India (UTI) to provide credit rating services to the corporate sector.

- Technology Development and Information Company of India Ltd. (TDICI), promoted by ICICI, to finance the transfer and Upgradation of technology and provide technology information.

- Programme for the Advancement of Commercial Technology (PACT) set up with a grant of US \$10 million provided by USAID (United states Aid) to assist market-oriented R&D activity, jointly undertaken by Indian and US companies, ICICI has been entrusted with the administration and management of PACT.

- Programme for Acceleration of Commercial Energy Research (PACER) funded by USAID with a grant of US \$20 million to support selected research and technology development proposals in Indian energy sector PACER was also launched by ICICI.

16.10 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

Small Industries Development Bank of India (SIDBI) was established as wholly owned subsidiary of Industrial Development Bank of India (IDBI) under the small Industries Development of India Act 1989. It is the principal institution for promotion, financing and development of industries in the small-scale sector. It also coordinates the functions of institutions engaged in similar activities. For this purpose, SIDBI has taken over the responsibility of administrating Small Industries Development Fund and National Equity Fund from IDBI.

Capital. SIDBI started its operations from April 1990 with an initial authorised capital of Rs. 250 crore, which could be increased to Rs. 1000 crore. It also took over the outstanding portfolio of IDBI relating to small scale sector held under Small Industries Development Fund as on March 31, 1990 worth over Rs. 4000 crore.

Objectives:

In the setting up of SIDBI, the main purpose of the government was to ensure larger flow of assistance to the small-scale units. To meet this objective, the immediate thrust of the SIDBI was on the following measures:

1. Initiating steps for technological upgradation and modernisation of existing units;
2. Expanding the channels for marketing the products of the small scale sector; and
3. Promotion of employment-oriented industries, especially in semi- urban areas to create more employment opportunities and thereby checking migration of population to urban areas.

The important functions of SIDBI are as follows:

- To initiate steps for technological upgradation and modernisation of existing units.
- To expand the channels for marketing the products of SSI sector in domestic and international markets.
- To promote employment oriented industries especially in semi-urban areas to create more employment opportunities and thereby checking migration of people to urban areas.

The SIDBI's financial assistance to small-scale industries is channelised through the existing credit delivery system comprising State Financial Corporations, State Industrial

Development Corporations, Commercial Banks and Regional Rural Banks. The SIDBI introduced two new schemes during 1992-93; equipment finance scheme for providing

direct finance to existing well-run small-scale units taking up technology upgradation/modernisation and refinance for resettlement of voluntarily retired workers of NTC. The other new scheme launched was venture capital fund exclusively for small-scale units, with an initial corpus of Rs. 10 crore. It enrolled itself as an institutional member of the OTC Exchange of India (OTCEI). SIDBI also provides financial support to National Small Industries Corporation for providing leasing, hire-purchase and marketing support to the industrial units in the small-scale sector.

Channels of Assistance:

SIDBI's financial assistance to small scale sector has three major dimensions:

- (i) **Direct assistance:** The objective behind SIDBI's direct assistance schemes has been to supplement the efforts of PLIs by identifying the gaps in the existing credit delivery mechanism for SSIs. Assistance is provided directly through 43 branches of SIDBI. The assistance is extended directly for setting up of new SSI units, small hotels, hospitals/nursing homes, technology upgradation and modernisation, expansion and diversification, marketing of SSI products, setting up of multiplexes, development of infrastructure for the SSI sector, discounting of bills etc.
- (ii) **Indirect assistance :** SIDBI's schemes of indirect assistance envisage credit to SSIs through a large network of 913 PLIs. SIDBI has bagged the prestigious "ADFIAP Development Award 2003" for its Rural Industries Programme designed to give impetus to rural development by creating sustainable industrial and service enterprises in rural areas. spread across the country with a branch network of over 65,000. The assistance is provided by way of refinance, bills rediscounting and resource support in the form of short term loans/line of credit in lieu of refinance etc.
- (iii) **Development and Support Services:** SIDBI extends development and support services in the form of loans and grants to different agencies working for the promotion and development of SSIs and tiny industries. The support is given for enterprise promotion with emphasis on rural industrialisation, HRD development in the SSI sector, technology upgradation, quality and environment management, marketing promotion, information dissemination etc.

16.11 SUMMARY

Financial institutions are those organizations that are involved in providing various types of financial services to their customers. The financial institutions are controlled

and supervised by the rules and regulations delineated by government authorities. Some of the financial institutions also function as mediators in share markets and debt security markets. Financial institutions include banks, credit unions, asset management firms, building societies, and stock brokerages, among others. There are basically two types of Financial Institutions with respect to the Government; those that fall under direct state authority and those that are private. Another basis of classification would be based on the institutions that are mainly involved in traditional banking activities related to deposits and the issuance of loans and those that are concerned primarily with loans, insurance, finance and credit, mortgage, stock and other functions related to the World of finance. In India Financial Institution are classified into two Categories.

1. Banking Financial Institution.
2. Non Banking Financial Institution.

There are various types of financial institutions depending upon the services they offer like Banks such as Industrial Development Bank of India (IDBI) established under Industrial Development Bank of India Act, 1964 and IDBI was a subsidiary bank of RBI. Unit Trust of India (UTI) is statutory public sector investment institution which was set up in February 1964 under the Unit Trust of India Act, 1963. UTI began operations in July 1964. It provides opportunity for small-savers to invest in areas where their risk is diversified. Government of India set up the Industrial Finance Corporation of India (IFCI) in July 1948 under a special Act. This is the first financial institution set up in India with the main object of making medium and long term credit to industrial needs. Industrial Credit and Investment Corporation of India (ICICI) was established in 1955 as public limited company under Indian Company Act, for developing medium and small industries of private sector. Small Industries Development Bank of India (SIDBI) was established as wholly owned subsidiary of Industrial Development Bank of India (IDBI) under the small Industries Development of India Act 1989.

16.12 GLOSSAARY:

Financial institution: Institutions are organizations engaged in providing various types of financial services to their clients.

IDBI: The establishment of the Industrial Development Bank of India (IDBI) was made

as a major financial institution to provide credit and other facilities for the development of industries and support for development institutions.

16.13 COMPREHENSIVE QUESTION

Fill in the blanks.

1. Banks, loan organizations, asset management firms, building societies, and stock brokers, etc. are included in.....
2. Financial institutions in India are divided into categories.
3. The Industrial Finance Corporation of India (IFCI) is the first financial company established in India, which was set up with the objective of providing long-term loans for industrial needs
4. The Unit Trust of India is a constitutional institution in the public sector, which was established in..... .

16.14 ANSWER TO COMPREHENSIVE QUESTIONS

1. Financial institutions 2. Two 3. Medium and long 4. February 1964

16.15 SELF ASSESSMENT QUESTIONS

- 18 What is meant by financial institutions?
- 19 Explain the various types of financial institutions in India.
- 20 Define IDBI and its development activities.
- 21 Discuss the various functions and activities of UTI.
- 22 What is meant by IFCI?
- 23 Provide a brief overview of the financial assistance of ICICI.
- 24 Write an essay on SIDBI.

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UNIT-17 FOREIGN TRADE: PRINCIPLES, ISSUES, AND MODERN CONTEXT

BLUE PRINT OF UNIT

- 17.1 Introduction
- 17.2 Mercantilism
- 17.3 Theory of Absolute Advantage
- 17.4 Theory of Comparative Advantage
- 17.5 Heckscher-Ohlin Trade Model
- 17.6 Leontief Paradox
- 17.7 Modern Theories of International Trade
- 17.8 Summary
- 17.9 Glossary
- 17.10 Comprehensive Questions
- 17.11 Answers to Comprehensive Questions
- 17.12 Self-Assessment Questions
- 17.13 Reference Books

OBJECTIVES:

After reading this lesson, you will be able to:

- Understand what fosters the international trade
- Know the classical, neo-classical and modern theories of international trade

17.1 INTRODUCTION

Since times immemorial, goods have moved across nations and people have made profit by selling the products to other countries, which were not available there. As per the principals of classical economics, there are four basic factors (resources) of production –Land, such as

land, trees and minerals; Labor- the mental and physical skills of individuals; Capital- such as tools, machines and factories used in production or to facilitate production; and Entrepreneurship -The availability of natural resources, labour and capital is not sufficient to ensure economic success. These factors of production have to be combined and organised by the enterprising people who see opportunities for making a profit and who are willing to take risks by producing goods and services in the expectation that they will be sold. However, for success in business, it is not just a matter of what resources we have but also of how well we use them. Since the times

of Adam Smith, people have been pondering on what underlies the movement of goods and services across nations, giving rise to the theories of international trade. As the times changed, the nature of economic activities also underwent a change and accordingly the ways to look at the underlying factors also underwent a change. Several economists proposed different theories of international trade. In this lesson, we shall study various theories of international trade.

17.2 MERCANTILISM

In the earlier days, dating back to the 16-18th century, Mercantilism was the economic philosophy that maintained that a country's wealth is measured by its holdings of gold and silver. Probably, it is this philosophy that India earned lot of gold and she was called as 'golden bird' in the ancient times. According to the principles of mercantilist theory, a country's goal should be to enlarge those holdings, i.e. the assets in the form of gold and silver. In order to increase the gold in the country, it was believed that money should come into the country and not go out of it. Therefore, mercantilism suggests that the ruling government should advance these goals by playing a protectionist role in the economy by encouraging exports and discouraging imports, notably through the use of subsidies and tariffs respectively. The theory dominated Western European economic policies from the 16th to the late-18th century. That was the time of colonialism and the nations concentrated on capturing the colonies, exploiting them to purchase the raw material and sell the finished goods. There was no move to sell the goods between the nations.

Considering the prevailing socio-economic conditions of those times, mercantilism might have been a useful line of thought, but it has several shortcomings. Its major limitation is that it confuses the acquisition of treasure with the acquisition of wealth. Assets in the

modern times do not exist only in the form of gold and silver. In the present times, there are newer forms of assets. Moreover, protectionist policy weakens the country because it robs individuals of the ability to trade freely, and to benefit from voluntary exchanges. Moreover, it forces countries to produce products it would otherwise not in order to minimize imports.

The theory of mercantilism was questioned by the economists like Adam Smith and later by Ricardo by giving due importance to the individuals, and stressing that their welfare was the welfare of the nation. They believed in free trade, supported liberalism and enlightenment, and treated the wealth of the nation in terms of the "the

sum of enjoyments" of the individuals in society, and not merely in terms of the gold and silver. Therefore, any activity, which would increase the consumption of the people, was to be considered with favour. Accordingly, their trade theories proposed by them were based upon the principles of free trade and the specialisation in the production of those goods where resources were most suitable.

17.3 THEORY OF ABSOLUTE ADVANTAGE

The theory of Absolute Advantage was proposed by Adam Smith, who argued that mercantilism robs individuals of the ability to trade freely and to benefit from voluntary exchanges. According to this theory of absolute advantage, a country should export those goods and services for which it is more productive than other countries and import those goods and services for which other countries are more productive than it is. A country is said to possess an absolute advantage over its trading partner when it can produce more of an output with a given amount of inputs. This can be understood with the help of an example.

Suppose that we are studying two countries – England and Portugal, who are producing wine and cloth. We further assume that there is no trade between the two countries and the output of the two countries per unit of the output is shown in the following table:

Table 17.1

Outputs / unit of Inputs of two countries

Country	Output of Wine/ unit input	Output of Cloth/ unit input
England	1	12
Portugal	6	10

When there is not trade between the two countries, both produce the goods as per their needs. We further assume that each country has 1000 units of inputs and uses the resources equally to produce the two products. When they are consuming their output alone, we can find their optimal production / consumption point by multiplying our 2X2 matrix of outputs by 500 (1/2 of the 1000 units of inputs for each country in the production of each product). We find that the output per one unit of Input Production Wine Cloth Inputs Wine Cloth England 1 12 500/500 500 6,000 Portugal 6 10 500/500 3,000 5,000 Total Production / Consumption in the two countries : 3,500 11,000. This can be shown with the help of the following table:

Table 17.2

Outputs / unit of Inputs of two countries

Output per unit of input				Production	
Country	Wine	Cloth	Inputs	Wine	Cloth
England	1	12	500/500	500	6000
Portugal	6	10	500/500	3000	5000

In this scenario, the total production of wine is 3500 units and cloth is 11000 units. Both the countries consume what they produce.

In the next scenario, we assume that each country specializes in the production of that product for which it has an absolute advantage. In this example, England has an absolute advantage in cloth and Portugal has an absolute advantage in Wine. The two countries produce only one product, i.e. England produces only cloth and Portugal produces only wine. Both allocate their full resources to only one product. Assuming that they allocate 1000 units, England will produce 12000 units of cloth and Portugal will produce 6000 units of wine. The total output of the two countries increases by 2500 additional units of wine and 1000 additional units of cloth. Hence, with the same output, foreign trade between the two countries increased the output. After trade, the international exchange ratio would lie somewhere between the pre-trade exchange ratio of the two countries. In other words, the additional output produced because of the trade will be distributed according to the terms of the trade between the two countries. For this purpose, the domestic scenario of the two countries has to be studied. In England, 1 unit of Wine is equivalent to 12 units of cloth and 1 unit of Cloth is equivalent to $1/12$ barrel of Wine. Similarly, in case of Portugal, 1 unit of wine is equal to $1\frac{2}{3}$ units of cloth and 1 unit of Cloth is equivalent to $3/5$ unit of Wine. Hence, the additional output will be taken by the two countries and both would benefit from trade, as compared to production in isolation.

17.4 THEORY OF COMPARATIVE ADVANTAGE

Theory of absolute advantage provided a useful framework for international trade for centuries, but it was looked upon with a different perspective. David Ricardo, a British economist argued that cost advantage is not the necessary and sufficient condition for trade between the nations. He argued that nations would benefit from trade even if they had absolute cost advantage. According to Ricardo, so long as the other country is not equally less productive in all lines of production, measurable in

terms of opportunity cost of each commodity in the two countries, it will still be mutually gainful for them if they enter into trade. This theory states that a country should produce and export those goods and services for which it is relatively more productive than are other countries and import those goods and services for which other countries are relatively more productive than it is.

A country is said to have a comparative advantage in the production of a good if it can produce it at a lower opportunity cost than another country. In the example given earlier, (wine-cloth) the opportunity cost of cloth production is defined as the amount of wine that must be given up in order to produce one more unit of cloth.

The Ricardian model assumes two countries producing two goods using labor as the only factor of production. Goods are assumed to be homogeneous (identical) across firms and countries. Labor is homogeneous within a country and heterogeneous (nonidentical) across countries. Goods can be transported costlessly between countries. Labor can be allocated costlessly between industries within a country but cannot move between countries. Labor is always fully employed. Production technology differences exist across industries and across countries and reflected in labor productivity parameters. Firms are assumed to maximize profit, while consumers are assumed to maximize utility.

The concept of opportunity cost can be explained with the help of the following table:

Table 17.3 Opportunity Cost

Output per unit of input	Paper	Fish
Finland	3	4
Germany	1	2

In this example, we assume that two countries – Finland and Germany produce paper and fish. If both the countries were to produce only one product, they would have to forego the production of the other product. For example, if Finland decided to produce only fish, then it would forego the production of paper, similarly, if Germany decides to produce paper, it has to forego the production of fish. In these cases, the foregone alternative is lost when one option is selected.

Each country has a comparative advantage over its trading partner in the production

of that good for which its opportunity cost is lower than that of its trading partner. In the above example, the Output/unit of the Input in case of paper produced by Finland is $\frac{3}{4}$ of that of fish, and in case of Germany, it is $\frac{1}{2}$. In other words, if Finland were to produce paper by foregoing fish, it would be able to produce $\frac{3}{4}$ th of the output per unit labour cost it would have used to produce fish. Opportunity cost (what must be given up to produce more) Output/Input for Paper for Fish in case of Finland is 1 : $\frac{1}{3}$ fish, and $\frac{3}{4}$ paper. In case of Germany it is 2 fish, and $\frac{1}{2}$ paper. With this background, if we assume that the input is 1000 units of labour in each country, the output for each country would be as shown in the following table:

Table 17.4

Output for 1000 units of labour inputs in isolation

	Paper	Fish	Inputs	Paper	Fish
Finland	3	4	500/500	1500	2000
Germany	1	2	500/500	500	1000

In the situation when there is no trade between the two countries, 1000 units of labour input is equally divided between the two products and the output paper produced by Finland and Germany would be 1500 and 500 units respectively. Similarly, the output of fish would be 2000 and 1000 units respectively. Therefore, the total production/consumption of the two countries would be 2000 units of paper and 3000 units of fish.

Further, let us assume that the two countries engage themselves into trade and produce the product in which they have a comparative cost advantage, i.e. produce the product which they can do at a price lower than the other country. In this example, Finland has a comparative advantage because she is able to produce 3 units of paper with one unit of input, as against Germany, who can produce 1 unit of paper. Similarly, Germany has a cost advantage of producing fish. Assuming that Finland allocates 70% of its inputs to producing paper and rest 30% to producing fish, and Germany allocates 100% of the inputs to producing fish, the output would be as shown in the following table:

Table 17.5

Output per 1000 unit of inputs in case of trade

Country	Paper	Fish
Finland (700/300)	2100	1200
Germany (0/1000)	0	2200
Total Output	2100	3300

We see that in situation of trade, the total output of the two countries increases. Now, who would take the increased output would depend upon the terms of trade and bargaining power of the two countries.

Ricardian theory concludes that when countries specialize and trade the relative price of the produced good rises, income for workers rises and imported goods are less expensive for consumers. Trade has the potential to benefit both high productivity and low productivity countries, although trade may change the distribution of income within countries. The high productivity or low wages give countries a cost advantage that allows them to produce efficiently. However, the limitation of the theory is that in actual practice the assumptions cannot be overlooked. There are transportation costs and several other factors that can influence with the flow of goods across nations. Still, this theory provides a basis to encourage free trade between the nations, as against the protectionist theory of the earlier times.

Both the absolute advantage and comparative advantage theories failed to realise that the welfare of society does not depend only on the gains from the international trade but depends upon the way the gains are distributed. The individual gains under the theories are not guaranteed unless the government adopts an appropriate redistribution policy. There have to be certain incentives for the producers also in order to keep them engaged in the exportable production. These theories have also been criticised on the ground that labour is not the only input determining the cost of production.

17.5 HECKSEHER-OHLIN TRADE MODEL

Adam Smith and Ricardo's trade models considered labour as the only factor input and the differences in the labour productivity determining the trade. Eli Heckscher (1919) and Bertin Ohlin (1933) developed the international trade theory (H.O. Trade Model) with two factor inputs, labour and capital, pointing out that different countries

have been bestowed with different factor endowments, and the differences in factor endowments cause trade between the trading partners.

According to Bertil Ohlin, trade arises due to the differences in the relative prices of different goods in different countries. The difference in commodity price is due to the difference in factor prices (i.e. costs). Factor prices differ because endowments (i.e. capital and labour) differ in countries. Hence, trade occurs because different countries have different factor endowments.

The Heckscher Ohlin theorem states that countries which are rich in labour will export labour intensive goods and countries which are rich in capital will export capital intensive goods. The theory is based on the assumption that there are impediments to trade, and that there is perfect competition in both the product and factor markets. Further, the theory is based on the comparative advantage in terms of the relative factor prices. A country specialising in the production of the goods which require its abundant factor can export them. Thus, if a country is rich in capital, it will produce capital intensive products and export them in exchange for the labour intensive products. On the other hand, another country, rich in labour, will produce labour intensive goods and export them. It will import capital intensive goods.

Heckscher-Ohlin's theory explains the modern approach to international trade on the basis of following assumptions :

- (a) There are two countries involved. For the sake of theoretical modelling, it is assumed that the trade is happening between two countries.
- (b) Each country has two factors (labour and capital). This is an extension of the classical theories, which considered labour as the only factor.
- (c) Each country produce two commodities or goods. These can be labour intensive and capital intensive.
- (d) There is perfect competition in both commodity and factor markets. Perfect competition leads to fair prize mechanism and normal profits for all the players.
- (e) All production functions are homogeneous of the first degree i.e. production function is subject to constant returns to scale.
- (f) Factors are freely mobile within a country but immobile between countries, i.e. labour and capital can be utilized within the countries.
- (g) Two countries differ in factor supply.

- (h) Each commodity differs in factor intensity.
- (i) The production function remains the same in different countries for the same commodity. For e.g. If commodity A requires more capital in one country then same is the case in other country.
- (j) There is full employment of resources in both countries and demand are identical in both countries.
- (k) Trade is free i.e. there are no trade restrictions in the form of tariffs or non-tariff barriers.
- (l) There are no transportation costs.

In light of these assumptions, Ohlin's thesis proposes that a country export goods which use relatively a greater proportion of its abundant and cheap factor. The same country imports the goods whose production requires the intensive use of the nation's relatively scarce and expensive factor.

The Concept of Factor Abundance

In the two countries, two commodities & two factor model, implies that the capital rich country will export capital intensive commodity and the labour rich country will export labour intensive commodity. But the concept of country being rich in one factor or other is not very clear. Economists quite often define factor abundance in terms of factor prices. Ohlin himself has followed this approach. Alternatively factor abundance can be defined in physical terms. In this case, physical amounts of capital & Labour are to be compared. Price Criterion for defining Factor Abundance

A country where capital is relatively cheaper and labour is relatively costly is said to be capital rich country. Whereas a country where labour is relatively cheaper and capital is relatively costly is said to be labour rich country. For the sake of developing the mathematical equation, let us assume that the trade is taking place between two countries – America and India.

Price of the factor can be measured as per the following equation:

$$PK/PL_a > PK/PL_i$$

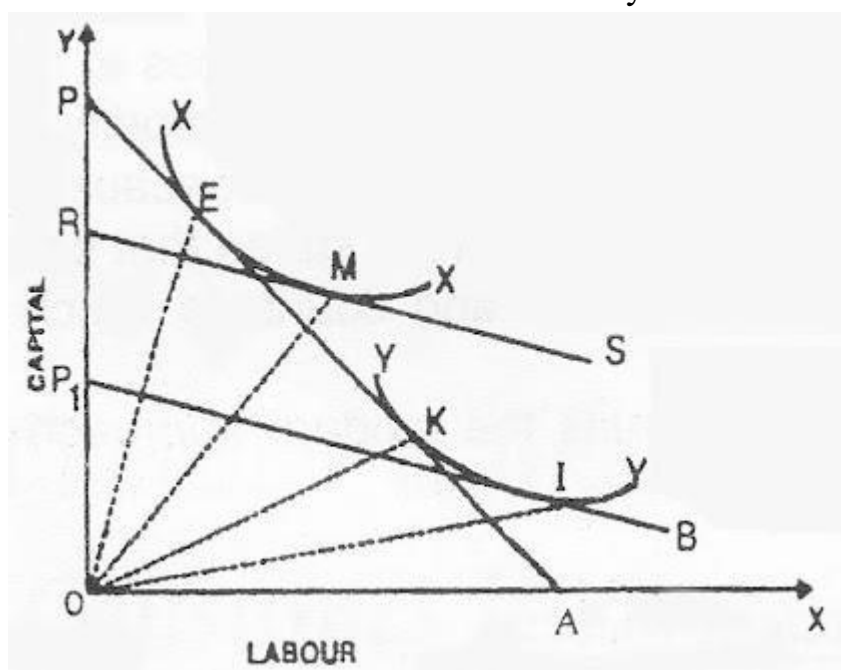
In this equation, P refers to price of the factor, K refers to Capital, L refers to Labour, a stands for England, and i stands for India.

In this equation, we observe that in America, capital is cheaper and hence it is a capital abundant country, while in India, labour is cheaper because it is abundant

here.

The emerging pattern of trade can be explained in the form of the following exhibit. As explained earlier, we have taken an example of same two countries i.e. America and India where America is a capital rich country while India is a labour abundant nation. In Exhibit 7.1, diagram XX is the isoquant (equal product curve) for the commodity X produced in America. YY is the isoquant representing commodity Y produced in India. It is very clear that XX is relatively capital intensive while YY is relatively labour intensive. The factor capital is represented on Y-axis while the factor labour is represented on the horizontal X-axis. PA is the price line or budget line of the country America. The price line PA is tangent to XX at E. The price line PA is also tangent to YY isoquant at K. The point K will help us to find out how much of capital and labour is required to produce one unit of Y in America.

Exhibit 7.1 Heckscher Ohlin's H-O Theory



P1B is the price line of the country India, The price line P1B is tangent to YY at I. The price line RS which is drawn parallel to P1B is tangent to XX at M. This will help us to find out how much of capital and labour is required to produce one unit of commodity X in India.

Under the given situations, the country America will choose the combination E. Which means more specialisation on capital goods. It will not choose the

combination K because it is more labour intensive and less capital intensive.

Thus according to Ohlin, America will specialise on production of goods X by using the cheap factor capital extensively while India specialises on commodity Y by using the cheap factor labour available in the country.

The Ohlin's theory concludes that the basis of internal trade is the difference in commodity prices in the two countries. Differences in the commodity prices are due to cost differences which are the results of differences in factor endowments in two countries. A capital rich country specialises in capital intensive goods & exports them. While a Labour abundant country specialises in labour intensive goods & exports them.

Limitations of Heckscher Ohlin's H-O Theory:

Unrealistic Assumptions : Besides the usual assumptions of two countries, two commodities, no transport cost, etc. Ohlin's theory also assumes no qualitative difference in factors of production, identical production function, constant return to scale, etc. All these assumptions makes the theory unrealistic one.

Restrictive : Ohlin's theory is not free from constrains. His theory includes only two commodities, two countries and two factors. Thus it is a restrictive one.

One-Sided Theory : According to Ohlin's theory, supply plays a significant role than demand in determining factor prices. But if demand forces are more significant, a capital abundant country will export labour intensive good as the price of capital will be high due to high demand for capital.

Static in Nature : Like Ricardian Theory the H-O Model is also static in nature. The theory is based on a given state of economy and with a given production function and does not accept any change.

Wijnholds's Criticism: According to economist Wijnholds, it is not the factor prices that determine the costs and commodity prices but it is commodity prices that determine the factor prices.

Consumers' Demand ignored: Ohlin forgot an important fact that commodity prices are also influenced by the consumers' demand.

Haberler's Criticism: According to Haberler, Ohlin's theory is based on partial equilibrium. It fails to give a complete, comprehensive and general equilibrium analysis.

Leontief Paradox: American economist Dr. Wassily Leontief tested H-O theory

under

U.S.A conditions. He found out that U.S.A exports labour intensive goods and imports capital intensive goods, but U.S.A being a capital abundant country must export capital intensive goods and import labour intensive goods than to produce them at home. This situation is called Leontief Paradox which negates H-O Theory. Leontiff Paradox is explained in details in the subsequent discussion.

Other Factors Neglected: Factor endowment is not the sole factor influencing commodity price and international trade. The H-O Theory neglects other factors like technology, technique of production, natural factors, different qualities of labour, etc., which can also influence the international trade.

17.6 THE LEONTIEF PARADOX

There was a setback to the proponents of the H.O. trade theory in the early 1950's, when Leontief tested his hypothesis that capital rich countries export capital intensive goods and import labour intensive goods and vice versa with the help of the input-output data of the United State's economy. His results refuted the H.O. contention. It was a shocking news for the economists that the U.S. being a capital rich country should be exporting labour intensive goods and importing capital intensive goods. Several, explanations were looked into for resolving the Leontief paradox. The key factors identified in support of the Leontief paradox were: U.S. protective trade policy, import of natural resources and the investment in human capital.

Economist William P. Travis examined the Leontief theory in terms of the U.S. tariff policy. When Leontief tested his hypothesis, the U.S. was importing more of such items as crude oil, paper pulp, primary. copper, lead, metallic ores and newsprint, which are capital intensive. Thus, according to Travis, the U.S. protective trade policy was responsible for Leontief's findings.

The U.S. imports of natural resources like minerals and forest products and the exports of farm products further support the Leontief presentation. Investment in human capital raises the productivity of labour. That is why the exports of the U.S. consisted of labour intensive products and its imports were of capital intensive nature.

17.6 MODERN THEORIES OF INTERNATIONAL TRADE

The issue of international trade has been studied by the modern day economists as well because several changes have happened in the business environment. The

present age of multipolar world, emergence of globalization, liberalization and privatization of trade, technological developments, particularly the developments in information technology have changed the nature of trade. The age of competition has given way to collaboration and the theories of yesteryears have undergone a shift. Some of the important theories of the modern times are as under:

Specific Factors and Income Distribution The Standard Model of Trade
The Competitive Advantage: The following discussion explains these theories of the modern times.

Specific Factors and Income Distribution (Paul Samuelson - Ronald Jones Model)

This theory was proposed by two American economists, Paul Samuelson and Ronald Jones, who elaborated a trade model based on specific factors:

There are at least two reasons why trade has an important influence upon the income distribution:

Resources can't be transferred immediately and without costs from one industry to another.

Industries use different factors and a change in the production mix a country offers will reduce the demand for some of the production factors whereas for others it will increase it.

While the earlier models were based on one or two factors, this is a tri-factorial model because it is based on 3 factors- labour (L), capital (K) and territory (T). Products like food (X) are made by using territory (T) and labour (L) while manufactured products (Y) use capital

(K) and labour (L). From this simple example it is easy to observe that labour (L) is a mobile factor and it can be used in both sectors of activity, while territory and capital are specific factors.

A country having capital abundance and less land tends to produce more manufactured products than food products, whatever the price, while a country with a territory abundance tends to produce more food. If the other elements are constant, an increase in capital will mean an increase in marginal productivity from the manufactured sector, while a rise in the offer of territory will increase the production of food in the detriment of manufacturers.

When the two countries decide to trade, they create an integrated global economy

whose manufacture and food production is equal with the sum of the two countries' productions. If a country doesn't trade, the production for a good equals the consumption. The gains from trade are bigger in the export sector of every country and smaller in the sector competed by imports.

The Standard Model of Trade: The standard model of trade has been proposed by Paul Krugman and Maurice Obstfeld. This theory implies the existence of the relative global supply curve resulting from the production possibilities and the relative global demand curve resulting from the different preferences for a certain good.

The exchange rate (the rapport between the export prices and the import prices) is determined by the crossing/intersection between the two curves, the relative global supply curve and the relative global demand curve. If the other elements remain constant, the

exchange rate improvement for a country implies a substantial rise in the welfare of that country.

The Competitive Advantage

This has been proposed recently by American management guru - Michael Porter, who proposed the concept of value chain analysis. A firm's activities could be segregated as primary and secondary activities. The primary activities were those, which directly contributed to creating value, while the secondary activities supported the happening of the primary activities. The firms' individual value chains integrated to become the industry value chain and this could gain strength if there existed a competitive advantage. The competitive advantage could be created by way of exclusive access to the resources (factor based development), having low cost investments, or developing innovation led competitive advantage. Porter proposed a competitiveness diamond, which comprised on the five determinants:

- The capacity of internal factors
- The specific of the domestic market
- The links between the industries
- Domestic competition environment

The nations needed to develop and sustain these factors in order to remain

competitive in the international trade.

17.6 SUMMARY

The issue of trade between the nations has been studied by the economists since long and Adam Smith proposed that the nations would trade if there is absolute cost advantage in producing a product in one country. However, Ricardo proposed that that absolute cost advantage could not fully justify trade between nations, and he proposed a comparative cost advantage theory. Ohlin's thesis proposes that a country export goods which use relatively a greater proportion of its abundant and cheap factor. The same country imports the goods whose production requires the intensive use of the nation's relatively scarce and expensive factor. However, Leontiff identified a paradox in Ohlin's theory and observed that America continued to export the products despite having costly labour. The modern theories extended the factors from two to three and the most recent theory proposed by Porter gave the concept of competitive advantage. Nations could gain competitive advantage not by the factors alone, but could develop and sustain it with the help of the investment and innovation, which could restrict competition by controlling the entry of newer players into the market.

17.7 GLOSSARY

Absolute cost advantage theory: According to this principle, a nation should export those goods and services for which it has a higher production compared to other countries, and import those goods and services for which other countries are more productive than this nation.

17.8 COMPREHENSIVE QUESTIONS

a) Fill in the blanks:

1. According to mercantilism, a nation's wealth exists as.....
2. According to the absolute advantage theory, a country should export those goods for which it has a higher.....
3. David Ricardo argued that nations will still gain from trade even if they have.....
4. The theories of both Smith and Ricardo have not experienced the importance of.....

b) Write True/False:

1. According to Ohlin's theory, the difference in commodity prices arises from the difference in resource allocation between two countries.
2. Ohlin's theory is based on complete equilibrium.
3. According to the H.O. theory, America should not export labor-intensive products, but Leontief found that this is not true.
4. The Samuelson and Jones model is based on two factors.
5. Porter argued that firms can achieve competitive advantage only through cost advantages.

17.9 ANSWER TO COMPREHENSIVE QUESTIONS

a) 1. Gold and silver 2. Producer 3. Absolute 4. People's welfare, distribution of income

(b) 1. True 2. False 3. True 4. False 5. False

17.10 SELF ASSESSMENT QUESTION

- What was Adam Smith's answer to the question - why do the nations trade?
- Explain the concept of comparative cost advantage with the help of an example.
- How does Ohlin's theory explain the trade between the nations? Why does this theory fail to explain the exports made by America?
- How does Micheal Porter's theory of competitive advantage explain the trade between the nations?

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UNIT-18 FDI AND FII

BLUE PRINT OF UNIT

- 18.1 Introduction
- 18.2 Structure of Foreign Direct Investment
- 18.3 Other Methods of Foreign Direct Investment
- 18.4 Foreign Technology Agreements (FTAs)
- 18.5 Types of Foreign Direct Investment
- 18.6 Determinants of FDI
- 18.7 FDI in India
- 18.8 Benefits of FDI in India
- 18.9 Drawbacks of FDI in India
- 18.10 FII in India
- 18.11 Difference between FDI and FII
- 18.12 Summary
- 18.13 Glossary
- 18.14 Comprehensive Questions
- 18.15 Answers to Comprehensive Questions
- 18.16 self-assessment Questions
- 18.17 Reference Books

OBJECTIVES:

The objectives of this lesson are:

- To understand the concept of Foreign Direct Investment and Foreign Institutional Investor
- To understand the different theories of Foreign Direct Investment and Foreign Institutional Investor
- To know about the current trends in Foreign Direct Investment and Foreign Institutional Investor

- To assess the different strategies of Foreign Direct Investment

18.1 INTRODUCTION

Foreign investment and technology plays an important role in the economic development of a nation and have been explained by a number of countries. The economic health of transition countries in Eastern Europe, Russia, and Central Asia is smoother due to FDI. Even communist countries like China have welcomed foreign investment to improve their economics. The Indian government has been trying so hard to turn India to become an attractive international investors friendly place, they tend to encourage and promote a favorable business environment for foreign investors. It seemed that their hard work is paying back.

18.2 STRUCTURE OF FORIEGN DIRECT INVESTMENT

Foreign Direct Investment (FDI) is an investment of new equity capital or re-investment of earnings in an enterprise. Foreign investment is of two kinds – (i) Foreign Direct Investment (FDI) and (ii) Foreign Portfolio Investment. FDI is defined as an investment made by an investor of one country to acquire an asset in another country with the intent to manage that asset.

FDI is defined under Dictionary of Economics as —”Investment in a foreign country through the acquisition of a local company or the establishment thereof an operation on a new site”.||

The International Monetary Fund defines FDI as when one individual or business owns 10% or more of a foreign company's capital. Every financial transaction afterwards is considered by the IMF as an additional direct investment. If an investor owns less than 10%, it is considered as nothing more than an addition to his/her stock portfolio.

According to OECD, FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transactions between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated.

Regulatory Framework for FDI in Indian companies can receive FDI under two routes

Automatic Route: FDI is allowed under the automatic route without prior approval either of the Government or the Reserve Bank of India in all activities/sectors as specified in the consolidated FDI Policy, issued by the Government of India from time to time. The investors are required to notify the concerned Regional office of RBI of receipt of inward remittances within 30 days of such receipt and will have to file the required documents with that office within 30 days after issue of shares to foreign investors. FDI upto 100% under the automatic route would be allowed for:

- 18.1** Processing and warehousing in coffee and rubber industry.
- 18.2** Power trading, subject to provisions of the Electricity Act, 2003.
- 18.3** Investment in creation of infrastructure related to marketing in petroleum sector
- 18.4** In captive mining of coal and lignite for consumption by eligible users.
- 18.5** Distillation and brewing of potable alcohol, industrial explosives and hazardous chemicals

Government Approval: Government route means that investment in the capital of resident entities by non-resident entities can be made only with the prior approval from FIPB, Ministry of Finance or SIA, DIPP as the case may be. FDI in sectors, not covered under automatic route requires prior approval of the government which is considered by Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, and Ministry of Finance. Following sectors require prior approval of Government of India. Following sectors require prior approval of Government of India. Sectors prohibited for FDI - retail trading, lottery business, atomic energy, gambling and betting, business of chit fund, agriculture and plantation, nidhi companies, housing and real estate business. Activities that require industrial license. Proposals in which the foreign collaborator has existing financial / technical collaboration in India in the same. Proposals for acquisition of shares in an existing Indian company in financial services and where Securities Exchange Board of India (SEBI) regulation, 1977 is attracted. All proposals falling outside notified sectoral policy in which FDI is not permitted. The Legal basis Foreign Direct Investment by non-resident in resident entities through transfer or issue of security to person resident outside India is a Capital account transaction and Government of India and Reserve Bank of India regulate this under the FEMA, 1999

and its various regulations. Keeping in view the current requirements, the Government from time to time comes up with new regulations and amendments/changes in the existing ones through order/allied rules, Press The Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry, Government of India makes policy pronouncements on FDI through Press Notes/ Press Releases which are notified by the Reserve Bank of India as amendment to notification No. FEMA 20/2000-RB dated May 3, 2000. These notifications take effect from the date of issue of Press Notes/ Press Releases. The procedural instructions are issued by the Reserve Bank of India vide Circulars. The regulatory framework over a period of time thus consists of Acts, Regulations, Press Notes, Press Releases, Clarifications, etc. This circular consolidates into one document all the prior policies/regulations on FDI which are contained in FEMA, 1999, RBI Regulations under FEMA, 1999 and Press Notes/Press Releases/Clarifications issued by DIPP and reflects the current policy framework on FDI. It deals comprehensively with all aspects of FDI Policy which are covered under the various Press Notes/Press Releases/ Clarifications issued by DIPP.

Table 1**Sector wise Division for FDI**

FDI --- AUTOMATIC ROUTE	FDI -- GOVERNMENT ROUTE
Agriculture, Animal Husbandry, Floriculture	Tea Plantation
Mining, Exploration of Metal and Nonmetal ores	Petroleum refining by Public Sector Undertakings (PSUs)
Coal and lignite mining and processing	Defence-26%
Petroleum and Natural Gas	

Broadcasting Carriage Services (DTH, Cable, mobile, TV, HITS) (49%)	Government route beyond 49% & upto 74%
Cable Networks (49%)	FM Radio- 26%
Airports – Greenfield Projects	Up- linking of ‘News & Current Affairs’ TV Channels-26%
Airports – Existing Projects (74%)	Publishing of Newspaper and Periodicals dealing with news and current affairs
Scheduled Air Transport Service/ Domestic Scheduled Passenger Airline	Publication of Indian editions of foreign magazines dealing with news and current affairs
Helicopter Services	Publishing/printing if Scientific and technical magazines/ specialty journals/periodicals
Maintenance and Repair organizations; flying training institutes; and technical training institutions	Publishing of facsimile edition of foreign newspapers
Townships, housing, built-up infrastructure and construction development projects	Satellites- Establishment and operation- 74%
Industrial Parks- new and existing	Private Security Agencies- 49%
Telecom Services (49%)	Government route beyond 49% and upto 74%
Cash & Carry Wholesale Trading/ Wholesale Trading	Test marketing
E-Commerce Activities	Single Brand product retail trading
Banking- Private Sector- 49%	Government route beyond 49% and upto 74%
Insurance -26%	
Non- Banking Finance Companies (NBFC)	
Pharmaceuticals- Greenfield	Pharmaceutical – Brownfield

18.3 OTHER MODES OF FOREIGN DIRECT INVESTMENTS:

Global Depository Receipts (GDR)/ American Deposit Receipts (ADR)/ Foreign Currency.

1. Convertible Bonds (FCCB): Foreign Investment through GDRs/ ADRs, Foreign Currency.

2. Convertible Bonds (FCCBs) are treated as Foreign Direct Investment. Indian

companies are allowed to raise equity capital in the international market through the issue of GDRs/ADRs/FCCBs.

18.4 FOREIGN TECHNOLOGY AGREEMENTS (FTA)

Foreign technology collaborations are permitted either through the automatic route under delegated powers exercised by the RBI, or by the government. FTAs are allowed either through the automatic route or through prior government approval.

Automatic Route: The Reserve Bank of India, through its regional offices, accords automatic approval to all industries for foreign technology collaboration agreements subject to:

- the lump sum payments not exceeding US \$2 million;
- royalty payable being limited to 5% for domestic sales and 8 % for exports, subject to a total payment of 8% on sales over 10 year period; and
- the period for payment of royalty not exceeding 7 years from the date of commencement of commercial production, or 10 years from the date of agreement, whichever is earlier. These royalty limits are net of taxes and are calculated according to standard conditions.
- For foreign technology agreements in respect of hotel and tourism related industries, automatic approval is granted if
 1. upto 3% of the capital cost of the project is proposed to be paid for technical and consultancy services including fees for architecture, design, supervision, etc;
 2. upto 3% of the net turnover is payable for franchising and marketing/ publicity support fee, and
 3. upto 10% of gross operating profit is payable for management fee, including incentive fee.

Government Approval: For the following categories, government approval would be necessary:

- Proposals attracting compulsory licensing.
- Items of manufacture reserved for the small –scale sector.
- Proposals involving any previous joint venture or technology transfer/ trademark agreement in the same or allied field in India.
- Extensions of foreign technology collaboration agreements (including those cases, which may have received automatic approval in the first instance).

- Proposals not meeting any or all of the parameters for automatic approval.

100% Export Oriented Units/ Export Processing Zones/ Special Economic Zones

100% Export Oriented Units (EOUs) and units in the Export Processing Zones (EPZs), enjoy a package of incentives and facilities, which include duty free imports of all types of capital goods, raw material and consumables in addition to tax holidays against export. The permission for setting up 100% EOUs and units in EPZs are granted through the automatic route or by the Government.

Automatic Route: The Development Commissioners (DCs) of Export Processing Zones (EPZs)/ Free Trade Zones (FTZs)/ Special Economic Zones (SEZs) accord automatic approval to projects where:

- Activity proposed does not attract compulsory licensing.
- Location is in conformity with the prescribed parameters;
- The units undertake to achieve exports and value addition norms as prescribed in the Export and Import Policy in force;
- The CIF value of imported capital goods is financed through foreign equity, or foreign exchange required for import of plant and equipment (net of taxes) is within Rs. 100 Million, and in the case of import of second hand goods if an Import License is not required;
- The foreign technology agreement if any, envisages a lump sum payment not exceeding US

\$2.00 Million and royalty payment up to 8% on exports and 5% on DTA sales (net of taxes) over a period of 5 years from the date of commencement of commercial production;

- The exports are to general currency/ hard currency areas;
- Unit is amenable to bonding by customs authorities; and
- The unit has projected the minimum export turnover, as specified in the Handbook of Procedures, Vol 1.

FDI Policy for 100% EOU/EPZ Units: All proposals for FDI/ NRI /OCB investments in EOU /EPZ units qualify for approval through the automatic route except those where FIPB approval is required. Conversion of existing Domestic Tariff Area (DTA) units into EOU is also permitted under automatic route, if the DTA unit satisfies the

parameters mentioned above and there is no outstanding export obligation under any other Export Oriented scheme of the Government of India.

Government Route: All proposals which do not meet any or all of the parameters for automatic approval need to be considered and approved by the Government. All proposals for FDI in EOUs and units in EPZ/FTZ failing under FIPB route, need to obtain Government approval.

FDI Policy for Units in SEZ

FDI up to 100% is allowed through the automatic route for all manufacturing activities in Special Economic Zones (SEZs), except for the following activities:

- i) Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships
- ii) Atomic substances
- iii) Narcotics and psychotropic substances and hazardous chemicals
- iv) Distillation and brewing of alcoholic drinks
- v) Cigarettes/cigars and manufactured tobacco substitutes
- vi) Sectoral norm as notified by Government shall apply to foreign investment in services

FDI limit for a few sectors is as follows (*source: <http://www.dipp.nic.in>*):

Banking: FDI in private banking sector of India is allowed up to 74% where FDI up to 49% is allowed through automatic route and FDI beyond 49% but up to 74% is allowed through government approval route.

Insurance: FDI of up to 26% in the insurance sector is allowed.

Telecommunication:

- In basic, cellular, value added services and global mobile personal communications by satellite, FDI is limited to 49% subject to licensing and security requirements.

- In ISPs with gateways, radio-paging and end-to-end bandwidth, FDI is permitted up to 74% with FDI beyond 49% requiring government approval. These services would be subject to licensing and security requirements.

- FDI upto 100% is allowed for the following activities in the telecom sector:

- Infrastructure providers gateways (both for satellite and submarine cables)
- Electronic Mail; and
- Voice Mail

18.5 TYPES OF FDI

FDIs can be broadly classified into following types:

ii) Outward FDI

iii) **Inward FDI**

1 Outward FDI: An outward-bound FDI is backed by the government against all types of associated risks. This form of FDI is subject to tax incentives as well as disincentives of various forms. Risk coverage provided to the domestic industries and subsidies granted to the local firms stand in the way of outward FDIs, which are also known as 'direct investments abroad.'

2 Inward FDI: Inward FDI can be defined as the capital provided from a foreign direct investor (i.e. the coca cola company) residing in a country, to that economy, which is residing in another country (i.e. China's economy).

EXAMPLE: General Motors decides to open a factory in Malaysia. They are going to need some capital. That capital is inward FDI for Malaysia.

3 Horizontal FDI: Horizontal FDI arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI. For example, Ford assembles cars in the United States. Through horizontal FDI, it does the same thing in different host countries such as the United Kingdom (UK), France, Taiwan, Saudi Arabia, and Australia. Horizontal FDI therefore refers to producing the same products or offering the same services in a host country as firms do at home.

4 Vertical FDI: Vertical FDI takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country. In other words, a vertical FDI arises when a multinational firm fragments the production process internationally, thereby locating each stage of production in the country where it can be done at the least cost. For example, if Peugeot (the French automaker) only assembles cars and does not manufacture components in France, but in the UK, it can be said that Peugeot enters into components manufacturing through FDI.

18.6 DETERMINANTS OF FDI

Determinants can be better understood by the Porter's diamond model of international competitiveness, which has identified four major determinants:

1) Factor Conditions: A nation may have comparative advantage over others because of certain factors of production. Organizations will shift their production base to those countries where the critical factors of production of their industry specific is economical. India's human resources of proven quantity as well as more economical in comparison to the US and Europe leading many countries to establish their manufacturing units here. India has the largest pool of English speaking people in Asia causing MNCs to shift their BPO, to India.

2) Demand condition: If the demand is higher, then FDI will become higher too. China and India are hot destinations of FDI because of their aggregate demand. In terms of PPP they are in top five countries of the world. Even the companies like P&G who don't believe in the customization of product for low income group is investing in R&D for the sake of customization of product for low income group.

3) Related and Supported Industry: MNCs prefer to go to the destination where there is well developed supported industry (ancillaries units) for the specific industry. Infrastructure plays a vital role in choosing of the site. All the facilities which are required should be properly taken into consideration.

4) Rivalry and Firm Strategy: The Competitive environment in a nation also plays a critical role. Organizations like to invest in countries where there is not stiff competition. Pepsi invested in India when the Indian policies were not liberal, consenting to many Indian conditions imposed on Pepsi. It did so only because here it wouldn't have to face competition from its rival Coca Cola.

18.7 FDI IN INDIA

The Department of Industrial Policy & Promotion, Ministry of Commerce and Industry, Government of India has come out with a revised Consolidated FDI Policy effective from April 5, 2013. Several key changes have been introduced during the previous financial year which has been consolidated in the new Policy.

One of the most important introductions in the present FDI Policy is the approval of FDI in Multi Brand Retailing where 51% FDI in multi brand retail sector will be allowed with government approval. However, the policy mandates the following conditions have to be fulfilled before applying to the Department of Industrial Policy & Promotion

(‘DIPP’):

1. Minimum amount of investment to be brought in by the foreign investor has to be US \$ 100 Million;
2. At least 50% of total FDI brought in shall be invested in ‘backend Infrastructure’ within three years of the first tranche of FDI. ‘Backend Infrastructure’ has been defined as capital expenditure on all activities, excluding that on the front end units and will include expenditures made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, warehouse, agriculture market produce infrastructure etc. However, expenditure on land cost and rentals, if any, will not be counted for purposes of backend infrastructure;
3. At least 30% of the value of procurement of manufactured/processed products purchased shall have to be made from Indian ‘small industries’ which have a total investment in plant and machinery of not exceeding US \$ 1.00 million;
4. Fresh agricultural products, poultry, fishery and meat products may be unbranded;
5. The government will have the first right of procurement of agricultural products;
6. Self certification from the company to ensure compliance with all the requirements with respect to minimum amount of investment, investment in backend infrastructure and procurement from Indian ‘small industries’;
7. Retail outlets may be set up only in cities which has a population of more than 10 lakh as per the 2011 Census and it may extend to an area of 10 kms around the municipal/urban agglomeration limits of such cities. However, In States/ Union Territories not having cities with population of more than 10 lakh as per 2011 Census, retail sales outlets may be set up in the cities of their choice, preferably the largest city and may also cover an area of 10 kms around the municipal/urban agglomeration limits of such cities;
8. The policy on FDI in multi brand retail is an enabling policy and all the states governments/ union territories will have the freedom to take their own decision in implementation of the Policy. Presently, only the following 10 states governments and union territories have agreed to implement the policy:
 - Andhra Pradesh
 - Assam

- Delhi
- Haryana
- Jammu & Kashmir
- Maharashtra
- Manipur
- Rajasthan
- Uttarakhand
- Daman & Diu and Dadra and Nagar Haveli (Union Territories)

9. Retail trading, in any form, by means of e-commerce, would not be permissible, for companies with FDI, engaged in the activity of multi-brand retail trading; Before being considered by Foreign Investment Promotion Board (FIPB) for Government approval, the application for the approval of foreign investment has to be first made to the Department of Industrial Policy & Promotion in order to determine whether the proposed investment fulfils the laid guidelines.

Another major change which the government has introduced in this Policy is the introduction of 49% FDI in civil aviation sector through which it has permitted foreign airlines to pick 49 per cent stake in domestic carrier companies. It has allowed foreign airline companies to invest in the capital of Indian companies under the Government Approval route, operating scheduled and non-scheduled air transport services, up to the limit of 49% of their paid-up capital. However, such investment would be subject to the following conditions:

- i. It would be made under the Government approval route;
- ii. The 49% limit will subsume FDI and FII investment;
- iii. The proposed investments will have to comply with the relevant SEBI Regulations including the Issue of Capital and Disclosure Requirements (ICDR) Regulations, Substantial Acquisition of Shares and Takeovers (SAST) Regulations;
- iv. The Scheduled Operators Permit will be granted only to a company:
 1. Which is registered and has its principal place of business in India;

2. The Chairman and at least two-thirds of the Directors of which are citizens of India; and

3. The substantial ownership and effective control of which is vested in Indian nationals.

v. All foreign nationals who are likely to be associated with Indian scheduled and non-scheduled air transport services, as a result of such investment shall have to obtain clearance from security view point before deployment; and

vi. All technical equipment that might be imported into India as a result of such investment shall require clearance from the relevant authority in the Ministry of Civil Aviation. In order to foster the friendly relations with Pakistan and to increase the trade between the two nations, the government has introduced a significant change in the present Policy allowing Pakistan nationals and companies to invest in the country under the government approval route in

sectors/activities other than defence, space and atomic energy and sectors/ activities prohibited for foreign investment.

Few policy changes for FDI Investment in single brand retailing have been introduced in the 2013 FDI Policy. As per the 2012 FDI Policy, the foreign Investor had to be the owner of the brand. However, as per the 2013 policy, only one non-resident entity, whether owner of the brand or otherwise, shall be permitted to undertake single brand product retail trading in the country, for the specific brand, through a legally tenable agreement, with the brand owner for undertaking single brand product retail trading in respect of the specific brand for which approval is being sought. Further, the procurement requirement has also been changed in the new policy wherein now, in proposals of FDI beyond 51%, 30% of the value of the goods purchased has to be done from India, preferably from Micro, Small and Medium Enterprises (MSMEs), village and cottage industries, artisans and craftsmen, in all sectors. This procurement requirement would have to be met, in the first instance, as an average of five years total value of the goods purchased, beginning 1st April of the year during which the first tranche of FDI is received. Thereafter, it would have to be met on an annual basis. Like Multi Brand retailing, retail trading, in any form, by means of e-commerce would not be permissible, for companies with FDI, engaged in the activity of single-brand retail trading. In the sector of Asset Reconstruction Companies (ARCs), the ceiling limit for

FDI in ARCs has been increased to 74 per cent from 49 per cent with government approval. This move has been made with the intention to bring more foreign expertise in the segment. Further conditions have been introduced which mandate that the total shareholding of an individual Foreign Institutional Investor (FII) cannot

be more than 10% of the total paid up capital of an ARC.

In the 2013 Policy, the Government has also decided that 49% (FDI & FII) in Power Exchanges registered under the Central Electricity Regulatory Commission (Power Market) Regulations, 2010 will be permitted after government approval (for FDI). In the Broadcasting Sector, the 2013 FDI Policy has raised the FDI cap to 74% in various services such as Direct to Home services and Cable Networks (Multi System operators (MSOs) operating at National or State or District level and undertaking upgradation of networks towards digitalization and addressability). Investment upto 49% will be allowed in the automatic route whereas for investment beyond 49%, approval of the government will be required. With respect to foreign investment in the broadcasting services, the Government has introduced several security conditions and terms including

- i. mandatory requirements for key executives of the Company,
- ii. security clearance of personnel,
- iii. Requirements related to infrastructure, network and softwares, iv) monitoring, inspection and submission of information, and v) National Security Conditions.

The 2012 FDI policy mandated that 100% foreign owned Non Banking Financial Companies (NBFCs) with a minimum capitalisation of US\$ 50 million can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital. However, this policy has been changed and as per the new 2013 Policy, NBFCs having foreign investment more than 75% and up to 100%, and with a minimum capitalisation of US\$ 50 million, can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital.

The Government of India has also tried to attract investment from Non-Resident Indians by making provisions where if an NRI is making an investment in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face

value of the shares subject to their eligibility to invest under the FDI scheme. The 2012 FDI Policy had listed nine mandatory conditions with regard to conversion of a company with FDI into a Limited Liability Partnerships (LLPs) firm which included the following clause:-

Foreign Capital participation in LLPs will be allowed only by way of cash consideration, received by inward remittance, through normal banking channels or by debit to NRE/FCNR account of the person concerned, maintained with an authorized dealer/authorized bank.

However, in the 2013 FDI Policy, the abovementioned clause has been made optional in case of a company, thereby bringing the number of mandatory conditions to eight.

18.7 ADVANTAGES OF FDI IN INDIA

i) Growth in Economy: Due to foreign companies entering into retail sector, new infrastructure will be built thereby bolstering the jaggging real estate sector. In turn, banking sector will also grow as the funds needed to build infrastructure will be provided by banks.

ii) Job Opportunities: It has been estimated according to government, that approximately ten million jobs will be created mostly in retail and real estate sectors.

iii) Benefits to Farmers: In the retailing business, the intermediaries have dominated the interface between the manufacturers or producers and the consumers. Hence the farmers and manufacturers lose their actual share of profit margin, as the lion's share is eaten up by the middlemen.

This issue can be resolved by FD1, as farmers might get contract farming, where they will be able to supply an organised retailer based upon demand and will get paid handsomely for that and they need not run in search of buyers.

iv) Benefits to consumers: Consumers will get variety of good quality products at low prices compared to market rates and will be able to choose from various international brands at one place.

v) Lack of Infrastructure: This has been one of the common issues in the retailing chain in India for years, which has led to the process of an incompetent market mechanism. To cite an example, inspite of India being one of the largest producers of fruits and vegetables, lack of proper cold storage facility significantly affects the selling of these perishable items and also in huge losses. Allowing FDI might help India have better logistics and storage technologies resulting in avoiding wastage. Due to FDI foreign

companies will invest around \$ 100 million in India. Thereby, infrastructure facilities, refrigeration technology, transportation sector will get a boost.

vi) Cheaper Production facilities: FDI will assure operations in production cycle and distribution. Due to economies of operation, production facilities will be available at a cheaper rate and thus resulting in availability of variety products to the ultimate consumers at a reasonable and cheaper price.

vii) Availability of new technology: FDI allows transfer of skills and technology from abroad and develops the infrastructure of the domestic country. Greater managerial talent will flow in from other countries. Domestic consumer will get the benefit of getting great variety and quality products at all price points.

viii) Long term cash liquidity: FDI will render necessary capital for establishing organised retail chain stores. It is a long term investment because the physical capital in the domestic company is not easily liquidated.

ix) Conducive for the country's economic growth: FDI will create a competition among the global investors, which will ultimately guarantee better and lower prices, thereby benefiting people in all sections of the society. The market growth and expansion will increase. It will step-up retail employment. It will ensure better managerial techniques and success. Higher wages will be paid by the international companies. Urban consumers will be exposed to international lifestyles.

x) FDI opens up a new avenue for Franchising: Restrictions on FDI are regarded as trade barriers as they traverse direct market access to foreign firms. Retail giants who are very keen in looking for entry into foreign markets look for other available alternatives. These restrictions on the global retailers regarding the inflow of FDI, leads them towards getting the market entry through franchises. Thus, countries which offer promising market potentialities for retail growth offer substantial growth in the franchising sector also.

xi) According to the Indian Government's condition, foreign companies have to source a minimum of 30% of their goods from Indian micro and small industries. This will encourage the domestic manufacturing by creating a big effect for employment and technology upgradation and income generation.

xii) Countries like China, Indonesia and Thailand have 100% FDI in retail. Reports show that these countries have experienced high growth in agro processing industry, refrigeration technology and infrastructure.

xiii) Foreign countries will also create a supply chain management in the Indian market.

This will result in avoidance of food wastage and perishables.

18.8 DRAWBACK OF FDI IN INDIA

(1) Impact on the organised players (eg. Kirana shops): The overall size of retail market in India at present is estimated at ` 5,88,000 crore of which, the unorganised portion of the market is worth ` 5,83,000 crore and the share of organised portion of the market is ` 5000 crores. The unorganised market provides the second largest employment opportunities to 3.95 million people (first being the agricultural sector). It is argued that opening the retail sector will have an impact on sales in the unorganised sector. As a result of this, employment provided by the unorganised sector will be affected. It is reasoned that by reducing the number of intermediaries, organised retailing will lead to some job displacement.

(2) Limited Employment Generation: It is said that FDI might provide employment opportunities, but it is argued that it cannot provide employment opportunities to semi-illiterate people. This argument gains more importance because in India, large number of semi-illiterate people are present.

(3) Fear of lowering of prices: There is a fear that allowing FDI in retail would result in lowering of prices, as FDI will bring in good technology, supply chain etc. If prices are lowered, then it will lower the margin of unorganised players also. As a result of this, the unorganised market will be affected. This in turn will have an impact on the employment opportunities provided by the unorganised market.

(4) FDI in retail will drain out the country's share of revenue to foreign countries, which may cause negative impact on India's economy.

(5) Fears that domestic organised retail sector might not be competitive enough to tackle international players might not only resulting in loss of market share for them but in closure of their units.

(6) There is a possibility of small business owners and workers from other functional areas, as lot of people are involved in unorganised retail business, may lose their jobs.

(7) Small retailers and other 'Kirana Stores' may close down.

(8) Supermarkets will establish their monopoly in the Indian market. Due to supermarkets fine tuning and higher accessibility they will be able to buy goods at lower prices and therefore

will be able to sell at lower prices to consumers. This will result in closing of many small retailers.

(9) Though Government has stipulated that 30% procurement should be from Indian sources, this may get diluted over the years. The remaining 70% procurement from cheaper countries will make the people run towards that stuff and the 30% supply from Indian small industries will have their own death, unable to compete with low price Chinese goods.

18.9 FII IN INDIA

Foreign Institutional Investor (FII) means “an institution established or incorporated outside India which proposes to make investment in India in securities, real property and other investment assets”. In India Foreign Institutional Investor (FII) refers to outside companies investing in the Indian Financial Markets.

India opened its stock market to Foreign Institutional Investors (FII) in September 1992. Since 1993, India received portfolio investment from foreigners in the form of Foreign Institutional Investors (FII) in equities. In order to trade in Indian equity market, all Foreign Institutional Investors (FII) must register with the Securities and Exchange Board of India (SEBI) which is the regulator for the securities market in India.

One who proposes to invest their proprietary funds or on behalf of: broad based” funds or of foreign corporate and individuals and belong to any of the under given categories can be registered for FII:

- (1) Pension funds
- (2) Mutual funds
- (3) Investment funds
- (4) Insurance or reinsurance companies
- (5) Endowment funds
- (6) University funds
- (7) Foundations or Charitable Trusts or Charitable Societies who proposes to invest on their own behalf, and
- (8) Asset Management Companies
- (9) Nominee Companies

- (10) Institutional Portfolio Managers
- (11) Trustees
- (12) Power of Attorney Holders
- (13) Bank

FII in India: According to Fitch, a global rating agency, foreign investors are highly confident about India's growth potential. Further it adding that more of the investments will start coming-in post general elections in 2014. Despite a gloomy global financial scenario, foreign institutional investors (FIIs) are betting big on Indian capital markets, wherein they pumped in about US\$ 25 billion in 2012. Over the past 15 years, the Indian markets have received almost a fifth of all FII equity flows to emerging markets while the country attracted almost half of all FII equity flows to Asia ex-Japan, China and Malaysia, in 2012.

Market experts believe that the recent reform initiatives undertaken by the Government, lack of investment options in other countries and overall a positive investor sentiment are certain factors that have made India attract the highest amount of foreign inflows as against its Asian peers.

- FIIs have infused US\$ 26 billion in the Indian stock market during the fiscal ended March 31, 2013, according to latest data available with the market regulator Securities and Exchange Board of India (SEBI). The amount is the highest ever since overseas entities started investing in the country.

- The number of registered FIIs in India stood at 1, 757 in FY 2012-13 while the number of FII sub-accounts rose to 6, 335, from 6, 322 at the end of 2011-12.

- Another statement issued by the Reserve Bank of India (RBI) revealed that foreign exchange reserves increased by US\$ 1.05 billion and stood at US\$ 293.37 billion for the week ended March 22, 2013. Foreign currency assets (FCAs), a major component of the

forex reserves, stood at US\$ 260.41 billion while the gold reserves amounted to US\$ 26.292 billion.

FII- Key Investments and Developments:

- Us-based philanthropic investment firm Omidyar Network is contemplating to

invest US\$ 100-200 million in for-profit and not-for-profit companies in India. The firm founded by eBay founder Pierre Omidyar and his wife Pam, has already invested US\$ 113 million across 35 companies in the country since 2010. The investments by Omidyar are focused around consumer internet and mobile, entrepreneurship, financial inclusion, government transparency and property rights. The firm identifies investment opportunities in firms where social impact is the unifying criterion

- India is increasing becoming a viable investment destination for international majors, particularly the Swedish firms. More than half of the Swedish investors are waiting to escalate their investments in India during FY 2014, said a survey carried out by the Swedish Chamber of Commerce. Swedish retailers such as IKEA & H&M are planning to establish stores in India in 2013. Major Swedish companies in India include transport major Volvo, big-pharma company Astra Zeneca, telecom firm Ericsson and industrial equipment makers Atlas Copco, Sandvik and SKF.

- The number of Swedish companies in India has increased 14.5 percent to 15.8 in 2012 as against 15.3 of them in the previous year, and the number is likely to go up in 2013 as well US venture capitalist Cannan Partners has planned to invest US\$ 100 million in India through 2013-17. The investor will earmark the amount from its US\$ 600 million Canaan IX fund, which was raised in 2012.

- Canaan manages assets worth US\$ 3.5 billion globally, and has invested US\$ 150 million in India till date. The firm is looking to infuse the funds in technology companies focused on consumer internet, enterprise, mobile, analytics and applications around cloud and big data.

18.11 DIFFERENCE BETWEEN FDI AND FII

Both FDI and FII is related to investment in a foreign country. In the Budget 2013-14, Mr. Chidambaram mention that foreign investors with less 10% stake in a particular stock will be considered as FII, and more than 10 % stake as FDI.

“To remove the ambiguity that prevails on what is FDI and what is FII, I propose to follow the international practice and lay down a broad principle that, where an investor has a stake of 10% or less in a company. It will be treated as FDI,” Mr. Chidambaram said in his Budget speech.

FDI refers to an investment made by a company or entity based in one country, into a company or entity based in another country. The investing company makes its overseas

investment in a number of ways- either by setting up a subsidiary or associate company in the foreign country, by acquiring shares of an overseas company, or through a merger or joint venture. An example of FDI would be an American Company taking a majority stake in a company in India.

The term FII refer to outside companies investing in the financial markets of India. International institutional investors must register with the securities and Exchange Board of India to participate in the market. One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies. Following are the points regarding differences in between them:

- FDI can be defined as investment made by a non-resident in equity of domestic company with intension of participating in the management company whereas FII can be defined as investment made by a Non-resident in equity of domestic company without intension of acquiring management control.
- FDI is generally associates with new technology, funding mechanism, new markets or new process whereas FII doesn't involve any management related interaction between the investor and the target company.
- FDI normally expected to be long-term involvement in the target company. On the other hand, FII is normally expected to be short- term investment. In FDI, intension of the investment is to achieve long-term growth whereas in FII intension is to make quick capital gains.
- FDI generally takes place through private placement of new shares or direct purchase from existing promoters whereas FII generally takes place through secondary market operations and there is no direct relationship between the investor and the company.
- FDI results in economic growth and employment and therefore is desired by all governments. On the other hand, FII basically substitutes domestic investment with foreign investment and although it helps to increase the available capital in the economy there is no direct relation with economic growth.
- Withdrawal or exit of FDI is difficult and time consuming whereas due to easy exit possibility FII results in 'HOT money" situation such funds destabilize the domestic market and exchange rates there by resulting in losses for genuine domestic operators. Due to this effect most countries restrict the inflow of such funds through exchange

control regulations.

- FDI involves an increase in resources of the company which has direct impact on its Balance sheet. It may or may not impact the market price. On the other side, FII does not have any connection with resources available to company and therefore has no effect on balance sheet. But due to transactions undertaken in secondary market it has immediate impact in the market price of the company.

1. FDI allows transfer of skills and technology from abroad and develops the infrastructure of the domestic country.

18.12 SUMMARY

FDI is defined as an investment made by an investor of one country to acquire an asset in another country with the intent to manage that asset. Foreign investment and technology play an important role in the economic development of a nation and have been exploited by a number of developing countries. In an era of globalization, organizations have wider choice of locations for their business operations and establishing production facilities. In true sense FDI was allowed in 1991 when the Indian economy was liberalized. India welcomed direct foreign investment in virtually every sector of the economy except those of strategic concern such as defence, railway transport and atomic energy. According to Global Value Chains FDI inflows to India dropped by 29 per cent to \$26 billion in 2012. Inflows to the services sector are likely to grow and flows to manufacturing are expected to increase as a number of countries, including Japan and Korea establish country and industry specific industrial zones in the Delhi-Mumbai industrial corridor. FDI has a wider impact on a country not only economically but also socially. It generates big opportunities for local manufacturer. FDI has created jobs in every field manufacturing, telecommunication, advertising, media and above all services. Perhaps the biggest beneficiary of the FDI is the Indian Consumer.

18.13 GLOSSARY

Foreign Direct Investment: It is an investment of new equity capital in an enterprise or reinvestment of earnings. **Internal FDI:** This is the capital provided by a foreign direct investor of one country to an enterprise in another country.

Linear FDI: This occurs when a firm moves up or down various value chains through FDI.

Foreign Institutional Investor: "An institution established or incorporated outside India

that proposes to invest in securities, real estate, and other investment properties in India

FDI- Foreign Direct Investment

FII- Foreign Institutional Investment

EPZ - Export Processing Zone

FTZ- Free Trade Zone SEZ –

SEZ-Special Economic Zone

DC- Development Commissioner.

18.14 COMPREHENSIVE QUESTIONS

a) Fill in the blanks:

1) Converting domestic tariff areas (DTAs) units into EOUs is permissible under the route of government.....

2. The term 'government route' means that investment in the capital of resident enterprises by non-resident enterprises can only be done with prior approval.....

3. FDI is permissible in the insurance sector within the limit of certain parameters.....

(b) Write true/false:

1. The capital provided by a direct foreign investor to an enterprise that resides in another country is called FDI.

2. FDI in retail trade will take a portion of a country's revenues to foreign nations, which may have a positive impact on the Indian economy.

3. FDI allows the transfer of skills and technology from abroad and develops the infrastructure of the domestic nation

18.15 ANSWER OF COMPREHENSIVE QUESTIONS

(a) 1. Automatic 2. FDI 3. 26 (b) 1. False 2. False 3. True

18.16 SELF- ASSESSMENT QUESTION

19.21.1 Discuss the various modes of FDI in India.

19.21.2 What are the different types of FDI in India? Explain with examples.

19.21.3 Discuss the determinants of FDI in India.

19.21.4 Describe the FDI policy of India in the present context.

19.21.5 Discuss the difference between FDI and FII.

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UNIT-19 FOREIGN EXCHANGE RATES AND FOREIGN EXCHANGE MARKETS

BLUE PRINT OF UNIT

19.1 Introduction

19.5 Foreign Exchange

19.6 Foreign Exchange Market

19.7 Nature of the Foreign Exchange Market

19.8 Functions of the Foreign Exchange Market

19.6 Participants in the Foreign Exchange Market

19.6.1 Wholesale Foreign Exchange Market

19.6.2 Retail Market

19.7 Transactions in the Interbank Market

19.7.1 Spot Transactions

19.7.2 Fully Advance Transactions

19.7.3 Swap Transactions

19.7.4 Future Transactions

19.7.5 Options

19.8 Comparison of Forward and Futures Currency Contracts

19.9 Exchange Rates and Price Quotations

19.9.1 Interbank Price Quotations

19.9.2 Direct and Indirect Price Quotations

19.9.3 Bid and Ask Price Quotations

19.10 Foreign Exchange Trading and SWIFT

19.11 Determination of Exchange Rates

19.11.1 Exchange Rate

19.11.2 Determination of Exchange Rates

19.12 Exchange Rates

19.13 Factors Affecting Forward Exchange Rates

19.14 Theories of Exchange Rate Determination

19.15 Arbitrage

19.16 Arbitrage and Interest Rates

19.17 Summary

19.18 Glossary

19.19 Comprehensive Questions

19.20 Answers to Comprehensive Questions

19.2 Self-Assessment Questions

19.3 Reference Books

Objectives:

The objectives of this lesson are:

1. To provide a comprehensive description of the nature, structure and operation of foreign exchange market.
2. To describe the types of foreign exchange transactions and the major participants of foreign exchange market.
3. To understand the foreign exchange quotations of The Wall Street Journal.
4. To understand the determination of the equilibrium rate of exchange in a free market.

19.1 INTRODUCTION

The foreign exchange market is a market in which foreign exchange transactions take place. In other words, it is a market in which national currencies are bought or sold against one another. In words of H.E.Evitt, “it is a that section of economic science which deals with the means and methods by which right to wealth in one country’s currency are converted into rights to wealth in terms of another country’s currency. It

also involves the investigation of the method by which render such exchange necessary, the forms which such exchange may take, and the ratios or equivalent values at which such exchanges are affected.” The foreign exchange market in terms value of transactions, is largest market in the world, with daily turnover of over USD 2 trillion. It is a 24 hrs market.

19.2 FOREIGN EXCHANGE

Foreign Exchange refers to foreign currencies possessed by a country for making payments to other countries. It may be defined as exchange of money or credit in one country for money or credit in another. It covers methods of payment, rules and regulations of payment and the institutions facilitating such payments.

19.3 FOREIGN EXCHANGE MARKET

A foreign exchange market refers to buying foreign currencies with domestic currencies and selling foreign currencies for domestic currencies. Thus it is a market in which the claims to foreign moneys are bought and sold for domestic currency. Exporters sell foreign currencies for domestic currencies and importers buy foreign currencies with domestic currencies. According to Ellsworth, "A Foreign Exchange Market comprises of all those institutions and individuals who buy and sell foreign exchange which may be

defined as foreign money or any liquid claim on foreign money". Foreign Exchange transactions result in inflow & outflow of foreign exchange.

19.4 NATURE OF FOREIGN EXCHANGE MARKET

The foreign exchange market is a decentralized market in the sense that market participants are generally separated from one another and transactions take place through electronic media such as by telephone or through computer networks.

Two implications of decentralization are fragmentation and lack of transparency. The foreign exchange market is fragmented in the sense that transactions may occur simultaneously or near simultaneously in the market at different prices.

It is opaque—or lacks transparency—in the sense that the absence of a physical market place makes the process of price-information interaction difficult to observe and understand. Although the market is decentralized, it nevertheless has various physical locations or trading centers throughout the world where many of the most important market participants—in particular the market-making dealers—tend to concentrate.

19.6 FUNCTIONS OF FOREIGN EXCHANGE MARKET

Foreign exchange is also referred to as forex market. Foreign bill of exchange, telegraphic transfer, bank draft, letter of credit etc. are the important foreign exchange instruments used in foreign exchange market to carry out its functions. The Foreign Exchange Market performs the following functions.

1. Transfer of Purchasing Power or Clearing Function:

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another i.e. payment between exporters and importers. For e.g. Indian rupee is converted into U.S. dollar and vice-versa. In performing the transfer function variety of credit instruments are used such as telegraphic transfers, bank drafts and foreign bills. Telegraphic transfer is the quickest method of transferring the purchasing power.

2. Credit Function:

The foreign exchange market also provides credit to both national and international, to promote foreign trade. It is necessary as sometimes, the international payments get delayed for 60 days or 90 days. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required.

3. Hedging Function:

A third function of foreign exchange market is to hedge foreign exchange risks. By hedging, means covering of a foreign exchange risk arising out of the changes in exchange rates. Under this function the foreign exchange market tries to protect the interest of the persons dealing in the market from any unforeseen changes in exchange rate. Hedging guards the interest of both exporters as well as importers, against any changes in exchange rate. Hedging can be done either by means of a spot exchange market or a forward exchange market involving a forward contract.

19.6 FOREIGN EXCHANGE MARKET PARTICIPANTS

The foreign exchange market consists of two tiers: the inter bank or wholesale market, and the client or retail market.

19.7.2 Wholesale Foreign Exchange Market: Major foreign exchange trading in the wholesale foreign exchange markets is undertaken by banks – popularly known as inter bank market. In this market, banks and non-bank financial institutions transact with each other. They undertake trading on behalf of customers, but majority of trading is

undertaken for their own account by proprietary desks. Besides banks and non-bank financial institutions, multinational corporations, hedge funds, pension and provident funds, insurance companies, mutual funds etc. participate in the wholesale market.

Foreign Exchange Dealers and Brokers: The role of foreign exchange dealers and brokers need to be discussed in detail. But, let us first understand who foreign exchange dealers are.

Dealers: Banks and some nonbank financial institutions act as foreign exchange dealer. These dealers quote both “**bid**” and “**ask**” for a particular currency pair (for spot, forward and swap contracts) and take opposite side to either buyers or sellers of currency. They make profit from the spreads between buying and selling prices i.e., bid and ask rate. Brokers are agents, which merely match buyers and sellers and get a brokerage fee. Before the internet, the brokers, dealers and clients were communicating over telephone or telex and through satellite communication. SWIFT (Society for Worldwide Inter bank Financial Telecommunication) facilitated the communication between these brokers and banks. These dealers are also known as “market maker”. As market makers, these dealers stand willing at all time to buy and sell currencies at the quoted rate.

Brokers: Brokers on the other hand, help clients to get a better rate on the currency trade by making available different quotes offered by dealers. Traders can compare rates and accordingly take a decision. Brokers charge a commission for providing these services. Communication between brokers and clients also used to be through dedicated telephone lines. A broker continuously remains connected to dealers to get latest quotes, depth of the market. The broker compares the rates offered by the dealers and provides the best rates to the clients i.e, highest bid prices quoted by different dealers when the client wants to sell and lowest ask price quoted by different dealers when the clients wants to buy.

Participants in Commercial and Investment Transactions:

Importers and exporters, international portfolio investors, multinational firms, tourists, and others use the foreign exchange market to facilitate execution of commercial or investment transactions. Some of these participants use the foreign exchange market to hedge foreign exchange risk.

Speculators and Arbitragers:

Speculators and arbitragers seek to profit from trading in the market. They operate in

their own interest, without a need or obligation to serve clients or to ensure a continuous market. Speculators seek all of their profit from exchange rate changes. Arbitragers try to profit from simultaneous exchange rate differences in different markets. Arbitragers buy and sell the same currency at two different markets whenever there is price discrepancy. The principle of “**law of one price**” governs the arbitrage principle.

Central Banks and Treasuries:

Central banks and treasuries use the market to acquire or spend their country's foreign exchange reserves as well as to influence the price at which their own currency is traded. In many instances they do best when they willingly take a loss on their foreign exchange transactions.

Foreign Exchange Brokers:

Foreign exchange brokers are agents who facilitate trading between dealers without themselves becoming principals in the transaction. For this service, they charge a small commission, and maintain access to hundreds of dealers worldwide via open telephone lines. It is a broker's business to know at any moment exactly which dealers want to buy or sell any currency.

19.6.2 Retail Market:

In the retail market, individuals (tourists, foreign students, patients traveling to other countries for medical treatment) small companies, small exporters and importers operate. Money transfer companies/remittance companies (for example like Western Union) are also major players in the retail market. Retail traders buy/sell currency for their genuine business/personal requirements. For example, an exporter enters into forward contract to convert foreign currency to domestic currency. A tourist buys foreign currency in the spot market before undertaking the journey. A UK patient visiting India to undertake an operation that would have cost him a fortune at UK

19.7 TRANSACTIONS IN THE INTER BANK MARKET

Transactions in the foreign exchange market can be executed on a spot, forward, future, options and swap basis. These are explained as follow:

19.7.1 Spot Transactions: In the spot exchange market, the business is transacted throughout the world on a continual basis. So it is possible to transaction in foreign exchange markets 24 hours a day. The standard settlement period in this market is 48 hours, i.e., 2 days after the execution of the transaction. The spot foreign exchange market is similar to the OTC market for securities. There is no centralized meeting place

and no fixed opening and closing time. Since most of the business in this market is done by banks, hence, transaction usually do not involve a physical transfer of currency, rather simply book keeping transfer entry among banks. A spot transaction requires almost immediate delivery of foreign exchange. In the inter bank market, a spot transaction involves the purchase of foreign exchange with delivery and payment between banks to take place, normally, on the second following business day. The date of settlement is referred to as the "value date."

19.11.2 Outright Forward Transactions:

A forward transaction requires delivery at a future value date of a specified amount of one currency for a specified amount of another currency. The exchange rate to prevail at the value date is established at the time of the agreement, but payment and delivery are not required until maturity. Forward exchange rates are normally quoted for value dates of one, two, three, six, and twelve months. Actual contracts can be arranged for other lengths. Outright forward transactions only account for about 9 % of all foreign exchange transactions. The basic objective of a forward market in any underlying asset is to fix a price for a contract to be carried through on the future agreed date and is intended to free both the purchaser and the seller from any risk of loss which might incur due to fluctuations in the price of underlying asset. A forward contract is customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price. The exchange rate is fixed at the time the contract is entered into. This is known as forward exchange rate or simply forward rate.

19.11.3 Swap Transactions: A swap transaction involves the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. The most common type of swap is a spot against forward, where the dealer buys a currency in the spot market and simultaneously sells the same amount back to the same back in the forward market. Since this agreement is executed as a single transaction, the dealer incurs no unexpected foreign exchange risk. Swap is private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolio of forward contracts. The currency swap entails swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction. There are a various types of currency swaps like as fixed-to- fixed currency swap, floating to floating swap, fixed to floating currency swap.

19.11.4 Future: A currency futures contract provides a simultaneous right and

obligation to buy and sell a particular currency at a specified future date, a specified price and a standard quantity. In another word, a future contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Future contracts are special types of forward contracts in the sense that they are standardized exchange-traded contracts.

19.11.5 Options: Currency option is a financial instrument that give the option holder a right and not the obligation, to buy or sell a given amount of foreign exchange at a fixed price per unit for a specified time period (until the expiration date). In other words, a foreign currency option is a contract for future delivery of a specified currency in exchange for another in which buyer of the option has to right to buy (call) or sell (put) a particular currency at an agreed price for or within specified period. The seller of the option gets the premium from the buyer of the option for the obligation undertaken in the contract. Options generally have lives of up to one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer dated options are called warrants and are generally traded OTC.

19.8 COMPARISON OF FORWARD AND FUTURES CURRENCY CONTRACT

BASIS	FORWARD	FUTURES
Size	Structured as per requirement of the parties	Standardized
Delivery date	Tailored on individual needs	Standardized
Method of transaction	Established by the bank or broker through electronic media	Open auction among buyers and seller on the floor of recognized exchange.
Participants	Banks, brokers, forex dealers, multinational companies, institutional investors, arbitrageurs, traders, etc.	Banks, brokers, multinational companies, institutional investors, small traders, speculators, arbitrageurs, etc.

Margins	None as such, but compensating bank balanced may be required	Margin deposit required
Maturity	Tailored to needs: from one week to 10 years	Standardized

19.9 EXCHANGE RATES AND PRICE QUOTATIONS:

A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell at an announced rate.

19.9.1 Inter bank Quotations: The most common way that professional dealers and brokers state foreign exchange quotations, and the way they appear on all computer trading screens worldwide, is called **European terms**. The European terms quote shows the number of units of foreign currency needed to purchase one USD:

CAD 1.5770 / USD

An alternative method is called the **American terms**. The American terms quote shows the number of units of USD needed to purchase one unit of foreign currency:

USD 0.6341 / CAD

Clearly, those two quotations are highly related. Define the price of a USD in CAD to be

Also, define the price of a CAD in USD to be

$S(\text{USD} / \text{CAD}) \square \text{USD}0.6341/\text{CAD}$

Then, it must be that

$S(\text{CAD} / \text{USD}) \square \square \square S(\text{USD} / \text{CAD})$

Because $\text{CAD } 1.5770 / \text{USD} = 1 / \{\text{USD } 0.6341 / \text{CAD}\}$.

These rules also apply to forward rates as well. We will denote an outright forward quote using the following notation:

$F(\text{CAD} / \text{USD})$

19.9.2 Direct and Indirect price Quotations:

A direct quote is a home currency price of a unit of foreign currency.

An indirect quote is a foreign currency price of a unit of home currency. In the US, a direct quote for the CAD is

USD 0.6341 / CAD

This quote would be an indirect quote in Canada.

19.9.3 Bid and Ask Quotations:

Inter bank quotations are given as "bid" and "ask".

A bid is the exchange rate in one currency at which a dealer will buy another currency. An ask is the exchange rate at which a dealer will sell the other currency. Dealers buy at the bid price and sell at the ask price, profiting from the spread between the bid and ask prices: $\text{bid} < \text{ask}$.

Bid and ask quotations are complicated by the fact that the bid for one currency is the ask for another currency: $S^b(\text{USD} / \text{CAD}) = 1 / S^a(\text{CAD} / \text{USD})$ $S^a(\text{USD} / \text{CAD}) = 1 / S^b(\text{CAD} / \text{USD})$

19.10 FOREIGN EXCHANGE TRADING AND SWIFT

In an inter bank foreign exchange transaction, no real money changes hand. All transactions are done electronically through SWIFT. Banks undertaking foreign exchange transactions simply transfer bank deposits through SWIFT to settle a transaction. SWIF is the Society for Worldwide Interbank Financial Telecommunication is a cooperative organization headquartered at Belgium. The Swift network connects around 8300 banks, financial institutions and companies operating 208 countries. Swift provides a standardized messaging service to these members. As

and when two counterparties undertake a transaction, SWIFT transports the message to both financial parties in a standard form. As the foreign exchange market is mainly an OTC market, SWIFT message provides some kind of legitimacy to the transactions. The following line captures summarizes the activities at SWIFT.

“SWIFT is solely a carrier of messages. It does not hold funds nor does it manage accounts on behalf of customers, nor does it store financial information on an ongoing basis. As a data carrier, SWIFT transports messages between two financial institutions. This activity involves the secure exchange of proprietary data while ensuring its confidentiality and integrity”. For every participating member, SWIFT assigns a unique code. This code is used to transport messages.

19.11 FOREIGN EXCHANGE RATE DETERMINATION

19.11.1 Exchange rate: Exchange rate refers to the rate at which a country’s currencies are exchanged for currencies of other country. In other words it is the price of one currency in terms of another currency. For E.g. If the value of 1 US dollar in Indian rupees is 45 then the exchange rate is 1 US \$ = 45. Thus foreign exchange rate indicates the external value of a country’s currency. It also shows the purchasing power of a country’s currency in terms of currency of another country

21.16.1 Determination of exchange rates: The rate of exchange being a price of national currency in terms of another, is determined in foreign exchange market in accordance with general principle of the theory of value i.e., by the interaction of forces of demand and supply. Thus the rate of exchange in the foreign exchange market will be determined by interaction between demand for foreign exchange and supply of foreign exchange.

Demand for Foreign Exchange:

Foreign exchange is required by citizens or Government to make payments abroad. This results in demand for foreign exchange. These payments are recorded in payment side of BOP. The demand for foreign currency arises due to the following payments

- **Import of Goods:**

Consumer as well as capital goods are imported from other countries. Foreign exchange is demanded by people who import these goods. Higher the value of Imports, higher is the demand for foreign currency.

- **Import of services:**

Services rendered by other countries which include banking, insurance, transport, communication, educational services, etc. are required to be paid in foreign exchange.

- **Dividend, Interest and Profits:**

In India, many foreign firms have invested in various sectors, which results in outflow of foreign exchange on account of dividend and profits. On other hand Government and Indian firms have also borrowed from foreign countries, which results in payment of Interest.

- **Unilateral Payments:**

Donations, gifts etc. are 'one sided payments without corresponding returns. Such payments create demand for foreign exchange.

- **Export of Capital:**

Repayment of debt, purchase of assets in foreign countries etc. all require foreign exchange. All the above categories of payments abroad result in aggregate demand for foreign exchange. The total demand for foreign currency is inversely related to foreign exchange rate. At a higher exchange rate, the demand for foreign currency may be low.

- **2) Supply of Foreign Exchange:**

Supply of foreign exchange in a country comes from receipts of its exports. The receipts of foreign currency are recorded in the receipt side of BOP. The main sources of supply are:

- **Exports of Goods:**

This constitutes a major source of supply of foreign exchange. Both size and price of exports depends on demand of elasticity for goods. In India, the manufactured items occupy the top position in exports.

- **Exports of Services:**

In recent years this source is gaining importance. Expert Services in various fields, tourists coming from other countries, transport, communication, insurance etc. are important services which earn and supply foreign exchange.

- **Dividend, Interest and profits:**

Indian firms have invested in various sectors in foreign countries. Thus there is inflow of foreign exchange on account of dividend and profits. Indian institutions also have lent money abroad, which results in receipt of interest.

- **Unilateral Receipts:**

Payments received in form of remittance from domestics working abroad, donations etc. form a part of foreign exchange supply.

- **Import of Capital:**

Foreign investment - direct and portfolio - repayment of debts by foreigners, all increase the supply of foreign exchange. All the above categories of receipts from abroad result in aggregate supply of foreign exchange. The total supply, like the supply of any other commodity, is directly related to price i.e. the foreign exchange rate. At a higher exchange rate, the supply of foreign currency may be high.

19.12 EXCHANGE RATES:

Transactions in exchange market are carried out at what are termed as exchange rates. In foreign exchange market two types of exchange rate operations take place. They are spot exchange rate and forward exchange rate.

1. Spot Exchange Rate:

When foreign exchange is bought and sold for immediate delivery, it is called spot exchange. It refers to a day or two in which two currencies are involved. The basic principle of spot exchange rate is that it can be analyzed like any other price with the help of demand and supply forces. The exchange rate of dollar is determined by intersection of demand for and supply of dollars in foreign exchange. The demand for dollar is derived

from country's demand for imports which are paid in dollars and supply is derived from

country's exports which are sold in dollars. The exchange rate determined by market forces would change as these forces change in market. The primary price makers buy (Bid) or sell (ask) the currencies in the market and the rates continuously change in a free market depending on demand and supply. The primary dealer (bank) quotes two-way rates i.e., buy and sell rate.

(Bid) Buy Rate 1 US \$ = ` 45.50 (Ask) Sell Rate 1 US \$ = ` 45.75

The bank is ready to buy 1 US \$ at Rs. 45.50 and sell at Rs. 45.75. The difference of Rs.0.25 is the profit margin of dealer.

2. Forward Exchange Rate:

Here foreign exchange is bought or sold for future delivery i.e., for the period of 30, 60 or 90 days: There are transactions for 180 and 360 days also. Thus, forward market deals in contract for future delivery. The price for such transactions is fixed at the time of contract; it is called a forward rate. Forward exchange rate differs from spot exchange rate as the former may either be at a premium or discount. If the forward rate is above the present spot rate, the foreign exchange rate is said to be at a premium. If the forward rate is below the present spot rate, the foreign exchange rate is said to be at a discount. Thus foreign exchange rate may be at forward premium or at forward discount. For e.g. an Indian importer may enter into an agreement to purchase US \$ 10,000 sixty days from today at 1 US \$ = Rs. 48. No amount is paid at the time of agreement, except for usual security margin money of about 10% of the total amount. 60 days from today, the importer will get 10,000 US \$ in exchange for Rs. 4,80,000 irrespective of the Spot exchange rate prevailing on that date.

19.13 FACTORS INFLUENCING FORWARD EXCHANGE RATE:

- 1) Interest rates.
- 2) Degree of speculation in foreign exchange market.
- 3) Inflation rate.
- 4) Foreign investor's confidence in domestic country.
- 5) Economic situation in the country.

- 6) Political situation in the country.
- 7) Balance of payments position.

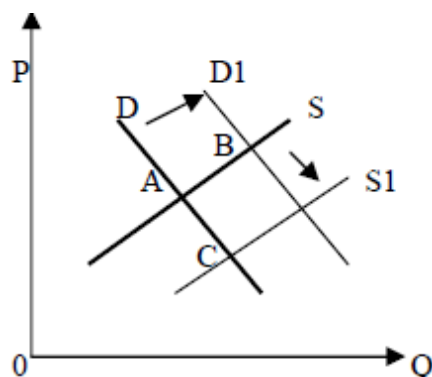
19.14 THEORIES TO DETERMINE EXCHANGE RATES:

Many theories there have been written in respect to the main determinant of future exchange rates. Although the majority of these theories give adequate reasons in order to explain what actually determines the rates between the currencies. Here below, we will refer to the main theories regarding the determinants of the exchange rates:

Supply and Demand:

The exchange rate, just like commodities, determines its price responding to the forces of supply and demand. Therefore, if for some reason people increase their demand (shift of the curve from D to D1) for a specific currency, then the price will rise from A to B, provided the supply remains stable. On the contrary, if the supply is increased (shift of the curve from S to S1), the price will decline from A to C, provided the demand remains stable (figure A). Any excess supply (above the equilibrium point) or excess demand (below the equilibrium point) will increase or decrease temporarily foreign currency reserves accordingly. Finally, such disequilibrium situations will be eliminated through the pricing, e.g. the market itself.

Figure A : Supply and Demand for foreign currency



P: shows the exchange rate, Q: shows the amount of currency demanded and supplied A, B, C: Show the equilibrium exchange rate

i) Purchasing Power Parity (PPP):

By definition the PPP states that using a unit of a currency, let us say one euro, which is the purchasing power that can purchase the same goods worldwide. The theory is based on the 'law of one price', which argues that should a euro price of a good be multiplied by the exchange rate (€ /US\$) then it will result in an equal price of the good in US dollars. In other words, if we assume that the exchange rate between the € and US \$ states at 1/1.2, then goods that cost € 10 in the EU should cost US\$ 12 in the United States. Otherwise, arbitrage profits will occur. However, it is finally the market that through supply and demand will force accordingly the euro and US dollar prices to the equilibrium point. Thus, the law of one price will be reinstated, as well as the purchase power parity between the euro and US dollar. Inflation differentials between countries will also be eliminated in terms of their effect on the prices of the goods because the PPP will adjust to equal the ratio of their price levels. More specifically, as stated in their book (Lumby S. & Jones C. 1999) "the currency of the country with the higher rate of inflation will depreciate against the other country's currency by approximately the inflation differential". In conclusion, it can be argued that the theory, although it describes in a sufficient way the determination of the exchange rates, is not of good value, mainly because of the following two disadvantages. Firstly, not all goods

are traded internationally (for example, buildings) and secondly, the transportation cost should represent a small amount of the good's worth.

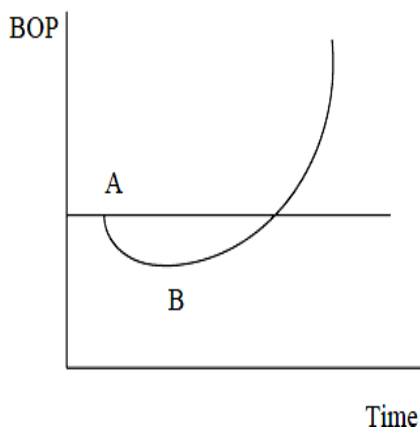
The Balance of Payments (BOP) Approach:

The balance of payments approach is another method that explains what the factors are that determine the supply and demand curves of a country's currency. As it is known from macroeconomics, the balance of payments is a method of recording all the international monetary transactions of a country during a specific period of time. The transactions recorded are divided into three categories: the current account transactions, the capital account transactions, and the central bank transactions. The aforementioned categories can show a deficit or a surplus, but theoretically the overall payments (the BOP as a whole) should be zero – which rarely happens. As stated earlier, a currency's price depreciation or appreciation (the change in the value of money), directly affects the volume of a country's imports and exports and, consequently, a likely fluctuation in the

exchange rates can add to BOP discrepancies. For example, a likely depreciation will increase the value of exports in home currency terms (the larger the exports demand elasticity the greater the increase). Conversely, the imports will become 'more expensive' and their value will be reduced in home currency (the larger the imports demand elasticity the greater the decrease).

The **J curve effect** illustrates that in the short-term a depreciation of the currency can initially worsen (from A to B) the current account balance before it improves its position (figure B). This is due to the low price elasticity of demand for imports and exports in the immediate outcome of an exchange rate change.

Figure B: The J curve effect



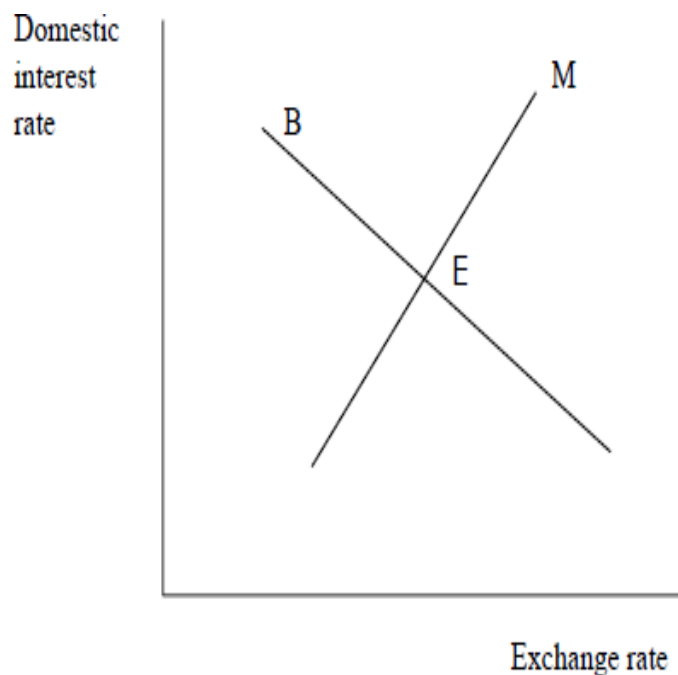
ii) The Monetary Approach:

In this approach attention is given to the stock of currencies in comparison to the willingness of people to hold these stocks. According to the monetary theory, exchange rates adjust to ensure that the quantity of money in each currency supplied is equal to the quantity demanded. Both Quantity Theory of Money (QTM) and Purchasing Power Parity (PPP) have been used in support of the aforementioned theory. The QTM states that there is a direct relationship between the quantity of money and the level of prices of goods and services sold. In other words, more money equals more inflation.

iii) The Portfolio Balance Approach:

The portfolio balance approach takes into consideration the diversification of investors' portfolio assets. Diversification is a technique that attempts to reduce risk by investing both among various financial instruments and across national borders, to mention just a few. For example, here below we consider a combination of domestic and foreign money and domestic and foreign bonds, the implications of which are illustrated in the following figure C.

Figure C : Portfolio balance approach



Both the M and the B lines show combinations of domestic interest rates and exchange rates. The upward line M is in agreement with the equilibrium in the money market and the downward line B is in agreement with the equilibrium in the bond market. Point E, which is the intersection of M with B, represents the combination of interest rate with the exchange rate that gives equilibrium to both the money and bond markets. What the theory argues is that an increase in the money supply will lead to a depreciation of the exchange rate. The extent of the depreciation depends upon the slope of the curves M and

B. For example, if we consider an increase in the domestic money supply, we will anticipate that a lower interest rate and /or a higher exchange rate can only absorb the

excess supply, which in turn will result in the reduction of bonds. To this end, line M will move to the right and line B will move to the left.

19.15 ARBITRAGE

Arbitrage is the act of simultaneously buying a currency in one market and selling it in another to make a profit by taking advantage of exchange rate differences in two markets. If the arbitrage is confined to two markets only it is said “two-point” arbitrage. If they extend to three or more markets they are known as “three-point” or “multi-point” arbitrage. Those who deal with arbitrage are called arbitrageurs. A Spot sale of a currency when combined with a forward repurchase in a single transaction is called “Currency Swap”. The Swap rate is the difference between spot and forward exchange rates in currency swap. Arbitrage opportunities may exist in a foreign exchange market. Suppose the rate of exchange is 1 US \$ = ₹ 50.50 in US market and 1 US \$ = ₹ 50.55 in Indian Markets, then an arbitrageur can buy dollars in US market and sell it in Indian market and get a profit of 5 per dollar. In today’s modern well connected and advanced markets, arbitrageurs (which are mainly banks) can spot it quickly and exploit the opportunity. Such opportunities vanish over a period of time and equilibrium is again maintained.

For e.g.

Bank A ₹ / \$ = 50.50 / 50.55 Bank B ₹ / \$ = 50.40 / 50.45

The above rates are very close. The arbitrageur may take advantage and he can purchase

\$ 1,00,000 from Bank B at 50.45 / a dollar and sell it to Bank A at 50.50, thus making a profit of 0.05. The total profit would be $(1,00,000 \times 0.05) = ₹ 5,000$. The profit is earned without any risk and blocking of capital.

19.16 ARBITRAGE AND INTEREST RATE:

Interest arbitrage refers to differences in interest rates in domestic market and in overseas markets. If interest rates are higher in overseas market than in domestic market, an investor may invest in overseas market to take the advantage of interest differential. Interest arbitrage may be covered and uncovered.

1. Uncovered Arbitrage

In this system, arbitrageurs would take a risk to earn profit by investing in a high interest bearing risk free securities in a foreign market. His earnings would be according to his calculations if the currency of foreign market where he invested does not depreciate. If depreciation is equal to the difference in interest rate, the investor would not incur loss. However, if depreciation is more than interest rate, then the arbitrageur will incur loss.

2. Covered Arbitrage

International investors would like to avoid the foreign exchange risk, thus interest arbitrage is usually covered. The investor converts the domestic currency for foreign currency at the current spot rate for the purpose of investment. At the same time, investor sells forward the amount of foreign currency which he is investing plus the interest that he will earn so as to coincide with maturity of foreign investment. The covered interest arbitrage refers to spot purchase of foreign currency to make investment and offsetting simultaneous forward sale of foreign currency to cover foreign exchange risk. When treasury bills mature, the investor will get the domestic currency equivalent of foreign investment plus interest without a foreign exchange risk.

19.17 SUMMARY

1) The foreign exchange market is the mechanism, by which a person or firm transfers purchasing power from one country to another, obtains or provides credit for international trade transactions, and minimizes exposure to foreign exchange risk. A foreign exchange transaction is an agreement between a buyer and a seller that a given amount of one currency is to be delivered at a specified rate for some other currency. A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell at an announced rate. The foreign exchange market consists of two tiers: the inter bank or wholesale market, and the client or retail market. Participants include banks and non bank foreign exchange dealers, individuals and firms conducting commercial and investment transactions, speculators and arbitrageurs, central banks and treasuries, and foreign exchange brokers. Transactions are effectuated either on a spot basis or on a forward or swap basis. A spot transaction is for an (almost) immediate value date while a forward transaction is for a value date

somewhere in the future. Quotations can be classified either as European and American terms or as direct and indirect quotes. A cross rate is an exchange rate between two currencies, calculated from their common relationship with a third currency. Arbitrage is the act of simultaneously buying a currency in one market and selling it in another to make a profit by taking advantage of exchange rate differences in two markets.

19.18 GLOSSARY

Foreign exchange: Foreign exchange refers to the foreign currencies held by one country to make payments to other countries.

Foreign exchange market: This is the structure through which a firm or an individual transfers purchasing power from one country to another, acquires or provides credit for international trade transactions, and minimizes foreign exchange risk.

Spot exchange rate: When foreign exchange is bought and sold for immediate delivery, it is referred to as spot exchange.

Swap deal: A swap deal involves the simultaneous buying and selling of foreign exchange for two different 'value' dates.

Futures contract: A futures contract is an agreement between two parties to buy and sell an asset at a specific time and price in the future. **Direct quote:** The price of domestic currency for one unit of foreign currency.

QTM: Quantity Theory of Money (QTM)

PPP: Purchasing Power Parity (PPP) Theory.

19.19 COMPREHENSIVE QUESTIONS

i) **Write True or False.**

1. Like stock and commodity exchanges, the foreign exchange market is a structured framework with a specific meeting place and formal licensing requirements.
2. Most foreign exchange transactions occur between commercial banks and domestic customers.
3. Foreign exchange brokers facilitate commercial banks to conduct foreign exchange trades and maintain the desired balance of foreign exchange.

4. The conversion of one currency to another at a certain point is subject to the understanding that it will be converted back to the original currency at some point in the future.

5. The bid rates refer to the rate at which the bank is willing to sell one unit of foreign currency, and the offer rate is the price at which the bank is ready to purchase one unit of foreign exchange.

6. A commercial bank profits from foreign exchange trading when its bid rate is higher than its offer rate.

ii) **Multiple Choice Questions:**

• The foreign exchange market refers to a market where the currency of one country is exchanged with the currency of another country. Currency exchange is typically carried out through the following methods

- (a) Buyers and sellers meet at a physical location.
- (b) Buyers and sellers meet via a telephone network.
- (c) Buyers and sellers meet through computer communication.
- (d) (a) and (b)
- (e) (b) and (c)

2. Which of the following participants can be called the most important participant in the foreign exchange market:

- (a) Retail customers
- (b) Commercial banks
- (c) Foreign exchange dealers
- (d) Central bank
- (e) None of the above.

3. In any method of trading currencies, the exchange of one currency for another at a point involves the agreement that it can be converted back into the original currency at a future point, is contained in:

- (a) Forward contract
- (b) Future contract
- (c) Spot contract

(d) Swap contract

4. Most of the foreign exchange trades occur between banks and... ..

(a) National governments

(b) Other bank

c) Corporation

(d) Domestic investor

19.20 ANSWER TO COMPREHENSIVE QUESTION

(a) 1.False 2.False 3.True 4.True 5.False 6.True (b) 1.(c) 2.(d) 3.(d) 4.(b)

19.21 SELF ASSESSMENT QUESTIONS:

Q 1. Define foreign exchange market. What are the functions of foreign exchange market? Q 2. Explain the major participants in foreign exchange market?

Q 3. What is SWIFT? Explain its role in foreign exchange market?

Q 4. What are the types of foreign exchange market? And the quotations used in foreign exchange market?

Q 5. What are the determinants of foreign exchange rates? What are the major types of foreign exchange rates?

Q 6. Explain the theories to determine the foreign exchange rates?

Q 7. Describe arbitrage and the relation between arbitrage and interest rate?

19.22 BOOK REFERENCES

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UNIT 20- IS-LM-BOP CURVE ANALYSIS

BLUE PRINT OF UNIT:

- 20.1 Introduction
- 20.2 Graphical Explanation of Foreign Exchange IS-LM-BOP Model
- 20.3 Mathematical Equations and Components of IS-LM-BOP Model
- 20.4 Structure of the Model
- 20.5 Differences from IS-LM
- 20.6 Summary
- 20.7 Glossary
- 20.8 Comprehensive Questions
- 20.9 Answers to Comprehensive Questions
- 20.10 Self-Assessment Questions
- 20.11 Reference Books

Objectives:

To understand the IS/LM model and its impact on monetary policy.

1. To describe the components of IS-LM-BOP Curve.
2. To understand the mechanics of the IS/LM model and the model's workings may be described in terms of an IS-LM-BOP graph.
3. Determination of IS-LM-BOP curve in fixed and flexible exchange rate regime.

20.1 INTRODUCTION:

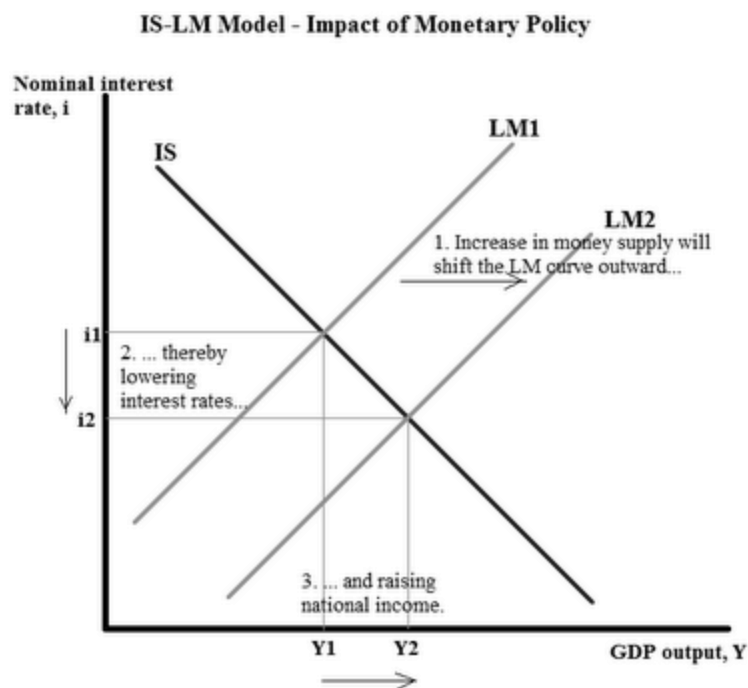
The IS/LM model, first developed by Sir John Hicks and Alvin Hansen, has been used from 1937 onwards to summarize a major part of Keynesian. It can be presented as graph of two intersecting lines in the first quadrant. The horizontal axis represents national income or real gross domestic product and is labeled Y. The vertical axis represents the real interest rate, i . The IS schedule is drawn as a downward-sloping

curve. The initials IS stand for "Investment/Saving equilibrium" but since 1937 have been used to represent the locus of all equilibrium where total spending (Consumer spending + planned private Investment + Government purchases + net exports) equals an economy's total output (equivalent to income, Y , or GDP). To keep the link with the historical meaning, the IS curve can represent the equilibrium where total private investment equals total saving, where the latter equals consumer saving plus government saving (the budget surplus) plus foreign saving (the trade surplus). Either way, in equilibrium, all spending is desired or planned; there is no unplanned inventory accumulation (i.e., no general glut of goods and services). The level of real GDP (Y) is determined along this line for each interest rate. Thus the IS schedule is a locus of points of equilibrium in the "real" (non-financial) economy. Given expectations about returns on fixed investment, every level of interest rate (i) will generate a certain level of planned fixed investment and other interest-sensitive spending: lower interest rates encourage higher fixed investment and the like. Income is at the equilibrium level for a given interest rate when the saving consumers choose to do out of that income equals investment (or, more generally, when "leakages" from the circular flow equal "injections"). A higher level of income is needed to generate a higher level of saving (or leakages) at a given interest rate. Alternatively, the multiplier effect of an increase in fixed investment raises real GDP. Either way explains the downward slope of the IS schedule. In sum, this line represents the line of causation from falling interest rates to rising planned fixed investment to rising national income and output. The LM schedule is an upward-sloping curve representing the role of finance and money. The initials LM stand for "Liquidity preference/Money supply equilibrium" but are easier to understand as the equilibrium of the demand to hold money (as an asset and for use in everyday transactions) and the supply of money by banks and the central bank. The interest rate is determined along this line for each level of given GDP. In a closed economy, the IS curve is defined as: $Y = C(Y-T) + I(r) + G$, where Y represents income, $C(Y-T)$ represents consumer spending as a function of disposable income (income, Y minus tax, T), $I(r)$ represents investment as a function of the real interest rate, and G represents government spending. In this equation, the level of G and T are presumed to

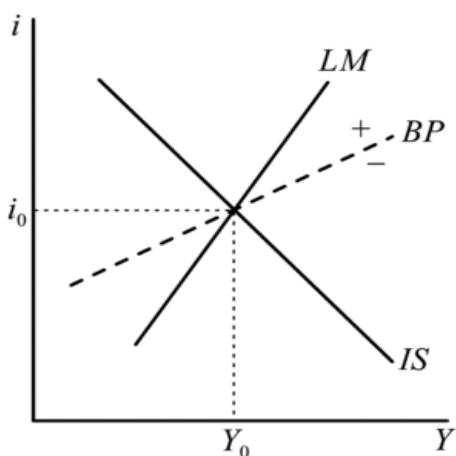
be exogenous. In a similar fashion, the LM curve is defined as $M/P = L(r, Y)$, where the supply of money represented as the real money balance M/P (as opposed to the nominal balance M), equals the demand for money L , which is some function of the interest rate and the level of income. To adapt this model to an open economy, a term for net exports (exports, X , minus imports, M) would need to be added to the IS equation. Rising GDP (Y) implies an increased transactions demand for money and liquidity preference. With a given and inelastic money supply curve, the equilibrium interest rate (i) rises. This explains the upward slope of the LM curve. The point where these schedules intersect represents a short-run equilibrium in the real and monetary sectors (though not necessarily in other sectors, such as labor markets): both product markets and money markets are in equilibrium. This equilibrium yields a unique combination of interest rates and real GDP. One Keynesian hypothesis is that a government's deficit spending has an effect similar to that of a lower saving rate or increased private fixed investment, increasing the amount of aggregate demand for national income at each individual interest rate. An increased deficit by the national government shifts the IS curve to the right. This raises the equilibrium interest rate (from i_1 to i_2) and national income (from Y_1 to Y_2), as shown in the graph above. The graph indicates one of the major criticisms of deficit spending as a way to stimulate the economy: rising interest rates lead to crowding out – i.e., discouragement – of private fixed investment, which in turn may hurt long-term growth of the supply side (potential output). Keynesians respond that deficit spending may actually "crowd in" (encourage) private fixed investment via the accelerator effect, which helps long-term growth. Further, if government deficits are spent on productive public investment (e.g., infrastructure or public health) that directly and eventually raises

potential output. The IS/LM model also allows for the role of monetary policy. If the money supply is increased, that shifts the LM curve to the right, lowering interest rates and raising equilibrium national income. In all this, the price level is assumed as fixed and no inflation is taken into consideration. The BP curve is the Balance of Payments curve. It plots Y on the x-axis and interest rates vs. foreign interest rates on the y axis.

It is the cost of funds given exchange rates both foreign and domestic for either fixed or flexible exchange regimes. The BP curve gives all the combinations of (Y, r) which keeps the market exchange rate unchanged in the absence of any central bank intervention.



20.2 GRAPHICAL EXPLANATION OF IS-LM-BOP CURVE:



Description of variables:

Y	National income and output	Exchange rate (domestic currency price of foreign currency)
i	Interest rate (real=nominal since prices are constant)	Exogenous capital inflow
I S	Goods market equilibrium (investment=savings)	Government spending
L M	Money market equilibrium (demand for money, L , equals supply)	Money supply
B P	Balance of payments (BOP) curve	

Explanation:

Equilibrium is at the intersection of IS and LM . With a pegged exchange rate this may lie off the BP curve, indicating a BOP in surplus (+) above or deficit (-) below. With floating exchange rate, a secondary adjustment of the exchange rate, E , (with effects shown in green) must move the three curves so as to intersect in one place, in order to get equilibrium in the exchange market. From the diagram, the following effects of exogenous changes, for the case shown (which assumes relatively mobile capital and sterilization of exchange market intervention).

Fiscal expansion: An increase in government spending (or a tax cut) shifts the IS -curve to the right. With a fixed exchange rate this causes income and the interest rate both to rise. The rise in interest rate attracts a capital inflow that, with relatively mobile capital, is sufficient to create a BOP surplus. With a flexible exchange rate this is an excess demand for domestic currency, which therefore appreciates. The appreciation dampens the increase in both income and the interest rate.

Monetary expansion: An increase in the money supply shifts the LM curve to the right, raising income and lowering the interest rate. With a fixed exchange rate, both of these changes contribute to BOP deficit. With a flexible rate, this is an excess supply of domestic currency, which therefore depreciates. The depreciation further stimulates income, but dampens the fall in interest rate.

Devaluation: A devaluation of the otherwise fixed exchange rate stimulates demand for domestic goods shifting the IS -curve to the right, but also shifting the BP curve down and creating a BOP surplus. (This ignores the possibility of a J -curve).

Capital Inflow: An exogenous capital inflow has no effect on IS or LM under a fixed exchange rate, since the central bank is sterilizing its effect on the interest rate. It merely

causes a BOP surplus. With a flexible rate, however, this surplus causes an appreciation, which reduces demand

and shifts the IS-curve to the left. Thus the capital inflow lowers income and the interest rate under a flexible exchange rate.

Explanation of the graph:

- The relative slopes of the LM and BP curves are crucial to some of these results. The case shown assumes that capital is sufficiently mobile internationally that the BP curve is flatter than the LM curve. The extreme case of perfect capital mobility would have a horizontal BP curve.
- In addition to the two cases shown, one could (and should) also look at the case of a fixed exchange rate with non sterilization. In that case, whenever there is a BOP disequilibrium the money supply will be changing, rising with a surplus and falling with a deficit (which are in turn indicated by the + and - signs in the diagram). The LM curve therefore shifts until all three curves intersect at once.
- Exchange rate devaluation (and depreciation) is shown as shifting the IS and BP curves both to the right. This requires that import demand elasticities are large enough to satisfy the Marshall-Lerner Condition. Without this, as is perhaps likely in the short run, both would shift in the other direction. This is one possible cause of the J-curve, worsening the balance of trade in the short run, and also reducing aggregate demand.
- An exogenous change in exports and/or imports due to any of a variety of causes ranging from changing trade policies to business cycle fluctuations abroad will have effects under fixed exchange rates similar to the devaluation shown above. Under a flexible exchange rate, however, matters are complicated by the need to know how an exchange rate change alters capital flows. Depending on the nature of expectations, among other things, anything or nothing is possible. In particular, it may be that, say, an exogenous increase in exports will be exactly offset, in its effects on the trade balance and aggregate demand, by an exchange rate appreciation.

- The model here takes all foreign variables as given, under the assumption that this is a small open economy. If that is not the case, there will be foreign repercussions from the foreign response to this country's changes in trade and capital flows, and results may change.

20.3 MATHEMATICAL EQUATIONS AND COMPONENTS OF IS-LM-BOP MODEL:

The IS-LM-BOP model, also known as the Mundell–Fleming model, is an economic model first set forth (independently) by Robert Mundell and Marcus Fleming. The model is an extension of the IS-LM Model. Whereas the traditional IS-LM Model deals with economy under autarky (or a closed economy), the IS-LM-BOP model describes an open economy. IS-LM-BOP model portrays the short-run relationship between an economy's nominal exchange rate, interest rate, and output (in contrast to the closed-economy IS-LM model, which focuses only on the relationship between the interest rate and output). IS-LM-BOP model has been used to argue that an economy cannot simultaneously maintain a fixed exchange rate, free capital movement, and an independent monetary policy. This principle is frequently called the "impossible trinity," "unholy trinity," "irreconcilable trinity," "inconsistent trinity" or the "Mundell–Fleming trilemma."

Variables

This model uses the following variables:

- 20 Y is GDP
- 21 C is consumption
- 22 I is physical investment
- 23 G is government spending (an exogenous variable)
- 24 M is the nominal money supply

25 P is the price level

26 i is the nominal interest rate

27 L is liquidity preference (real money demand)

28 T is taxes

Equations

The IS-LM-BOP model is based on the following equations. The **IS** curve:

where NX is net exports. The **LM** curve:

$$Y = C + I + G + NX$$

$$\frac{M}{P} = L(i, Y)$$

A higher interest rate or a lower income (GDP) level leads to lower money demand. The **BOP** (Balance of Payments) Curve:

$$BoP = CA + KA$$

where **BOP** is the balance of payments surplus, CA is the current account surplus, and KA is the capital account surplus.

IS components

$$C = C(Y - T(Y), i - E(\pi))$$

where $E(\pi)$ is the expected rate of inflation. Higher disposable income or a lower real interest rate (nominal interest rate minus expected inflation) leads to higher consumption spending.

$$I = I(i - E(\pi), Y_{-1})$$

where Y_{-1} is GDP in the previous period. Higher lagged income or a lower real interest

rate leads to higher investment spending.

$$NX = NX(e, Y, Y^*)$$

where NX is net exports, e is the nominal exchange rate (the price of domestic currency in terms of units of the foreign currency), Y is GDP, and Y^* is the combined GDP of countries that are foreign trading partners. Higher domestic income (GDP) leads to more spending on imports and hence lower net exports; higher foreign income leads to higher spending by foreigners on the country's exports and thus higher net exports. A higher e (cheaper domestic currency in terms of foreign currency, and equivalently more expensive foreign currency in terms of domestic currency) leads to less purchasing of foreign goods due to the higher cost of acquiring the foreign currency to pay for them, and also leads to more purchasing of the country's exports by foreigners since they find it less costly to acquire the country's currency with which to pay for them; for both reasons, higher e leads to higher net exports.

Balance of payments (BOP) components

$$CA = NX$$

where CA is the current account and NX is net exports. That is, the current account is viewed as consisting solely of imports and exports.

$$KA = z(i - i^*) + k$$

where i^* is the foreign interest rate, k is the exogenous component of financial capital flows, z is the interest-sensitive component of capital flows, and the derivative of the function z is the degree of capital mobility (the effect of differences between domestic and foreign interest rates upon capital flows KA). This derivative is positive if there is any capital mobility (since a higher relative domestic interest rate makes funds more prone to flow into the country), and it is infinitely positive if there is perfect capital mobility.

Variables determined by the model

After the subsequent equations are substituted into the first three equations above, one has a system of three equations in three unknowns, two of which are GDP and the domestic interest rate. Under flexible exchange rates, the exchange rate is the third endogenous variable while **BOP** is set equal to zero. In contrast, under fixed exchange rates e is exogenous and the balance of payments surplus is determined by the model. Under both types of exchange rate regime, the nominal domestic money supply M is exogenous, but for different reasons. Under flexible exchange rates, the nominal money supply is completely under the control of the central bank. But under fixed exchange rates, the money supply in the short run (at a given point in time) is fixed based on past international money flows, while as the economy evolves over time these international flows cause future points in time to inherit higher or lower (but pre-determined) values of the money supply.

20.4 MECHANICS OF THE MODEL:

The model's workings can be described in terms of an IS-LM-BOP graph with the domestic interest rate plotted vertically and real GDP plotted horizontally. The IS curve is downward sloped and the LM curve is upward sloped, as in the closed economy IS-LM analysis; the BOP curve is upward sloped unless there is perfect capital mobility, in which case it is horizontal at the level of the world interest rate. In this graph, under less than perfect capital mobility the positions of both the IS curve and the BOP curve depend on the exchange rate (as discussed below), since the IS-LM graph is actually a two-dimensional cross-section of a three-dimensional space involving all of the interest rate, income, and the exchange rate. However, under perfect capital mobility the BOP curve is simply horizontal at a level of the domestic interest rate equal to the level of the world interest rate.

Under a flexible exchange rate regime:

In a system of flexible exchange rates, central banks allow the exchange rate to be

determined by market forces alone.

Changes in the money supply

An increase in money supply shifts the LM curve to the right. This directly reduces the local interest rate relative to the global interest rate. This depreciates the exchange rate of local currency through capital outflow. (To the extent that funds are internationally mobile, they flow out to take advantage of the interest rate abroad, which has become relatively more attractive, and hence the currency depreciates.) The depreciation makes local goods cheaper compared to foreign goods, and this increases exports and decreases imports. Hence, net exports are increased. Increased net exports lead to the shifting of the IS curve (which is $Y = C + I + G + NX$) to the right, partially or entirely mitigating the initial decline in the domestic interest rate. At the same time, the BOP curve shifts rightward, since with a depreciated currency it takes a lower interest rate or higher income level to give a zero balance of payments surplus (which is what the curve describes). The combined effect of these three curves shifting is to increase the economy's income. A decrease in the money supply causes the exact opposite process.

Changes in government spending

An increase in government expenditure shifts the IS curve to the right. The shift causes both the local interest rate and income (GDP) to rise. The increase in the local interest rate causes increased capital inflows, and the inflows make the local currency stronger compared to foreign currencies. On the other hand, the higher GDP increases spending on imports, tending to make the currency weaker. Assuming the BOP curve is not as steep as the LM curve (i.e., assuming that capital mobility is relatively strong), the former effect will dominate and the currency will become stronger. The stronger exchange rate also makes foreign goods cheaper compared to local goods. This encourages greater imports and discourages exports, so net exports become lower. As a result of this exchange rate change, the IS curve shifts back toward its original location. The stronger currency also shifts the BOP curve upward, as higher levels of the interest rate would now be

consistent with a zero payments surplus in the presence of the stronger currency

exchange rate. The LM curve is not at all affected in the short run. The net effect of all this is that, if there is perfect capital mobility, the level of income of the local economy is unchanged from originally, while it has gone up if capital is less than perfectly mobile. A decrease in government expenditure reverses the process.

Changes in the global interest rate

An increase in the global interest rate shifts the BOP curve upward and causes capital flows out of the local economy. This depreciates the local currency and boosts net exports, shifting the IS curve to the right. Under less than perfect capital mobility, the depreciated exchange rate shifts the BOP curve somewhat back down. The net effect is an increase in income and the local interest rate. Under perfect capital mobility, the BOP curve is always horizontal at the level of the world interest rate. When the latter goes up, the BOP curve shifts upward by the same amount, and stays there. The exchange rate changes enough to shift the IS curve to the location where it crosses the new BOP curve at its intersection with the unchanged LM curve; now the domestic interest rate equals the new level of the global interest rate. A decrease in the global interest rate causes the reverse to occur.

Under a fixed exchange rate regime:

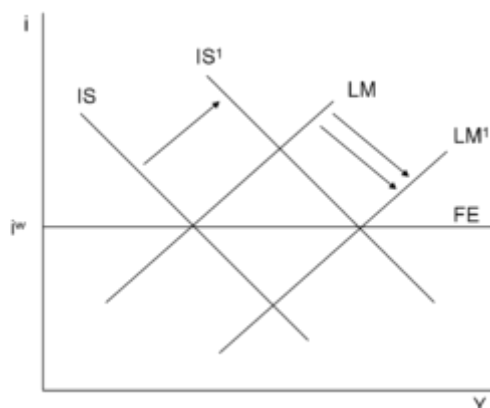
In a system of fixed exchange rates, central banks announce an exchange rate (the parity rate) at which they are prepared to buy or sell any amount of domestic currency. Thus net payments flows into or out of the country need not equal zero; the exchange rate e is exogenously given, while the variable BOP is endogenous. Under the fixed exchange rate system, the central bank operates in the foreign exchange market to maintain a specific exchange rate. If there is pressure to depreciate the domestic currency's exchange rate because the supply of domestic currency exceeds its demand in foreign exchange markets, the local authority buys domestic currency with foreign currency to decrease the domestic

currency's supply in the foreign exchange market. This keeps the domestic currency's exchange rate at its targeted level. If there is pressure to appreciate the domestic currency's exchange rate because the currency's demand exceeds its supply in the foreign exchange market, the local authority buys foreign currency with domestic currency to increase the domestic currency's supply in the foreign exchange market. Again, this keeps the exchange rate at its targeted level.

Changes in the money supply

In the very short run the money supply is normally predetermined by the past history of international payments flows. If the central bank is maintaining an exchange rate that is consistent with a balance of payments surplus, over time money will flow into the country and the money supply will rise (and vice versa for a payments deficit). If the central bank were to conduct open market operations in the domestic bond market in order to offset these balance-of-payments-induced changes in the money supply, a process called sterilization, it would absorb newly arrived money by decreasing its holdings of domestic bonds (or the opposite if money were flowing out of the country). But under perfect capital mobility, any such sterilization would be met by further offsetting international flows.

Changes in government expenditure



An increase in government spending forces the monetary authority to supply the market with local currency to keep the exchange rate unchanged. Shown here is the case of perfect capital mobility, in which the BOP curve (or, as denoted here, the FE curve) is horizontal. Increased government expenditure shifts the IS curve to the right. The shift results in an incipient rise in the interest rate, and hence upward pressure on the exchange rate (value of the domestic currency) as foreign funds start to flow in, attracted by the higher interest rate. However, the exchange rate is controlled by the local monetary authority in the framework of a fixed exchange rate system. To maintain the exchange rate and eliminate pressure on it, the monetary authority purchases foreign currency using domestic funds in order to shift the LM curve to the right. In the end, the interest rate stays the same but the general income in the economy increases. In the IS-LM- BOP graph, the IS curve has been shifted exogenously by the fiscal authority, and the IS and BOP curves determine the final resting place of the system; the LM curve merely passively reacts. The reverse process applies when government expenditure decreases.

Changes in the global interest rate

To maintain the fixed exchange rate, the central bank must accommodate the capital flows (in or out) which are caused by a change of the global interest rate, in order to offset pressure on the exchange rate. If the global interest rate increases, shifting the BOP curve upward, capital flows out to take advantage of the opportunity. This puts pressure on the home currency to depreciate, so the central bank must buy the home currency that is, sell some of its foreign currency reserves to accommodate this outflow. The decrease in the money supply resulting from the outflow, shifts the LM curve to the left until it intersect the IS and BOP curves at their intersection. Once again, the LM curve plays a passive role, and the outcomes are determined by the IS-BOP interaction. Under perfect capital mobility, the new BOP curve will be horizontal at the new world interest rate, so the equilibrium domestic interest rate will equal the world interest rate. If the global interest rate declines below the domestic rate, the opposite occurs. The BOP curve shifts

down, foreign money flows in and the home currency is pressured to appreciate, so the central bank offsets the pressure by selling domestic currency (equivalently, buying foreign currency). The inflow of money causes the LM curve to shift to the right, and the domestic interest rate becomes lower (as low as the world interest rate if there is perfect capital mobility).

20.5 DIFFERENCES FROM IS-LM:

It is worth noting that some of the results from this model differ from those of the IS-LM model because of the open economy assumption. Results for a large open economy, on the other hand, can be consistent with those predicted by the IS-LM model. The reason is that a large open economy has the characteristics of both an autarky and a small open economy. In particular, it may not face perfect capital mobility, thus allowing internal policy measures to affect the domestic interest rate, and it may be able to sterilize balance-of-payments-induced changes in the money supply. In the IS-LM model, the domestic interest rate is a key component in keeping both the money market and the goods market in equilibrium. Under the Mundell–Fleming framework of a small economy facing perfect capital mobility, the domestic interest rate is fixed and equilibrium in both markets can only be maintained by adjustments of the nominal exchange rate or the money supply (by international funds flows).

20.6 IS-LM MODEL (IN CLOSED ECONOMY):

This is an articulated version of K model.

- Unlike previous, this model integrates interest rates into the analysis.
- the axes: interest rate on the vertical axis, Y or income (GDP) on horizontal axis.
- The I-S curve (investment = savings, or more properly investment + government = saving + taxes)

Recall that overall demand for goods determines level of Y in simple K model -- thus, in this context, lower interest rate leads to higher investment spending and higher income and output (thus downward slope for IS curve).

- The IS curve is the locus of all equilibrium in the goods market (demand = supply), based on changing the interest rate (one for each interest rate).
- The L-M curve.
- The interest rate in the economy is best thought of as being determined by the interaction of the money supply and money demand.
 - the money supply ($M1$) is set by the Fed through monetary policy basically through its ability to control bank reserves and bank lending (the money supply increases when the Fed engages in open market operations of the kind which expand bank reserves and thus bank lending).
 - the demand for money is a complex notion (better to think of desire to have money balances), but it involves mostly people who need money for desired transactions (purchases) and people who may want to hold cash as an "investment" (i.e., cash vs. bonds).
 - the bottom line: when transactions in the economy rise (increase in Y) there is a greater need for transactions balances, which increases the demand for money and raises interest rates
 - therefore, the L-M curve slopes upward
 - and the L-M curve is the locus of all equilibrium in the money market one for each level of income.
- In a closed economy (no Foreign Trade) the IS-LM intersection is the equilibrium between Y and int. rate. Both the goods market and the money market must be simultaneously in equilibrium.
- The government can affect the economy through fiscal or monetary policy, as a means of speeding up or slowing down the economy.
- To stimulate the economy through Fiscal Policy, a tax cut or government spending increase could be implemented. This would shift

the IS curve to the right (more G or more C) and would raise Y and interest rate. (A new equilibrium).

- To stimulate the economy through Monetary Policy, an increase in the money supply would be undertaken. This shifts the LM curve to the right and would raise Y and lower interest rate.

IS-LM Model (In an open economy):

- In a Large economy like the US or Germany or Japan, where their policies affect world interest rates i.e., big enough to lose anonymity.
- The model must be amended by now including a balance of payments (BP) curve. The BOP curve represents the relationship between various levels of income, and the interest rates which are needed for balance of payments equilibrium. (And stable exchange rate)
 - First the case of fixed exchange rates.
 - Since net exports fall as Y rises (current acct deficit) there is a need for higher interest rates: to cause the opposite effect in the capital account (a surplus due to a capital inflow) all of this means an up sloping BOP curve.
 - Now, there is a rightward shift of the IS curve (maybe due to Fiscal Policy stimulation). This will tend to push the interest rate above the BOP equilibrium line. This (hypothetical equilibrium) is not consistent with balance of payments equilibrium the interest rate is too high and capital inflow takes place excessively threatening to raise the exchange rate (excessive demand for \$ in currency markets).
 1. The upshot: the central bank must expand the money supply (by selling dollars in currency markets) to keep the interest rate from rising so much , and the LM curve moves to the right enough to make for a three-way intersection (including BOP line)
 2. Conclusion: with fixed exchange rates fiscal policy works well.
 - If there was a rightward shift of the LM curve. Say, due to a desire to expand the economy via monetary policy.
 1. This time the tendency would be for the interest rate to be pushed below the BOP

line leading to capital outflow and the need for the central bank to head off a drop in the exchange rate by shrinking the money supply (by buying dollars) moving the economy back to where it was.

2. Conclusion: with fixed exchange rates monetary policy doesn't work.

IS-LM Model (In small open economy with fixed exchange rates): In this economy it is assumed that there is perfect capital mobility, which is not sensible for large economy analysis.

- The only difference is that the small economy must keep domestic interest rates at "world" level.
- This means the BOP line is horizontal if the interest rate varies at all from world levels there will be rapid and overwhelming capital flows which will drive the exchange rate up or down in the absence of central bank intervention
- So with IS, LM, and horizontal BOP lines the same analysis as above applies: rightward IS movement would raise int. rate and cause capital inflow, so expansion of money supply (via selling domestic currency) is needed to keep exchange rate stable fiscal policy works (is reinforced by necessary monetary action). Key is that the interest rate must not be allowed to vary from world rate.

• Likewise, as above, monetary policy can not be used as an independent policy tool.

IS-LM Model (In Small Open economy with flexible exchange rates):

- Using same arrangement of horizontal BOP line, but this time with no interest on part of central bank to "defend" a particular exchange rate i.e., any balance of payments "imbalance" will disappear through out exchange rate adjustment.
- Say fiscal policy expansion is implemented. Effect will cause an increase in the int. rate, which will cause an immediate capital inflow and an appreciation of the exchange rate.
- This, in turn, causes a decrease in net exports, which automatically moves the IS curve to left until the exchange rate has adjusted downward enough to bring the interest rate back down to world levels.
- Conclusion: fiscal policy doesn't work in flexible exchange rate system.

IS-LM Model (In large economies):

They find themselves in the position of making other countries happy or miserable by their actions. For example if the US wants to fight inflation by raising interest rates (in a system of flexible rates), everyone else will be forced to go along since the US has a major effect on international interest rates.

20.7 SUMMARY

1. IS-LM Model can be presented as a graph of two intersecting lines in the first quadrant. The horizontal axis represents national income or real gross domestic product and is labeled Y . The vertical axis represents the real interest rate, i . The IS schedule is drawn as a downward-sloping curve. The initials IS stand for "Investment/ Saving equilibrium"

2. The IS-LM-BOP model also known as the Mundell–Fleming model, is an economic model first set forth (independently) by Robert Mundell and Marcus Fleming. The model is an extension of the IS-LM Model. Whereas the traditional IS- LM Model deals with economy under autarky (or a closed economy), the IS-LM-BOP model describes an open economy. IS-LM-BOP model portrays the short-run relationship between an economy's nominal exchange rate, interest rate, and output (in contrast to the closed-economy IS-LM model, which focuses only on the relationship between the interest rate and output).

3. The model's workings can be described in terms of an IS-LM-BOP graph with the domestic interest rate plotted vertically and real GDP plotted horizontally. The IS curve is downward sloped and the LM curve is upward sloped, as in the closed economy IS- LM analysis; the BOP curve is upward sloped unless there is perfect capital mobility, in which case it is horizontal at the level of the world interest rate.

4. The IS-LM-BOP model may be described in open and closed economies, and in small and large economies with the fixed and flexible exchange rate regime.

20.8 COMPREHENSIVE QUESTION

(A) Multiple Choice Questions

1) The meaning of balance of payments equilibrium is

- (A) Trade balance being equal to zero
- (B) Current account balance being equal to zero
- (C) Capital account balance being equal to zero
- (D) Current account balance being fully adjusted to the capital account balance

2). Under fixed exchange rates in the p.d.s model, the automatic adjustment process generates equilibrium through:

- (A) The S curve remains fixed and the D curve shifts.
- (B) The P curve remains fixed and the D curve shifts.
- (C) The D curve remains fixed and the P curve shifts.
- (D) P, D, and S curves all shift.

3. Under variable exchange rates, a decrease in the value of the domestic currency will shift the.....curve.....to the.

- (A) P and S to the right
- (B) P and S to the left
- (C) P and D to the right
- (D) P and D to the left

The Marshall-Lerner conditions ensure that:

- (a) The currency market is stable.
- (b) The goods market is stable.
- (c) A decrease in the value of the domestic country's currency improves the current account of the domestic country.
- (d) An increase in the value of the domestic country's currency improves the current account of the domestic country.

5. The main difference between the monetary approach and the portfolio balance approach is:

- (a) The monetary approach allows holding both domestic and foreign currencies.
- (b) The monetary approach allows holding both domestic and foreign bonds.
- (c) The portfolio balance approach allows holding both foreign currencies.
- (d) The portfolio balance approach allows holding both domestic and foreign bonds.

Please answer questions 7 to 9 in the context of the following model.

7. Starting from initial equilibrium, if there is an expansionary fiscal policy, then

- (a) A
- (b) A
- (c) B
- (d) B
- (e) None of the above

8. Temporary

- (a) Surplus
- (b) Deficit or shortfall

(c) Balance

(d) None of the above

9. Assuming this is a variable exchange rate system, for re-establishing equilibrium:

- (a) A
- (b) B
- (c) B
- (d) B
- (e) B.

20.9 SELF ASSESSMENT QUESTIONS

Q 1. Explain the IS-LM-BOP curve analysis in detail?

Q 2. Describe the IS-LM-BOP model components and variables with the help of graph?

Q 3. What are the mathematical equations of the IS-LM-BOP model?

Q 4. Describe the IS-LM-BOP analysis in different type of economies with fixed and flexible exchange rates?

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UNIT-21 LIBERALISATION, PRIVATISATION, GLOBALISATION

BLUE PRINT OF UNIT

21.1 Introduction

21.2 Globalization: Conceptual Framework

21.2.1 Definitions of Globalization

21.2.2 Characteristics/Components of Globalization

21.3 Strategies for Globalization

21.3.1 Export

21.3.2 Licensing and Franchising

21.3.3 Contract Manufacturing

21.3.4 Joint Ventures

21.3.5 Management Agreements

21.3.6 Wholly Owned Subsidiaries

21.3.7 Assembly Contracts

21.3.8 Cross-Border Mergers and Acquisitions

21.3.9 Third Country Routing/Location

21.4 Preconditions for Globalization

21.4.1 Liberalization

21.4.2 Multilateral Trade Agreements

21.4.3 Multilateral Investment Agreements

21.4.4 Adequate Resources

21.4.5 Comparative Advantage

21.4.6 Improvement in Transportation

21.4.7 Improvement in Information and Communication Technology

21.4.8 Experience of Other Countries

21.4.9 Increase in Corporate Organization

21.4.10 Good Quality Infrastructure Facilities

21.5 Impact of Globalization on Indian Economy

21.5.1 Positive Effects of Globalization

21.5.2 Negative Effects of Globalization

- 21.6 Political Impact of Globalization
- 21.7 Barriers to Globalization
- 21.8 Glocalization
- 21.9 Liberalization
- 21.10 Measures taken for liberalization
- 21.11 Meaning of privatization
- 21.12 Reasons for privatization
- 21.13 Objectives of privatization
- 21.14 Benefits of privatization
- 21.15 Barriers / disadvantages of privatization
- 21.3 rivatization in India
- 21.4 Summary
- 21.5 Glossary
- 21.6 Comprehensive Questions
- 21.7 Answer to Comprehensive questions
- 21.8 self assessment question
- 21.9 Book references

Objective

After reading this unit, you will be able to:

1. Understand the meaning of globalization, liberalization and privatization
2. Assess the impact of globalization, liberalization and privatization on trade
3. Appreciate their relevance and importance in Indian context

21.1 INTRODUCTION

The present times in global economy are characterized by a multi-polar world where there is a free flow of goods and services across the countries. The age of regulated business is over and the governments across the world prefer free market economy over other forms of economic systems. In this unit, the key concepts – globalisation,

liberalisation and privatisation and their impact on business is explained.

21.2 GLOBALISATION: CONCEPTUAL FRAMEWORK

Globalisation means linking the economy of a country with the economies of other countries by means of free trade, free mobility of capital and labour, etc. It also means inviting multinational corporations to invest in domestic economy.

"Globalisation may be defined as a process associated with increasing openness, growing economic interdependence and deepening economic integration in the world economy."

Globalisation implies opening of economy to foreign investment, removing obstacles to the entry of multinational corporations (MNCs), carrying out massive import liberalisation by bringing down import duties considerably, promoting international trade, etc. With the globalisation in India, MNCs are allowed to enter in number of crucial sectors to which their entry was previously restricted or banned. Globalisation assumes that domestic economy should have close link with the world economy. As a result, there will be unrestricted flow of goods and services, technology and expertise among different countries of the world. There will be increased cooperation of domestic economy with different economies across the world. Capital and technology will flow from the developed countries of the world towards developing nations like China and India.

MNCs are playing an important role in the process of globalisation. Now there is increased movement of investment, technology, goods and services among different nations. Different countries of the world have come in close contact with one another. Now movement of people among different nations has increased. With the improvement in transportation and communication, more people move from one nation to another in search of better jobs, better education, tourism, medical treatment and other opportunities, etc. The ultimate aim of globalisation is to look upon the world as a 'global village.' Thus, globalisation is the process of integrating the domestic economy with the world economy. Globalisation mainly includes:

- a) Reducing tariff and non-tariff barriers across different nations.
- b) Allowing free flow of capital among different nations.
- c) Allowing free flow of technology across different nations.
- d) Allowing free movement of labour among different nations.

21.2.1 DEFINITIONS OF GLOBALISATION

There are several ways to define globalization. Some of the definitions can be stated as under:

(i) In the words of **Rubens Ricupero**, Secretary-General of UNCTAD. "Globalisation is the integration of the world economy as a result of three main forces: (i) increase in trade in goods and services (ii) increase in the investment of transnational companies and the consequent change in the nature of production. Production is becoming no longer national but as a process that takes place in different countries, and (iii) international monetary transactions. "

(ii) According to eminent economist **Deepak Nayyar**, "Globalisation may be defined as a process associated with increasing openness, growing economic interdependence and deepening economic integration in the world economy. "

(iii) According to **International Monetary Fund**, "Globalisation means growing economic interdependence of different countries through increasing cross-border transactions in goods and services and of international capital flows, and also through widespread diffusion of technology. "

In short, above definitions highlight the following features of globalisation: (i) Integration of domestic economy with global economy.

(1) Opening up of the economy to foreign capital, foreign technology and foreign competition.

(2) Free world trade with liberalised approach towards exports and imports. Elimination of tariffs and quotas.

(3) Expansion of multinational corporations.

(4) Free flow of international capital.

21.2.2 CHARACTERISTICS/COMPONENTS OF GLOBALISATION

(ii) **Free Trade of Goods and Services:**

In globalisation, liberal policy is adopted for export and import of goods and services. Various tariff and non-tariff barriers are removed so as to ensure unrestricted movement of goods and services across different nations. The whole world is treated as a single global village.

(iii) **Free Movement of Capital:**

Globalisation implies opening of domestic economy to foreign capital and investment and removing obstacles to the entry of multinational corporations. In globalisation, restrictions on inflow and outflow of capital are removed and several concessions are offered to attract foreign investment.

3. Free Movement of Labour:

Globalisation also implies free mobility of labour across different nations. Immigration and emigration rules are liberalised. Hiring of technicians, technocrats, skilled labour is made easy. It enables the business units to take advantage of cheap human labour available in other nations. It increases interdependence of different nations .

21.3 STRATEGIES OF GLOBALISATION

Different companies grow globally by adopting different types of strategies of globalisation. Some companies adopt even different strategies for different nations. Various strategies of globalisation are discussed as follows:

21.3.1 EXPORTING:

Exporting is the most traditional way of globalisation. Initially, a domestic business unit starts its international business by exporting to one nation. Gradually, it expands its exports to various nations. Exporting is very useful when a country has surplus production capacity i.e., its domestic consumption is less than its production capacity. At the same time, the country enjoys comparative advantage in producing those goods in comparison to other nations. The comparative advantage may be due to cheap labour, abundant supply of good

quality raw material, technological advantage, etc.

21.3.2 LICENSING AND FRANCHISING:

In licensing, business unit of one country (Licensor) allows the business unit of other country (Licensee) to use its technical know-how (patents, trademarks, copyrights, etc.). For this, licensor charges royalty from licensee for a stipulated period of time. In most of the nations, the rate of royalty ranges from 5 per cent to 8 per cent of sales. Licensing agreements enable the licensor to make maximum utilisation of its intellectual property. Licensee, too, can avail the benefits of modern technology by entering into licensing agreement. Under franchising, business unit of one nation (Franchiser) grants rights to do business in a particular manner to the business unit

of other nation (Franchisee). This right can be with regard to selling the goods under the brand names of franchiser. In some cases, the key components are provided by franchiser to franchisee. In another form of franchising, the manufacturer may appoint dealers in other nations. For example, soft drink manufacturers like Pepsi and Coca-Cola provide the key part of their product i.e., syrup to their franchisee in other nations. The franchisee have their own bottling plants where they make soft drinks but they sell the same under the brand name of franchiser.

21.3.3 CONTRACT MANUFACTURING:

In this agreement, business unit of one nation enters into agreement with manufacturers of other nations to allow them to manufacture the goods at their own, but right to market these goods is retained by the parent foreign enterprise. Under such agreement, the parent foreign enterprise can expand its business to other nations without setting up its own manufacturing plant in other nations. If the parent enterprise feels that marketing in a particular nation is not much profitable, it can have easy exit from that nation as it has not set up its own production plant in other nation.

21.3.6 JOINT VENTURES:

It is a common strategy for getting an entry into foreign market. In joint venture, foreign partner makes an arrangement with local unit of other country in which ownership and management are shared by local unit and foreign partner. Local unit has thorough knowledge of domestic conditions and it has its local set-up, and infrastructure like manufacturing unit, distribution network, service centres, etc. If foreign partner belongs to developed nation, then it provides its advanced technology and technocrats while local unit makes arrangement for labour. Profit of joint venture is shared between foreign partner and local unit.

21.3.5 MANAGEMENT CONTRACTING:

In this arrangement, parent enterprise of one nation sets up management agencies. Through these management agencies, business units of other nations are managed without any stake in ownership/capital. It means the parent enterprise is simply providing its managerial expertise to business units of other nations. For this, some fees in the form of percentage of profit or lump - sum fee is charged by parent enterprise.

21.4.5 Wholly Owned Subsidiaries:

Some companies open wholly owned manufacturing units in other nations.

These subsidiary companies are wholly owned by their parent company. MNCs prefer this route for globalisation when they want to have complete control over manufacturing activities in other nations. Instead of entering into joint ventures, licensing, franchising, exporting, etc., they set up their own manufacturing units in different nations. For example, LG Electronics has set up LG India as its wholly owned manufacturing subsidiary unit in India. It has its own manufacturing and marketing set-up in India. The brand name of parent company is extended to subsidiary companies.

21.3.7 Assembly Contracts:

In this strategy of globalisation, foreign partner provides key components and parts which are assembled in another nation. Usually business unit of developed nation provides key components, while these are assembled in developing nation. These contracts are entered into so as to avail the benefit of cheap labour available in developing nations. The products so assembled are marketed under the brand name of foreign parent company. This arrangement also helps to save custom duty as only key components are imported rather than finished product. The custom duty is lower on components than on finished products. In this form of globalisation, political resistance is less as it creates employment avenues in the developing nation where components are assembled. These assembled finished products are not only sold in the domestic market but are also exported to other nations which helps to increase exports of developing nation.

21.3.8 Cross-border Mergers and Acquisitions:

Such mergers and acquisitions take place between business units of different nations. In merger, business units usually operating at the same level, having same types of business join hands to avoid competition and to enhance their long-term competitive strength. It further adds to economies of scale. In cross-border acquisitions, generally a larger business unit of one nation acquires the comparatively smaller business unit in other nation. For example, Tata Steel (Indian company) acquired Corus Steel (European company). Similarly, Bharti Airtel acquired Zain's Telecom Operations in Africa. In this way, through cross-border mergers and acquisitions, the business units expand their business activities to other nations. This strategy of globalisation also provides instant access to manufacturing and marketing set-up in other nation.

21.3.9 Third Country Route/Location:

This strategy of globalisation is used to take advantage of friendly relations between two nations. In this case, one country does not make direct investment in other nation, rather investment is made in third nation. Through this third nation, the investment is routed to destination country. For example, India has tax-concession treaty with Mauritius, i.e., if any investment is made in India through Mauritius, it will get tax concession. To take advantage of this treaty, some foreign investors of other nations like Japan, UK and USA who intend to invest in India, instead of directly investing in India, route their investment through Mauritius to avail tax concessions. Third country location strategy is also used when two nations (say A and B) do not have good political or trade relations. If an investor of country A wants to invest in country B or vice versa, then the investor will route its money through third nation.

Thus, in this strategy of globalisation, third country location is used to invest in destination country.

21.4 PRECONDITION CONDITIONS FOR GLOBALISATION

21.4.1 Liberalisation: It promotes globalisation Liberalisation means to reduce unnecessary restrictions and controls on business units imposed by government. It means procedural simplification, relaxing trade and industry from unnecessary bureaucratic hurdles. It provides relaxation with regard to industrial licensing, price control on goods, import licence, foreign exchange control, investment by big business houses, etc. It also includes reducing tariff and non-tariff barriers on foreign trade, relaxing restrictions on inflow and outflow of foreign investment, etc. Liberal policy of government regarding foreign direct investment paves the.

21.4.2 Multilateral Trade Agreements:

Earlier, foreign trade was done through bilateral trade agreements, i.e., trade agreements between two foreign nations. But with the emergence of international institutions like WTO, IMF, UNCTAD, etc., foreign trade changed its route from bilateral trade agreements to multilateral trade agreements i.e., trade agreements among many nations. Multilateral trade agreements have promoted foreign trade among many nations which has brought many nations of the world closer to one another. It has promoted interdependence among various nations. Without multilateral trade agreements, globalisation would not have been possible. In 2010, 153 countries of the world were members of WTO. Any agreement entered at the

WTO platform is in the nature of multilateral trade agreement and is simultaneously applicable to 153 nations.

21.4.3 Multilateral Investment Agreement:

In multilateral investment agreement, many nations of the world enter into agreement to remove restrictions on inflow and outflow of foreign investment. It offers opportunity to MNCs to expand their business in different parts of the world. TRIMs i.e., Trade Related Investment Measures at WTO platform is an example of multilateral investment agreement. Such agreements promote globalisation.

21.4.4 Sufficient Resources:

Expansion of business at global level is possible only when the business unit possesses sufficient financial resources, managerial and technological expertise, entrepreneurial skills, popular brands, marketing skills, efficient human resources, etc. If there is lack of these resources, business cannot be expanded at global level.

21.4.9 Comparative Advantage:

If a business unit has comparative advantage with regard to cost of production, product quality, marketing advantage, brand image, etc., then it becomes easy for the business unit to expand its business to different parts of the world. This comparative advantage can be due to abundant supply of good quality raw material, availability of cheap and skilled labour, technological advantage, etc. For example, in India the skilled labour for gems and jewellery industry is available at low cost which has helped to reduce its production cost. It has enabled Indian gems and jewellery industry to shine at global level.

21.4.6 Improvement in Transportation:

In past many years, there has been significant improvement in transportation technology. With the improvement in air transportation system and development of ports, it has become easy to deliver goods at long distance at reduced rates. With the growth in container transportation, foreign trade has increased significantly. It has promoted foreign trade and integrated markets of various nations.

21.4.10 Improvement in Information and Communication Technology:

There has been significant improvement in information and communication technology. With the growth in telecommunication, internet, computers, sharing of information among various nations has become very easy. Now mobile phones, fax, electronic mail, voice mail have become very common. It has enabled outsourcing of

various jobs in various nations.

21.4.7 Experience of Other Countries:

Over the last two or three decades, centrally planned economies like Russia, Eastern Europe, Eastern Germany, etc. have failed on economic front. These economies were hesitant in adopting the process of globalisation. On the contrary, some developing economies like Korea, Thailand, Hong Kong, Singapore, etc. which adopted the

process of globalisation achieved new heights of economic success. China also succeeded in achieving high rate of economic growth by resorting to the process of globalisation. These success stories of globalisation inspired India and other countries to globalise their economies.

21.4.8 Growth in Corporate Organisation:

Development of corporate form of organisation has accelerated the pace of globalisation. Foreign investors can easily invest in corporate form of organisation by buying shares of companies. In corporate organisations, foreign investors can increase or decrease their investment by buying or selling shares through stock exchange.

21.5.2 Quality Infrastructural Facilities:

Good quality infrastructural facilities are essential for globalisation. If good quality infrastructural facilities are available in a country, then it attracts MNCs to set up their business units in that nation. It includes uninterrupted power supply, transportation, port facilities, warehousing, banking, communication, efficient capital markets, etc.

21.4.10 Globally Accepted Currency:

For globalisation, currency accepted at international level is must. It facilitates international payments and increases international liquidity. International Monetary Fund (IMF) has recognised five currencies, i.e., US dollars, British Pound, French Franc, German Deutsche Mark and Japanese Yen as internationally accepted currency. IMF has also floated Special Drawing Rights (SDRs) to facilitate international payments and liquidity.

21.5 EFFECTS OF GLOBALISATION ON INDIAN ECONOMY

21.5.1 Positive Effects of Globalisation

(1) Increase in Foreign Trade: As a result of foreign trade policies adopted in the wake of globalisation, India's share in the world trade has gone up. In 1990-91, India's share in world trade was 0.53 per cent. In 1995-96, it rose to 0.60 per cent. In 2009-10 it further increased to 1.78 per cent.

Table: India's Share in World Trade

Year	India's Percentage Share In World
1990-91	0.53
1995-96	0.60
2005-06	1.00
2007-08	1.50
2008-09	1.64
2009-10	1.78

(Source: Economic Survey, 2010-11)

Above table shows that as a result of globalisation of India's foreign trade, there has been some increase in India's share in world trade. Share of India's exports in India's GDP has also been constantly rising. In 1990-91, it was 6 per cent of GDP that rose to 15.54 per cent in 2009-10.

(2) Increase in Foreign Investment: As a consequence of globalisation, there has been a considerable increase in foreign direct investment as well as foreign portfolio investment.

- **Foreign Direct Investment (FDI) :** Foreign direct investment is made by foreign companies in order to establish wholly owned companies in another country and to manage them or to purchase shares of companies in another country for the purpose of managing such companies. The main characteristic of foreign direct investment is that native companies are managed by the foreign companies or new companies are set up in India by foreign companies. In this type of investment, it is the foreign investor who takes risk and is solely responsible for profit/loss of such company.

- **Portfolio Investment:** Under this type of investment, foreign companies/foreign institutional investors (FIIs) buy shares/debentures of native companies, however management and control remain vested with the

native/domestic companies themselves.

There is significant increase in foreign investment in India. In the year 1990-91, total foreign investment (FDI and Portfolio investment) was US\$ 103 million. In the year 2007-08, amount of foreign investment increased to US \$ 62,106 million. Due to global slowdown, inflow of foreign investment in 2008-09 has reduced to US \$ 23,983 million. In 2009-10 again inflow

of foreign investment has increased to US \$ 70,139 million. Because of significant increase in foreign investment, India began to experience a surplus balance of payments and a very remarkable improvement in foreign exchange reserves.

(3) Increase in Foreign Collaborations:

Globalisation has promoted collaboration of foreign companies with many Indian companies. These collaboration agreements can be technical collaboration, financial collaboration or both. In financial collaboration, foreign companies provide financial resources, while in technical collaboration modern foreign technology is provided by foreign companies. Foreign companies are setting up many enterprises in India in collaboration with Indian companies.

(4) Increase in Foreign Exchange Reserves:

As a result of globalisation of Indian economy, foreign exchange reserves have also increased substantially. In 1991, foreign exchange reserves of India amounted to Rs. 4,388, crore which in March, 2011 increased to Rs. 13,43,188 crore (US \$ 301.84 billion). Thus, there has been an increase of 306 times in foreign exchange reserves of India.

(5) Expansion of Market:

Globalisation has expanded the size of market. It has permitted Indian business units to expand their business in the whole world. Now multinational corporations have no national boundaries. Indian companies like Infosys, Tata Consultancy, Wipro, Tata Steel, Reliance, etc. are doing their business in many countries.

(6) Technological Development:

Globalisation has enabled the inflow of foreign technology, which is very superior and advanced. Now Indian business units use this modern technology.

(7) Brand Development:

Globalisation has promoted the use of branded goods. Now not only durable goods are branded but products like garments, juices, snacks, foodgrains, etc., are also

branded. Foreign brands are very popular among Indian consumers. Brand development has led to quality improvement.

(8) Development of Capital Market:

Globalisation has helped in development of Indian capital market. Now many foreign investors invest in Indian Capital market. Recently, there has been substantial increase in inflow of foreign direct investment and portfolio investment.

(9) Development of Service Sector:

Globalisation has helped in growth of service sector. With the entry of foreign companies, tremendous improvement has been witnessed in various services like telecommunication, insurance, banking, etc. Now mobile phones are very cheap and popular in India.

(10) Increase in Employment:

Globalisation has promoted employment opportunities. Foreign companies are establishing their production and trading units in India. It has increased employment opportunities for Indians, e.g. many Indians are presently employed in foreign insurance companies, mobile companies, etc.

(11) Reduction in Brain Drain:

As a result of globalisation, many multinational corporations have set up their business units in India. These MNCs provide attractive salary package and good working conditions to efficient, skilled Indian engineers, managers, professionals, etc. Now Indians get good employment opportunities in India. It has resulted in reduction in brain drain.

(12) Improvement in Standard of Living:

As a result of globalisation, the standard of living of Indian population has improved. Now Indians get better quality goods at low prices. Globalisation has resulted in reduction of prices of many products particularly electronic items like television, AC, mobile phones, refrigerator, etc. Now middle-income group also uses these luxury products, which were earlier used by rich class only.

i. Negative effects of globalisation

21 Loss to Domestic Industries:

As a consequence of globalisation foreign competition has increased in India. Now Indian industrial units have to compete with foreign industrial units. Because of better

quality and low cost of foreign goods, many Indian industrial units have failed to face competition and have been closed. Small and cottage industries are worst hit by this increased competition.

22 Unemployment:

Foreign companies operating in India use capital intensive technology. Even some Indian companies use imported capital-intensive technology. With the increasing use of computers and automatic machines, employment avenues are reduced.

23 Exploitation of Labour:

Globalisation is exploiting unskilled workers by giving lower wages, less job security, long working hours. Labourers have to work even in these conditions because bad job and less wages are better than no jobs.

24 Demonstration Effect:

With the easy availability of foreign goods, demonstration effect has increased among Indians. Now many consumers are using luxury products by imitating others. It has promoted tendency of wasteful consumption in India. This increasing wasteful expenditure has in turn reduced saving and capital formation.

25 Increase in Inequalities:

Globalisation has increased inequalities in our economy. Globalisation has benefitted MNCs and big industrial units but small and cottage industries are adversely hit by it. It has increased income inequalities in India.

26 Dominance of Foreign Institutions:

With globalisation dominance of foreign institutions has increased in India. Globalisation has helped foreign companies in enlarging their market share. For example, in Indian cold drink market, a large share is controlled by Pepsi and Coca-Cola, which are foreign companies.

21.6 POLITICAL IMPACT OF GLOBALISATION

Globalisation has multidimensional character covering economic, social, political and cultural aspects. The main political impact of globalisation is as follows:

(1) Improvement in Cross-border Relationship:

Globalisation has increased interaction among different nations of the world. It has made the whole globe one market. It has improved the relations among different nations.

(2) Changing Role of Bureaucracy:

Globalisation and liberalisation have resulted in procedural simplification. It has reduced government intervention in the economic activities. Earlier, bureaucracy was a hurdle in the path of development, but now it is a booster, accelerator and facilitator in the development process.

(3) Growth in Capitalism:

Globalisation has promoted capitalism across the world. Even countries like China and Russia who were great advocates of socialism have adopted capitalism.

(4) Changing Role of Government:

Prior to globalisation, government had to participate in economic, political, social activities, but with globalisation, government has reduced its role in the economic sector. Now private sector, MNCs play an important role in the economic sector. Now government can concentrate on other sectors like health, education, safe drinking water, environmental protection, infrastructure, defence, etc.

(5) Increase in Efficiency of Public Sector Units:

With the globalisation, privatisation and liberalisation, the efficiency of public sector units has increased. With increase in competition and threat of privatisation, now public sector units are under pressure to cut down wasteful expenses and increase productivity and efficiency

21.7 BARRIER TO GLOBALISATION

(1) Bureaucratic Hurdles:

Business units have to face many bureaucratic hurdles in the form of much documentation, lengthy and cumbersome procedures, etc. Many foreign investors hesitate to invest in Indian economy due to excessive administrative hindrances.

(2) Unstable Government Policy:

In India, there are frequent changes in ruling party. As a result, the economic policies of government are not stable. Frequently changing economic policies discourage long-term investors to invest in Indian economy. Moreover, there is lack of transparency in the working of government which also raises doubt in the minds of foreign investors.

(3) Backward Technology:

In Indian industries, level of technology is poor and low in comparison to advanced nations. Research and development of technology is also very poor in India. Due to backward technology, Indian products are of poor quality. Indian companies find it very difficult to expand their business in foreign nations due to poor quality products.

(4) Poor Infrastructure:

In India, infrastructural facilities are very poor in comparison to developed nations. MNCs hesitate to invest in India due to poor infrastructure. Lack of strong infrastructure also creates hindrance in expansion of Indian companies in other nations. Like lack of sufficient port facilities is a great hindrance in export-import transactions.

(5) Small-sized Business Units:

In India, most of the business units are family owned. Their business activities are mainly confined to local or regional level. They Cannot think of expanding their business activities to other nations.

(6) Lack of Global Vision:

In India, very few entrepreneurs have global vision. Most of the entrepreneurs have narrow vision. They do not have global orientation. They avoid risk involved in foreign business and remain confined to local or at the most national level.

(7) Increasing Global Competition:

Indian goods have to face tough competition in the global market from the products of other nations. Increasing global competition has made it very difficult for Indian exporters to sell their products in global market.

(8) Tariff and Non-tariff Barriers Imposed by Developed Nations:

Developed countries have imposed various tariff and non-tariff barriers to the imports from developing countries like custom duties, quantitative restrictions, packing regulations, safety norms, etc. This has adversely affected exporters of developing nations to sell their products in developed countries.

21.8 GLOCALISATION

Glocalisation is another term which is used nowadays in the context of global markets. Under glocalisation, global companies modify their products according to domestic requirements, culture and fashion of different nations. The global

companies sell different types of products and services to suit local needs. Thus, glocalisation is the fusion of two concepts-Globalisation and Localisation. Nowadays in the face of tough competition in the global market and different cultures, income levels, customs, traditions, laws, etc., a multinational company cannot sell the same product in all the nations. It has to adopt different production and marketing strategies for different nations. Glocalisation is the strategy of being global but simultaneously being sensitive to local needs and conditions. Glocalisation offers solutions to multicultural nature of different nations and regions. In simple words, glocalisation means, "Think Global and Act Local." For example, McDonalds, a leading international fast food brand localised its menu based on Indian traditions and culture. Most of the Indians, unlike western consumers, do not consume beef and most of the Indians are vegetarians. Realising this, McDonalds entered the Indian fast food with its strong vegetarian menu and confined only to chicken and mutton in the non-vegetarian category. It has also chosen local names for its food items like Maharaja Mac, Chicken Tikka AIoo, etc.

21.9 Liberalisation

Liberalisation of the economy means to free it from direct or physical controls imposed by the government. Prior to 1991, government has imposed several types of controls on Indian economy e.g. industrial licensing system, price control or financial control or financial control on goods, import licence, foreign exchange control, restriction on investment by big business houses, etc. It was experienced by the government that several short comings had crept into the economy on account of these controls. These had dampened the enthusiasm of the entrepreneurs to establish new industries. These controls had given rise to corruption, undue delays and inefficiency. Rate of economic growth of the economy fell sharply and high-cost economic system came into being. Economic reforms therefore made a bid to reduce restriction imposed on the economy.

21.10 MEASURES TAKEN FOR LIBERALISATION

Following measures have been taken under economic reforms for liberalisation of Indian economy.

21 Abolition of Industrial licensing and Registration: Main feature of the New Industrial Policy is to adopt a policy of liberalisation in place of controlled economy.

Till now, private sector of the economy was functioning under a rigid licensing system. Under New Economic Policy private sector has been freed, to a large extent, from the yoke of licences and other restrictions. In July, 1991, a new industrial policy was announced in this respect. According to it, with the exception of 6, industrial licensing has been abolished for all other industries. Industries for which licences are still necessary are (i) liquor, (ii) cigarette, (iii) defense equipments (iv) drugs, (v) industrial explosives (vi) dangerous chemicals. Any entrepreneur can float any new company and sell its shares without any restriction.

22 Concession from Monopolies Act: According to the provisions of Monopolies and Restrictive Trade Practices Act (MRTP Act) all those companies having assets worth more than 100 crore used to be declared MRTP firms and were subjected to several restrictions. Now the concept of MRTP has been done away with. These firms are now no longer required to obtain prior approval of the governments, at the time of taking investment decisions. They are free to expand themselves. Large concessions have been granted to companies falling under MRTP Act. Capital investment limit fixed earlier has removed. As a result, there would be no restriction on dominant companies and industrial houses for setting up new industries or expansion of industries, taking over and amalgamation. However, under this policy more emphasis will be laid on checking unfair trade practices to safeguard the interests of the consumers. The newly empowered Monopoly Board will be authorised to investigate any matter suo-moto or on complaints received from individual consumers. They also criticised the MRTP Act and stated, “The checks imposed on the larger business under the MRTP Act meant that in certain key industrial sectors, which needed massive investment for which the smaller business houses could not muster adequate resources, the expansion of capacity became particularly difficult”.

22.10 Freedom for Expansion and Production to Industries: Under the policy of liberalisation, industries are free to expand and produce. They need no prior official approval. As a result of liberalisation policy, industries have been given the following freedom: Prior to liberalisation under the provisions of old policy at the time of granting licence government used to fix maximum limit of production capacity. No industry could produce beyond this limit. Now this limit has been removed, so as to enable the industry to take full advantage of large-scale production.

22.11 Producers are now free to produce anything on the basis of demand in the

market. Previously, only those goods could be produced which were mentioned in the licence. It is no longer so now.

23 Increase in the Investment Limit of the Small Industries: Investment limit of the small industries has been raised to Rs. 1 crore so as to enable them to introduce modernisation. Investment limit of industries has also been increased to Rs. 25 lakh.

24 Freedom to Import Capital Goods: Under the policy of liberalisation, India industries will be free to buy machines and raw material from abroad in order to expand and modernize themselves.

25 Freedom to Import Technology: New Economic Policy of economic reforms has laid emphasis on the use of high technique to promote modernisation. The objective of this policy is to develop sunrise industries. i.e., computers and electronics. Under new economic reforms, to promote technological dynamism in Indian industries, Government has allowed agreements to import high technology. There is a provision in the new industrial policy that high priority industries need not seek permission to enter into agreements relating to high technology.

26 Free Determination of Interest Rates: Interest rate of the banking system of the country will no longer be determined by the Reserve Bank of India as per the policy of liberalisation. Banks all over the country are now free to determine the rate of interest as they like.

27 Action Plan for Information Technology and Software Development: A National Task Force on information technology and software development submitted 108 point action plan in July, 1998. The recommendations have been accepted by the Government and directions for their implementations have been given to all concerned departments.

21.11 MEANING OF PRIVATISATION

In the context of economic reforms, privatisation means allowing the private sector to set up more and more of industries that were previously reserved for public sector. Under it, existing enterprises of the public sector are either wholly or partially sold to private sector.

“Privatisation is the general process of involving the private sector in the ownership or operation of a state owned enterprise.” Need for privatisation was felt mainly

because of the inefficiency of the public sector. Most of the enterprises of the public sector were running into loss. The main reason behind it was that the managers of public sector enterprises were not free to take any decision independently. All important decisions were taken by the Ministers, who were more concerned with their political interests. It took long time to take decision. Consequently, production capacity remained under utilized, managers failed to function in a responsible manner causing productivity to go down. All these factors contributed to the inefficiency of the public sector. As a result of privatisation there will be more competition, efficiency of the economy will increase, quality and diversity of production enhance. Consumers will specially be benefited. It can take three forms:

- **Change in Ownership:** The degree of privatisation is judged by the extent of ownership transferred from the public enterprises to the private sector. Ownership may be transferred to an individual, co-operative or corporate sector. This can have four forms;
 - **Total Nationalisation:** It implies 100% transfer of ownership of a public enterprise to private sector.
 - **Joint Venture:** It implies partial transfer of a public enterprise to the private sector.
 - **Liquidation:** It implies sale of assets to a person who may use them for the same purpose or some other purpose. This solely depends on the preference of the buyer.
 - **Workers Co-operative:** It is a special form of denationalisation. In this form, ownership of the enterprises is transferred to workers who may form a co-operative to run the enterprise. In such a situation, appropriate provision of bank loans is made to enable workers to buy the shares of the enterprise.
- **Organisational Measures:** It includes a variety of measures to limit state control. They include:
 - **A Holding company Structure:** It may be designed in a manner in which the government limits its control to top level major decisions and leaves a sufficient degree of autonomy for the operating companies in their day-to-day operations.
 - **Leasing:** In this arrangement, the government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period, say of 5 years. While entering into a lease, the bidder is required to give an assurance of the quantum of profits that would be made available to the state.

- **Restructuring:** It is of two types: financial restructuring and basic restructuring.

1. Financial Restructuring implies the writing off of accumulated losses and rationalisation of capital composition in respect of debt-equity ratio.

2. Basic Restructuring said to occur when the public enterprise decides to shed some of its activities to be taken up by ancillaries or small scale units.

- **Operational Measures:** The efficiency of public sector enterprises depends upon the organisational structure. Unless this structure grants a sufficient degree of autonomy to the operators of the enterprise or develops a system of incentives, it cannot raise its efficiency and productivity. Privatisation in a narrow sense indicates transfer of ownership of a public sector undertaking to private sector, either wholly or partially. But, in another sense it implies the opening up of the private sector to areas hitherto reserved for the public sector. The basic purpose is to limit the areas of the public sector and to extend the areas of private sector operation, including heavy industries and infrastructure.

21.12 REASON OF PRIVATISATION

Inefficiency and low productivity of public sector account for the increasing tendency of privatisation in the recent years. The main causes of privatisation are as follows:

- (1) **Disintegration of Socialist Economies:** Most crucial sector of Russia and other socialist economies was public sector. Taking these economies as model, almost all

underdeveloped countries gave excessive importance to public sector. However, public enterprises turned inefficient and proved to be the single factor responsible for the failure of these economies. Russian economy disintegrated thereafter. As a result, other economies also lost confidence in the efficiency of public sector. On the other hand, economies of USA, Japan, Germany, etc. were making rapid progress under private sector. Thus, economies of rest of the world were attracted towards market economy and private sector because of its efficiency.

- (2) **Inefficient Public Sector:** Management of public sector does not have the independence to take decisions. Most of the decisions of public sector enterprises are taken by the ministers. Their decisions are politically motivated. Because of bureaucratic set up decisions are delayed. As a result, production capacity is not fully

utilised and there is fall in productivity. All these factors render public sector inefficient.

(3) **Uneconomic Price Policy:** Prices of public utility services like, electricity, irrigation, transport, water, etc. are not determined on the basis of commercial principles. These are determined on the basis of political, social and other non-economic considerations. In some cases, prices are deliberately kept less than the cost of production. Consequently, public sector enterprises suffer losses. Privatisation is advocated to avoid such losses.

(4) **Burden on the Government:** Losses incurred by public sector enterprises are not borne by their management or any other person. Losses are made good from government revenue. Managers are therefore indifferent to profits earned or losses incurred. No attention is paid to the productivity and the efficiency of the enterprise. 59 public sector units are running at loss. This creates unnecessary economic burden on the government. For reducing its economic burden government has promoted privatisation.

(5) **Experience of New Industrial Nations of Asia:** Industrial nations of Asia like Japan, Korea, Singapore, Hong Kong, Taiwan have achieved a faster rate of economic development with the help of privatisation. So government of other countries started thinking to adopt privatisation and to expand the area of private sector.

(6) **To Avail Benefits of Capitalism:** Capitalism is very successful in countries like Japan, USA, Hong Kong, Singapore, Korea, Taiwan, etc. Considering the benefits of capitalism like

increase in competition, increase in technological advancement, increased efficiency etc., our government has decided to adopt privatisation.

(7) **For Promoting Industrial Growth:** Government thought that public sector will not be able to bear the burden of developing basic and heavy industries alone, because of shortage of funds. So privatisation was promoted to increase industrial growth.

21.13 OBJECTIVES OF PRIVATISATION

The objectives of privatisation are to increase efficiency and competitiveness among industries, to increase profit, productivity and efficiency of the enterprises. Main objectives are described as under:

1. To achieve rapid economic development of nation.

2. To reduce deficit financing by reducing government expenditure on public enterprises.
3. To strengthen industrial management.
4. To make public sector units more competitive.
5. To make optimum use of economic resources.
6. To achieve rapid industrial development of the country.
7. To increase return on invested capital.
8. To enhance productivity in the industrial units.
9. To make maximum use of foreign investment and to attract its inflow.
10. To improve technological level.
11. To diversify the ownership and to widen entrepreneurship base i.e., increasing involvement of private entrepreneurs in these enterprises.
12. To reduce the economic burden of government and to release large amount of public resources blocked up in loss-making public sector units.
13. To increase competition.

21.14 ADVANTAGES OF PRIVATISATION

- (1) **Increase in Efficiency:** Privatisation of public sector industries increases their productivity, profitability and effectiveness.
- (2) **Professional Management:** Through privatisation, benefits of professional management of private sector can be availed. In private sector, persons with professional qualifications like MBAs from reputed management institutes are appointed. If strategic partner is foreign investor, then benefits of foreign expertise can also be availed.
- (3) **Increase in Competition:** By increasing the area of private sector and by privatising existing public sector units, benefits of competition can be availed. Consumers are benefited as a result of increase in competition. For example, because of privatisation of telecommunication sector, tariff rates of telephone services have come down. Now there is no monopoly of public sector units and the business environment is more competitive.
- (4) **In Line with International Trends:** Most of the developing and developed

economies have already adopted privatisation. So by adopting privatisation, our economy will come in line with international trends.

(5) **Reduction in Economic Burden of Government:** Through privatisation, the private sector will share the burden of economic development and will provide funds for capital investment. The burden of government with regard to investment in new projects and modernisation of loss-making projects and sick units is reduced. Economic burden of government is reduced by privatising loss making public sector units.

(6) **Increase in Financial Resources of Government:** By selling government equity to private sector, government can raise huge funds. These funds can be used for developing infrastructure

(7) **Increase in Responsibility:** Privatisation puts an end to problems like red tapism, nepotism, and other bureaucratic problems. The rule of 'Earn According to Work' is followed. If a person does not work, he is thrown out of job. This increases the feeling of responsibility among staff.

(8) **Reduction in Political Interference:** One gets rid of political interference to some extent as a result of privatisation. There is no delay in taking industrial decisions. Industries are run on sound economic principles. Functioning of these industries by the experts become possible.

(9) **Encouragement to New Inventions:** In private sector, more emphasis is given to

research. Privatisation encourages new inventions, research and development activities.

(10) **Globalisation of Economy:** With the growth of globalisation and economic liberalisation, our economy is interacting with the rest of the world. This is possible because of privatisation of our economy. When PSUs are sold to foreign strategic partners then privatisation promotes globalisation.

(11) **Increase in Industrial Growth Rate:** Privatisation promotes industrialisation. It further creates employment, boosts industrial production and promotes export.

(12) **Increase in Foreign Direct Investment:** Privatisation promotes globalisation. It encourages foreign investors to invest in domestic economy. In India, from Aug. 1991 to Feb. 2011, Rs. 6,36,120 crore were invested in the form of foreign direct investment.

(13) **Reduction in Loss of Public Sector Units:** Privatisation also encourages existing public sector units to improve their efficiency because there is always threat of privatisation to loss making public sector units. This way privatisation helps in improving the profitability of public sector units. Many loss making PSUs have started generating profits because of threat of privatisation.

21.15 ARGUMENTS AGAINST/DISADVANTAGES/OBSTACLES IN PRIVATISATION

(1) Industrial Sickness: Privatisation does not necessarily add to efficiency. Widespread industrial sickness in India is a glaring example. In 2008, there were 89,641 sick industrial units in private sector. Bank loans amounting to Rs. 35,366 crore are outstanding against them.

(2) Ignores Social Welfare: Under privatisation, private entrepreneurs are keen to invest their capital in those industries in which margin of profit is very high. Private sector gives more importance to profit motive than social welfare.

(3) Class Struggle: Privatisation implies class struggle. Capitalists (entrepreneurs) and labourers have conflicting interests that adversely affect smooth functioning of the economy.

(4) Increase in Inequality: Privatisation gives rise to increased possibility of economic inequality and it results in concentration of economic power. Privatisation helps the

large industries to grow further and small industries suffer from privatisation because of increased competition. For example, when government privatised VSNL and IPCL, it created monopoly in the hands of Tata and Reliance respectively.

(5) Opposition by Employees: Trade unions in India oppose privatisation of public enterprises. According to them, it will spread unemployment and lead to exploitation of employees. Although, in order to protect the interest of the employees, government has set up **National Renewal Fund** and has provided Rs. 200 crore for it, yet the Trade Unions have not so far favoured privatisation.

(6) Problem of Financing: Private sector needs huge resources to buy public sector enterprises. Private sector cannot manage large financial resources all by itself. If it borrows funds from financial institutions to buy shares of public enterprises, then it will amount to buying government enterprises with government funds by the private sector. It will not be fair. Shares of public enterprises should be sold to the public

through stock markets. However, there is little possibility of it, because generally people are less sure of the profitability of public sector enterprises and so they will be reluctant to invest their capital therein.

(7) Political Pressure: Some political parties mainly communists (left parties) are against privatisation. So it hinders the process of privatisation.

(8) Increase in Unemployment: There is more possibility of increase in unemployment in the wake of privatisation. In case of privatisation, some employees who are working in PSUs which are privatised may be retrenched. Moreover, to augment their profits, private entrepreneurs employ highly sophisticated technology which is mostly capital intensive. Such a technology causes unemployment. So privatisation increases unemployment.

(9) Wasteful Expenses: Many wasteful expenses are incurred by private sector units like wasteful advertising, sales promotion, perquisites for promoters and directors, etc. These wasteful expenses are passed on to the customers in the form of higher prices.

(10) Exploitation of Poor Nations: Privatisation promotes globalisation. In

globalisation some rich nations exploit the poor nations and use these poor nations as

their colonies. MNCs of rich nations prove fatal for domestic industries of poor nations.

(11) Ignores Weaker Sections: Profit motive is the guiding principle of privatisation. Private sector producers aim at maximising profits. Entrepreneurs are more inclined to produce goods that cater to luxuries and comforts. Needs of weaker sections of the society are ignored. Moreover, private sector does not offer job reservations to SC, ST and BC candidates.

(12) Ignores Enterprises of National Importance: Private sector works only for profit motive. So this sector does not enter in such area in which profitability is low. So sometimes key and basic industries are ignored by private sector.

(13) Increase in Regional Imbalances: Because of inadequate infrastructure private sector hesitates to set up units in backward areas. Private entrepreneurs prefer to set up their units in already developed regions. It has led to regional imbalances.

21.16 PRIVATISATION IN INDIA

Before independence, private sector dominated in India. During the period of planning, importance of public sector increased and that of private sector relatively declined. In 1991, New Economic Policy was declared. Under this policy, private sector has been accorded great importance and the process of privatisation has been initiated. Main features of the process of privatisation in India are as follows:

(1) Contraction of Public Sector: Number of industries reserved for the public sector has been reduced from 17 to 2 only. These two industries are - atomic energy and railways, and the remaining industries have been opened for private sector. This measure will increase the flow of investments to priority sectors. It is hoped that competition and efficiency will increase in the areas which have been opened for private sector. For example, in the area of telecommunication, after privatisation huge funds are invested by private sector and it has promoted competition.

(2) Sale of Shares of Public Sector to the Private Sector: Upto 74 per cent of shares

of public sector have been sold to foreign investors, institutional investors, mutual funds, public and workers. Till the end of March 2011, shares of public sector worth Rs.

99,739 crore were sold. In some PSUs, even 100 per cent shares are disinvested. Now shares of PSUs are sold through Bidding Process.

(3) Sick Public Sector Industries: Public sector industries will be treated in the same way as sick industries of private sector. In order to re-organise the sick enterprises of public sector, the same will be entrusted to **Board of Industrial and Financial Reconstruction (BIFR)**. Various cases of sick industrial companies of public sector have been forwarded to BIFR. Sick PSUs which cannot be revived are sold to private sector.

(4) Memorandum of Understanding (MoU): With a view to improve the working of public sector enterprises, a system of MoU has been introduced. Under it, management of public sector enterprises is given more freedom and they are accountable for the results. In MoU, more autonomy is given to directors and they need not take permission for routine decisions from ministers. In 1991-92, 71 public sector enterprises signed MoU. In the year 2010-11, 202 enterprises have signed memorandum of understanding. 77 per cent of the public sector units who have signed MoU, have improved their performance.

(5) National Renewal Fund: This fund was established for protecting the interest of employees on account of privatisation. All the employees of public sector unit which is sold to private sector cannot be absorbed in private sector. Some employees are retrenched and some are offered Voluntary Retirement under this scheme. Upto March 2010, 3.541akh employees have sought voluntary retirement from public sector units. This fund is even used for payment of compensation and for providing social security measures to retrenched employees of PSUs; and for making payment for voluntary retirement. It has been decided that worker's interest will be protected in all disinvestment decisions.

(6) Implementation of Recommendations of Rangarajan Committee: For recommending ways to improve the functioning of PSUs, Rangarajan Committee was appointed. Following recommendations of Rangarajan Committee have been implemented, which have gone in the direction of privatisation of PSUs: (i) To disinvest 49 per cent equity of reserved public sector units and to disinvest 74 per cent equity of

other public sector units. (ii) Corporatisation of public sector units (running PSUs as

corporate body). (iii) Public Issue of shares: In the public issue of shares, employees of the same public sector company should be given preference. (iv) 10 per cent of disinvestment proceeds should be set aside for granting concessional loans to PSUs.

(7) Increase in Private Sector Investment in Plans: In five year plans, share of private sector in total investment of plans has increased. Share of private sector investment has been increased from 42 per cent in fifth five year plan to 78.1 per cent in eleventh five year plan.

(8) Withdrawal of Convertibility Clause of Loans into Shares: While advancing loans, earlier government financial institutions used to include convertibility clause. As per this clause, financial institutions could convert their loans into equity capital in case of non-repayment of loan and thus financial institutions could take ownership and control of private sector units in their own hands. This was a great threat and hindrance in the growth of private sector. In the economic reforms of 1991, this convertibility clause has been withdrawn. It is a welcoming step in the direction of privatisation.

(9) Setting up National Investment Fund: In year 2005, government has set up National Investment Fund. Proceeds of disinvestment are credited to this fund.

The 75% of income of this fund is utilised for social sector schemes like health, education, employment etc. and remaining 25% of income is used for capital investment in profitable and revivable public enterprises.

21.17 SUMMARY

The present day economic systems are based on a free market economy, in which, the governments do not interfere with the working of the business systems. The market forces of demand and supply decide the prices of goods and services. They are free to move across the world and the consumer gets the best option to choose from. This free market regime is called globalization where there is freedom of trade across nations and there are no trade barriers. In order to achieve this, the governments across the world are resorting to liberalization of their economies and reducing the control and regulation over their business. During the communist or socialist system, governments had made huge investments in establishing public sector undertakings. In privatization, these are being transferred to private ownerships. Globalisation, privatization and liberalization of economies is having both positive as well as negative impact on the population of the countries.

21.18 GLOSSARY

Globalization: The process of connecting a country's economy with the economies of other countries through free trade, the mobility of capital and labor, etc.

Foreign Direct Investment (FDI): Investment made by foreign companies to establish wholly-owned companies in another country.

Privatization: Allowing the private sector to establish more industries that were previously reserved for the public sector.

12.19 COMPREHENSION QUESTION

Fill in the blanks.

1) Opening up the domestic economy to foreign capital and investment and removing barriers to the entry of multinational corporations.....

2. Reducing unnecessary restrictions and controls imposed by the government on business units.....

3. Under Foreign Direct Investment (FDI), foreign companies/foreign institutional investors (FIIs) purchase shares/debentures of domestic companies, while management and control remain with domestic companies.....

4. Under globalization, global companies modify their products according to the domestic needs, culture, and fashion of various countries.....

21.20 ANSWER TO COMPREHENSION QUESTION

1. Globalization 2. Liberalization 3. Portfolio Investment 4. Glocalization

a. SELF ASSESSMENT QUESTIONS

23 Explain the concept of privatisation. What are its causes, advantages and disadvantages?

24 What is meant by globalisation of economy? Explain dimensions and causes of globalisation.

25 What do you mean by globalisation of Indian economy? Discuss its features and effects.

26 Examine the process of globalisation of Indian economy.

27 What is globalisation? Discuss its *positive* and *negative* effects on Indian economy.

22 SUGGESTED READING

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UNIT-22 REGIONAL TRADING BLOCKS

BLUE PRINT OF UNIT

22.1 Introduction

22.2 Forms of Regional Trade Blocks

22.3 Benefits of Regional Trade Blocks

22.4 Regional Trade Blocks and the World Trade Organization

22.5 International Grouping

22.6 Summary

22.7 Glossary

22.8 Comprehensive Questions

22.9 Answers to Comprehensive Questions

22.10 Self-Assessment Questions

22.11 Book references

Objective:

The objectives of this lesson are:

- (1) To acquaint the students with the various regional trading blocks in the global economy.
- (2) To understand the role of the different types of regional trading blocks in the world market.

22.1 INTRODUCTION:

“What is emerging is a world economy of blocks represented by NAFTA (North American Free Trade Agreement), the European Union and ASEAN (Association of South East Asian Nations). There is no one centre in this world economy. India is becoming a powerhouse very fast,”Peter Drucker.

Globalization is the today’s buzzword. International trade is coming down, nations are coming closer, they are negotiating with each other on the common table to access other markets, and they are negotiating for fair competition in the world. Nations are altering their domestic law according to international standards, and above all today more than 125 nations sit together on one table at the WTO.

Definition of Regional Trading Blocks:

Trade bloc can be defined as a ‘preferential trade agreement’ (PTA) between a subset of countries which is designed to significantly reduce or remove trade barriers within member countries. When a trade bloc comprises neighbouring or geographically close countries, it is referred to as a ‘regional trade (or integration) agreement’. It is sometimes also referred to as a ‘natural’ trade bloc to underline that the preferential trade is between countries that have presumably low transport costs or trade intensively with one another.

The two principal characteristics of a trade bloc are that:

- a) it implies a reduction or elimination of barriers to trade, and
- b) this trade liberalisation is discriminatory, in the sense that it applies only to the member countries of the trade bloc, outside countries being discriminated against in their trade relations with trade bloc members.

In general terms, regional trade blocks are associations of nations at a governmental level to promote trade within the block and defend its members against global competition.

A regional trading bloc is a group of countries within a geographical region that protect themselves from imports from non-members. Trading blocs are a form of economic integration, and increasingly shape the pattern of world trade.

22.2 FORM OF REGIONAL TRADING BLOCK

(1) **Preferential Trade Area:** (PTAs) exist when countries within a geographical region agree to reduce or eliminate tariff barriers on selected goods imported from other members of the area. This is often the first small step towards the creation of a trading block. It is the first stage of economic integration. The line between a PTA and a free trade area (FTA) may be blurred, as almost any PTA

has a main goal of becoming a FTA in accordance with the General Agreement on Tariffs and Trade.

(2) **Free Trade Area:** Free Trade Areas (FTAs) are created when two or more countries in a region agree to reduce or eliminate barriers to trade on all goods coming from other members. . There are no barriers regarding the trading of goods and services among the member countries. Besides it, there is no discrimination of quota, tariff, subsidies among the member countries and these countries can decide their own policies for non- member countries.

(3) **Customs Union (CU):** A customs union involves the removal of tariff barriers

between members, plus the acceptance of a common (unified) external tariff against non-members. This means that members may negotiate as a single bloc with 3rd parties, such as with other trading blocs, or with the WTO. Benefits of forming Customs Union:

- a. when a CU is formed and trade barriers among member nations are eliminated, producers in each nation become more efficient to meet the competition of other producers within the union.
- b. A second possible benefit from the formation of a CU is that economies of scale are likely to result from the enlarged market.
- c. Another possible benefit is the stimulus to investment to take advantage of the enlarged market and to meet the increased competition.
- d. These dynamic gains resulting from the formation of a CU are presumed to be much greater than the static gains discussed above and to be very significant.

(4) **Common Market:** A 'common market' is the first significant step towards full economic integration, and occurs when member countries trade freely in all economic resources – not just tangible goods. This means that all barriers to trade in goods, services, capital, and labour are removed. In addition, as well as removing tariffs, non-tariff barriers are also reduced and eliminated. For a common market to be successful there must also be a significant level of harmonisation of micro-economic policies, and common rules regarding monopoly power and other anti-competitive practices. There may also be common policies affecting key industries, such as the Common Agricultural

Policy (CAP) and Common Fisheries Policy (CFP) of the European Single Market (ESM).

(5) **European Union (EU):** The EU is the world's largest trading bloc, and second largest economy, after the USA. The EU was originally called the Economic Community (*Common Market*, or *The Six*) after its formation following the Treaty of Rome in 1957. The original six members were Germany, France, Italy, Belgium, Netherlands, and Luxembourg. The initial aim was to create a single market for goods, services, capital, and labour by eliminating barriers to trade and promoting free trade between members. In terms of dealing with non-members, common tariff barriers were erected against cheap imports, such as those from Japan, whose goods prices were artificially low because of the undervalued yen.

22.3 ADVANTAGES OF REGIONAL TRADING BLOCKS:

1. Countries are free to go for regional agreements for finished goods market and

to take comparative advantage as allies may also be supplying goods not available with the host countries.

2. The countries have free access to each other's markets, members are encouraged to specialise. This means that, at the regional level, there is a wider application of the principle of comparative advantage.

3. Producers can benefit from the application of scale economies, which will lead to lower costs and lower prices for consumers.

4. Jobs may be created as a consequence of increased trade between member economies.

5. Firms inside the bloc are protected from cheaper imports from outside, such as the protection of the EU shoe industry from cheap imports from China and Vietnam.

6. It also increases the bargaining power of trading blocks in the WTO because they cooperate with each other in the process of negotiation. It also helps in decreasing the bargain power of other countries because with the formation of RTAs among the developing nations like G-15 and ASEAN, their bargain power has increased significantly.

7. With economic integration, mobility will lead to the movement of labour and capital from areas of low productivity to areas of high productivity, resulting in decrease in production cost.

8. Market size will be increased which results in alluring the number of competing firms which lead to increased competition, greater efficiency and lower prices for consumers.

22.4 REGIONAL TRADING BLOCKS AND WTO

Although the term used in the WTO is “regional”, this subject includes bilateral free trade agreements between countries or groups of countries that are not in the same region. These agreements have become so widespread that most WTO members are now also parties to one or more of them, and their scope, coverage and number are still growing.

It is estimated that more than half of world trade is now conducted under agreements of this kind. They are found in every continent. Among the best known are the European Union, the European Free Trade Association (EFTA), the North American Free Trade Agreement (NAFTA), the Southern Common Market (MERCOSUR), the Association of Southeast Asian Nations (ASEAN) and its ASEAN Free Trade Area

(AFTA), and the Common Market of Eastern and Southern Africa (COMESA).

From its inception, GATT — and now the WTO — has allowed member countries to conclude customs unions and free-trade areas, as an exception to the fundamental principle of non discrimination set out in the most-favoured-nation clause of GATT's Article 1. All conditions for trade in goods within these agreements were set in GATT Article 24. Essentially, a regional trade agreement should aim to boost trade between its member countries and not to raise barriers against the trade with other WTO members. During the 1986–94 Uruguay Round negotiations, Article 24 was clarified to some extent and updated.

22.5 SOME INTERNATIONAL GROUPINGS

ASEAN:

The Association of Southeast Asian Nations (ASEAN) is a primary multinational trade group of Asia. It was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN, namely Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei Darussalam then joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999.

The Treaty of Amity and Cooperation (TAC) in Southeast Asia, signed at the First ASEAN Summit on February 24, 1976. The TAC stated that ASEAN political and security dialogue peace and stability by enhancing regional resilience.

Aims and Purposes of ASEAN

- to accelerate the economic growth, social progress and cultural development in the region through joint endeavors in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations, and
- (ii) to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.
- To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;
- To provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;

- To collaborate more effectively for the greater utilisation of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communications facilities and the raising of the living standards of their peoples;
- To promote Southeast Asian studies.

ASEAN Community

The ASEAN Vision 2020, adopted by the ASEAN Leaders on the 30th Anniversary of ASEAN, agreed on a shared vision of ASEAN as a concert of Southeast Asian nations, outward looking, living in peace, stability and prosperity, bonded together in partnership in dynamic development and in a community of caring societies.

At the 9th ASEAN Summit in 2003, the ASEAN Leaders resolved that an ASEAN Community shall be established.

At the 12th ASEAN Summit in January 2007, the Leaders affirmed their strong commitment to accelerate the establishment of an ASEAN Community by 2015 and signed the Cebu Declaration on the Acceleration of the Establishment of an ASEAN Community by 2015.

The ASEAN Community is comprised of three pillars, namely the ASEAN Political-Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community. Each pillar has its own Blueprint, and, together with the Initiative for ASEAN Integration (IAI) Strategic Framework and IAI Work Plan Phase II (2009-2015), they form the Roadmap for and ASEAN Community 2009-2015.

The Framework for Elevating Functional Cooperation to a Higher Plane was adopted in 1996 with a theme: “Shared prosperity through human development, technological competitiveness, and social cohesiveness.” Functional cooperation is guided by the following plans:

1. ASEAN Plan of Action on Social Development;
2. ASEAN Plan of Action on Culture and Information;
3. ASEAN Plan of Action on Science and Technology;
4. ASEAN Strategic Plan of Action on the Environment;
5. ASEAN Plan of Action on Drug Abuse Control; and
6. ASEAN Plan of Action in Combating Transnational Crime

SAARC

The South Asian Association for Regional Cooperation (SAARC) was established on December 8, 1985 by India, Pakistan, Bangladesh, Sri Lanka, Nepal, Maldives and Bhutan. In April 2007, at the Association's 14th summit, Afghanistan became its eighth member. The objective of the Association is to promote the welfare of the people of South Asia and to improve their quality of life through accelerated economic growth, social progress and cultural development in the region.

The SAARC Secretariat is based in Kathmandu, Nepal. It coordinates and monitors implementation of activities, prepares for and services meetings, and serves as a channel of communication between the Association and its Member States as well as other regional organisations.

The Secretariat is headed by the Secretary General, who is appointed by the Council of Ministers from Member States in alphabetical order for a three year term. H.E. Mr. Ahmed Saleem from Maldives is the current Secretary General. The Secretary General is assisted by eight Directors on deputation from the Member States. The SAARC Secretariat and Member States observe 8 December as the SAARC Charter Day.

Areas of Cooperation

SAARC seeks cooperation in the following thrust areas:

- Agricultural and Rural
- Biotechnology
- Culture
- Economic and Trade
- Education
- Energy
- Environment
- Finance
- Funding Mechanism
- Information, Communication and Media
- People to People Contacts

- Poverty Alleviation
- Science and Technology
- Science Aspects
- Social Development
- Tourism

SAPTA

South Asian Preferential Arrangement (SAPTA) was signed by the SAARC members on April 11, 1993 and came into force in December 1995. The objective of the SAPTA is the creation of trade among the SAARC countries through the reduction of tariffs and on preferential basis.

- overall reciprocity and mutuality of advantages so as to benefit equitably all Contracting States, taking into account their respective level of economic and industrial development, the pattern of their external trade, and trade and tariff policies and systems;
- negotiation of tariff reform step by step, improved and extended in successive stages through periodic reviews;
- recognition of the special needs of the Least Developed Contracting States and agreement on concrete preferential measures in their favour; and
- inclusion of all products, manufactures and commodities in their raw, semi-processed and processed forms.

SAFTA

The South Asian Free Trade Area (SAFTA) Agreement came into force in January 2006, with a ten year period for full- fledged implementation. It is an agreement reached on 6 January 2004 at the 12th SAARC summit in Islamabad, Pakistan. It created a free trade area of 1.6 billion people in Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka (as of 2011, the combined population is 1.8 billion people). The seven foreign ministers of the region signed a framework agreement on SAFTA to reduce customs duties of all traded goods to zero by the year 2016.

As of 13 September 2012, the total f.o.b. value of exports by Member States under SAFTA has crossed US\$ 2 billion since launching of SAFTA Trade Liberalisation Programme (i.e. July 2006) as per details given below:

Year	Bangladesh	India	Maldives	Pakistan	Sri Lanka	Total

20 06	0.00	0.0 0	14,001. 15	55,234.00	0.00	69,325.1
20 07	15,273,177	-	0.00	576,164.99	19,828.0 2	19,652,581. 1
20 08	98,316,963.16	-	0.00	31,796,718. 51	40,789.2 2	139,138,891 .5
20 09	199,786,454.72	-	0.00	43,509,984. 90	608,623. 96	559,161,799 .9
20 10	236,711,501.24	-	0.00	56,119,007. 59	517,566. 00	663,019,127 .6
20 11	-	-	-	43,174,978. 83	102,393. 00	331,087,834 .2
20 12	-	-	-	-	-	342,980,545 .0
T otal	550,088,096,62 7.55	-	14,001. 15	175,232,17 8.82	1289,200 .20	2,055,110,1 04.6

Objectives of SAFTA:

1. eliminating barriers to trade in, and facilitating the cross- border movement of goods between the territories of the Contracting States;
2. promoting conditions of fair competition in the free trade area, and ensuring equitable benefits to all Contracting States, taking into account their respective levels and pattern of economic development;
3. creating effective mechanism for the implementation and application of this agreement, for its joint administration and for the resolution of disputes; and
4. establishing a framework for further regional cooperation to expand and enhance the mutual benefits of this agreement.

NAFTA

The North American Free Trade Agreement (NAFTA) is a comprehensive trade agreement that sets the rules of trade and investment between Canada, the United States, and Mexico. Since the agreement entered into force on January 1, 1994, NAFTA has systematically eliminated most tariff and non-tariff barriers to free trade and investment between the three NAFTA countries. In addition, NAFTA has established a strong foundation for future growth and has set a valuable example of the benefits of trade liberalization. Canada and US had signed a Free Trade Agreement which came into effect on January 1, 1989, and later Mexico approached the United States to establish one. The result was that on January 1, 1994 North America Free Trade Agreement came into effect.

NAFTA covers the following areas:

Market Access for Goods

- a. The elimination of duties on thousands of goods crossing borders within North America.
- b. Phased-in tariff reductions – now complete – and special rules for agricultural, automotive, and textile and apparel products.
- c. Important rights for NAFTA services providers and users across a broad spectrum of sectors.
- d. Special commitments regarding telecommunications and financial services.
- e. Formal dispute resolution processes that help resolve differences that arise in the interpretation or application of NAFTA's rules.

Protection for Foreign Investment

- f. Commitment to treat each others' investors and their investments in the territory of the host NAFTA country no less favorably than their own domestic investors.
- g. Commitment to provide NAFTA investors with the best treatment given to foreign investors from beyond North America.
- h. A transparent and binding dispute resolution mechanism specially designed to deal with investment.

Protection for Intellectual Property

- i. Adequate and effective protection and enforcement of a broad range of intellectual property rights (including through patents, trademarks, copyrights, and industrial designs), while ensuring that the measures that enforce these rights do not themselves become barriers to legitimate trade.

Easier Access for Business Travelers

- j. Easier access for business professionals in hundreds of different professions so that they can travel for business throughout the continent.

Access to Government Procurement

- k. Access to government procurement opportunities at the federal levels in Canada, Mexico, and the United States.

Rules of Origin

- l. NAFTA rules of origin are used to determine whether a good is eligible for

preferential treatment under NAFTA.

m. At various times since NAFTA came into effect, the partners have implemented measures to liberalize or expand the list of products that qualify for preferential treatment. Since 2005, for example, the NAFTA partners have implemented two sets of changes to make it easier for traders to qualify for duty-free treatment under NAFTA.

Side Agreements

The NAFTA partners also negotiated two side agreements: the North American Agreement on Environmental Cooperation and the North American Agreement on Labor Cooperation.

Commitment to the Environment

The NAFTA partners signed a parallel agreement addressing environmental issues, the North American Agreement on Environmental Cooperation (NAAEC). Under the NAAEC, the United States, Canada and Mexico have committed to take certain steps to protect the environment, including the obligation that each of the parties will not fail to effectively enforce its environmental laws. A party's failure to meet this environmental obligation is subject to the same type of dispute resolution mechanism that is included in the NAFTA for commercial obligations.

Commitment to Labor Cooperation

The NAFTA partners signed a parallel agreement on labor cooperation designed to promote the effective enforcement of each country's labor laws and regulations and to facilitate further cooperation between NAFTA partners on labor matters.

The North American Agreement on Labor Cooperation (NAALC) established the Commission for Labor Cooperation (CLC), consisting of a Ministerial Council and a Secretariat. In the implementation of the NAALC, the CLC is assisted by National Administrative Officers (NAOs) in each of the three countries.

FTAA

FTAA stands for the "Free Trade Area of the Americas". It is essentially an expansion of the present North American Free Trade Agreement (NAFTA). It would include Canada, the US, Mexico, and all of the Americas not including Cuba. The Free Trade Area of the Americas (FTAA), currently being negotiated by 34 countries of the Americas, is intended by its architects to be the most far-reaching trade agreement in history. Although it is based on the model of the North American Free

Trade Agreement (NAFTA), it goes far beyond NAFTA in its scope and power. The FTAA, as it now stands, would introduce into the Western Hemisphere all the disciplines of the proposed services agreement of the World Trade Organization (WTO) - the General Agreement on Trade in Services (GATS) - with the powers of the failed Multilateral Agreement on Investment (MAI), to create a new trade powerhouse with sweeping new authority over every aspect of life in Canada and the Americas.

The goal of the FTAA is to build on NAFTA by further "reducing barriers to trade". It will contain a series of commitments to "liberalize" services — including education, health care, environmental services (including access to water), energy, postal services and anything else we pay for that isn't a physical object. It effectively increases privatization and deregulation in the western hemisphere — a very "business friendly" agreement that takes power away from governments and increases that of corporations.

CACM

Central American Common Market (CACM), an association of five Central American nations, was established on December 13, 1991, by the signing of the Protocol to the Charter of the Organization of Central American States (ODECA) or Tegucigalpa Protocol, which amended the Charter of ODECA, signed in Panama on December 12, 1962, and formally came into operation on February 1, 1993. It was formed to

facilitate regional economic development through free trade and economic integration. It is established by the General Treaty on Central American Economic Integration signed by Guatemala, Honduras, El Salvador and Nicaragua in December 1960, its membership expanded to include Costa Rica in July 1962. The CACM is headquartered in Guatemala City.

Purposes of CACM:

- a. To consolidate democracy and strengthen its institutions based on the existence of governments elected by universal, free and secret suffrage, and on the unrestricted respect for human rights.
- b. To set up a new model of regional security based on the reasonable balance of forces, the strengthening of civilian authority, the overcoming of extreme poverty, the promotion of sustainable development, the protection of the environment, and the eradication of violence, corruption, terrorism, and drug and arms trafficking.

- c. To promote a broad regime of freedom to ensure the full and harmonious development of the human person and of society as a whole.
- d. To achieve a regional system of welfare and economic and social justice for the peoples of Central America.
- e. To attain economic union and strengthen the Central American financial system.
- f. To strengthen the region as an economic bloc in order to insert it successfully into the international economy.
- g. To reaffirm and consolidate the self-determination of Central America as it pertains to the region's external relations, through a single strategy to strengthen and expand the participation of the region as a whole in the international arena.
- h. Promote, in a harmonious and balanced way, the sustained economic, social, cultural and political development of Member States and the region as a whole.
- i. Establish concerted actions directed toward the preservation of the environment through respect and harmony with nature, ensuring the balanced development and rational exploitation of natural resources of the area, with a view to establishing a New Ecological Order in the region.
- j. To constitute the Central American Integration System based on a legal and institutional order and mutual respect among Member States.

APEC

Asia-Pacific Economic Cooperation is the premier forum for facilitating economic growth, cooperation, trade and investment in the Asia-Pacific region established in 1989 to further enhance economic growth and prosperity for the region and to strengthen the Asia-Pacific community. It is an intergovernmental grouping that operates on the basis of non-binding commitments, open dialogue and equal respect for the views of all participants. Unlike the WTO or other multilateral trade bodies, APEC has no treaty obligations required of its participants. Decisions made within APEC are reached by consensus and commitments are undertaken on a voluntary basis. APEC has 21 members - referred to as "member economies" - which account for approximately 40 percent of the world's population, approximately 55 percent of world GDP and about 44 percent of world trade.

APEC's 21 Member Economies are Australia; Brunei Darussalam; Canada; Chile; People's Republic of China; Hong Kong, China; Indonesia; Japan; Republic of Korea; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; The Republic of the Philippines; The Russian Federation; Singapore; Chinese Taipei; Thailand;

United States of America; Viet Nam. APEC member-economies have outlined four objectives:

- a. To sustain the growth and development of the region for the common good of its people thus contributing to the growth of world economy;
- b. To enhance the gains of both regional and world economy by encouraging the flow of goods, services, capital and technology;
- c. To develop and strengthen the open multilateral trading system in the interest of Asia-Pacific member economies and all other economies; and
- d. To reduce barriers to trade in goods and services, and minimise hindrance to investment among its participants in a manner consistent with GATT/WTO principles, where applicable and without detriment to other economies.

APEC envisions full trade and investment liberalization and facilitation by 2010 for industrialized economies and 2020 for developing members. With respect to tariffs, the goal is zero tariffs in 2010 and 2020 for developed and developing countries, respectively.

India-Mercosur PTA

MERCOSUR is a trading bloc in Latin America comprising Brazil, Argentina, Uruguay and Paraguay. It was formed in 1991 with the objective of facilitating the free movement of goods, services, capital and people among the four member countries. It is the third largest integrated market after the European Union (EU), North American Free Trade Agreement (NAFTA). India had a total trade of US\$ 1247.32 million with MERCOSUR during 2003-2004. India's exports to MERCOSUR were approximately US\$ 385.45 million during 2003-2004 and imports from MERCOSUR were approx. US\$ 861.87 million in the same period.

A Preferential Trade Agreement (PTA) was signed in New Delhi on January 25, 2004. The aim of this Preferential Trade Agreement is to expand and strengthen the existing relations between MERCOSUR and India and promote the expansion of trade by granting reciprocal fixed tariff preferences with the ultimate objective of creating a free trade area between the parties.

The major product groups covered in the offer list of MERCOSUR are food preparations, organic chemicals, pharmaceuticals, essential oils, plastics & articles, rubber and rubber products, tools and implements, machinery items, electrical machinery and equipments

ANDEAN PACT (The Andean Community)

The Andean Community of Nations is a trade bloc comprising the South American countries of Bolivia, Colombia, Ecuador and Peru. The trade bloc was called the Andean Pact until 1996, and came into existence in 1969 with the signing of the Cartagena Agreement. Andean Community headquarters are located in Lima, Peru. The trading bloc encompasses a combined of 101 million (2010).

Facts on the Andean Pact:

1. Andean Community has 120 million inhabitants in an area of 4,700,000 square kilometers, and a Gross Domestic Product of US \$900 billion (excluding Venezuela).
2. The Andean Community and Mercosur comprise the two main trading blocs in South America.
3. The Community organization includes Andean Presidential Council, Foreign Minister's Council Commission, justice tribunal, congress and reserve fund.
4. With the cooperation agreement with Mercosur, the Andean Community gained five new associate members: Argentina, Brazil, Paraguay, Chile and Uruguay.

Economic Development stages of the Andean Pact

The original Andean Pact was founded in 1969 by Bolivia, Chile, Colombia, Ecuador and Peru. In 1973, Venezuela joined the pact. Its membership was reduced when Chile withdrew in 1976, and Venezuela announced its withdrawal in 2006. In 1994, the Common External Tariff (CET) was approved. In July 2005, the four Mercosur members were granted associate membership by the Andean Council of Foreign Ministers. This move reciprocated the actions of Mercosur, which granted associate membership to all the Andean Community nations by virtue of economic agreements, Free Trade agreements, signed between the CAN and individual Mercosur members. The United States approved the pact in July 2005.

CARICOM

In 1972, Commonwealth Caribbean leaders at the Seventh Heads of Government Conference decided to transform the Caribbean Free Trade Association (CARIFTA) into a Common Market and establish the Caribbean Community, of which the Common Market would be an integral part.

The signing of the Treaty establishing the Caribbean Community, Chaguaramas, 4th July 1973, was a defining moment in the history of the Commonwealth Caribbean. Although a free-trade area had been established, CARIFTA did not provide for the free movement of labour and capital, or the coordination of agricultural, industrial and foreign policies. The objectives of the Community, identified in Article 6 of the

Revised Treat, are:

- To improve standards of living and work;
 - Full employment of labour and other factors of production;
 - Accelerated, coordinated and sustained economic development and convergence;
 - Expansion of trade and economic relations with third States, group of States and entities of any description.
1. The third largest integrated market after the European Union (EU), North American Free Trade Agreement (NAFTA)

22.6 SUMMARY

After the era of globalization, we are entering the era of Regionalisation. Except a few nations, almost all the signatories of WTO are also members of any RTA (Regional Trade Agreement) and most of them are members of more than one RTA. India too has entered into many free trade agreements. India signed a comprehensive treaty with Singapore; Britain hope that India will also sign the same treaty with European Union. Every country is in hurry to gain entry in other nation's markets and to have access to the raw material of other nations. Countries may make a partial movement towards free trade by the adoption of a preferential trading system. This involves free trade between the members, but restrictions on trade with the rest of the world. Such a system can be either a simple free trade area, or a customs union (where there are common restrictions with the rest of the world), or a common market (where in addition there is free movement of capital and labour, and common taxes and trade laws). Preferential trading may bring dynamic advantages of increased external economies of scale, improved terms of trade from increased bargaining power with the rest of the world, increased efficiency from greater competition between member countries, and a more rapid spread of technology. On the other hand, it can lead to increased regional problems for members, greater oligopolistic collusion and various diseconomies of scale. There may also be large costs of administering the system. There have been several attempts around the world to form preferential trading systems. The two most powerful are the European Union and the North America Free Trade Association (NAFTA).

The European Union is a customs union in that it has common external tariffs and no internal ones. But virtually from the outset it has also had elements of a common

market, particularly in the areas of agricultural policy, regional policy, monopoly and restrictive practice policy, and to some extent in the areas of tax harmonisation, transport policy and social policy. The Single European Act of 1986 sought to sweep away any remaining restrictions and to establish a genuine free market within the EU: to establish a full common market. Benefits from completing the internal market have included trade creation, cost savings from no longer having to administer barriers, economies of scale for firms now able to operate on a Europe-wide scale, and greater competition leading to reduced costs and prices, greater flows of technical information and more innovation.

22.7 GLOSSARY

Regional trade block: refers to when a trade bloc is formed by neighboring countries or countries that are geographically similar, it is referred to as a regional trade (or integration) agreement. A preferential trade area means that when nations in a particular geographic area agree to reduce or eliminate tariff barriers on the import of selected goods from other member nations of that area.

A free trade area: means that when two or more nations in a region agree to reduce or eliminate trade barriers on all goods coming from any member, they are said to have established a free trade area.

ASEAN: is the Association of Southeast Asian Nations, which is a primary multinational trade group in Asia.

22.8 COMPREHENSION QUESTION

a) Fill in the blanks.

1. The method of protection through which European organizations and nations provide protection to the agricultural sector is called
2. When member nations trade freely in all economic resources, it is called
3. The situation in which a country exports a product at a price lower than the production cost is called

b) Multiple Choice Questions

1. ASEAN refers to

- A. South East Agricultural Nations Organization
- B. South East Asian Nations Organization
- C. South East Asian Neighboring Coalition
- D. South East African Nations Coalition

2. The third largest integrated market after the European Organization and North America Free Trade Agreement (NAFTA) is –

- A). SAPTAB.
- b) MERCOSURC.
- c) APECD.
- d) WTO

3. The number of member countries in SAARC is –

- A. Six
- B. Eight
- C. Seven
- d. Sixteen

4. Which country has become the eighth member of SAARC?

- A. Afghanistan
- B. Cuba
- C. India
- D. Sri Lanka

22.9 ANSWER TO COMPREHENSION QUESTION

a) 1. Import duties, 2. Common market, 3. Dumping (subsidy)

(b) 1. b (Association of Southeast Asian Nations), 2. b (Mercosur), 3. b (Eight), a (Afghanistan)

22.10 SELF- ASSESSMENT QUESTIONS:

Q1. Define Regional trading blocks. Discuss its various types with examples.

Q2. Describe ASEAN with its aims and objectives.

Q3. Write short notes on: SAARC, CACM, APEC, European Union and Free Trade Area.

Q4. Discuss about the various areas of NAFTA in detail.

22.11 BOOK REFERENCES

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UNIT-23 WORLD TRADE AND EMERGING ENVIRONMENT

BLUE PRINT OF UNIT

1. Introduction
2. State of the Global Economy
3. World Trade
4. India's Merchandise Trade
 - India's export growth
 - Export growth and exchange rate changes
5. Export performance of India and EDEs
6. India's import growth
7. Trade Deficit
8. World Trade in Services
9. WTO Negotiations and India
10. Bilateral and Regional Cooperation
11. Challenges and Outlook
 - Outlook
 - Challenges
12. Summary
13. Glossary
14. Comprehensive questions
15. Answer to Comprehensive questions
16. self assessment
17. Book references

Objectives:

After going through this lesson, you will be able to study:

The state of the Global Economy;

World Trade as well as India's Merchandise Trade;

India's export-import growth;

World Trade in Services;

WTO Negotiations and India;

Bilateral and Regional Cooperation;
Challenges and Outlook before Indian economy.

23.1 INTRODUCTION

The globalization of India has given rise to new opportunities but it has also brought with it new challenges and responsibilities. It means that the global economy can no longer be viewed from a spectator's standpoint. What happens there has large implications for India. Every time there is a major financial crisis anywhere in the world, there is need to take brace position. And, in turn, the rise and fall of India's growth rate has an impact on global growth and there is need for India to take this responsibility seriously. This chapter, a new addition to the Economic Survey, is recognition of this fact. It examines the state of the global economy and India's position therein. It analyses the current global slowdown and eurozone crisis, what this means for India and the policy challenges that these international matters give rise to on domestic soil. The chapter also discusses G-20 imperatives and India's role as a constructive player in the evolving global order.

○ STATE OF THE GLOBAL ECONOMY

The developments over the last year in major economies of the world have not been encouraging. There is an apprehension that the process of global economic recovery that began after the financial crisis of the 2008 is beginning to stall and the sovereign debt crisis in the eurozone area may persist for a while. There is an effort to build firewalls around these danger zones, but the world has little experience with this; so we need to be prepared for breaches in the walls. The US economy has shown some improvement but economic growth remains sluggish. The global economy is expected to grow by 3.3 per cent in 2012 compared to 3.8 per cent in 2011 as per the International Monetary Fund's (IMF) January 2012 update of the World Economic Outlook (WEO). Gross domestic product (GDP) growth in advanced economies declined to 1.6 per cent in 2011 compared to 3.2 per cent in 2010 and is expected to be even lower at 1.2 per cent in 2012. Growth in emerging economies slowed to 6.2 per cent in 2011 compared to 7.3 per cent in 2010 and is projected to be 5.4 per cent in 2012. The US economy seems to have revived somewhat and is projected to maintain its growth rate at 1.8 per cent for 2012. Even so, economic growth in the US remains sluggish despite extensive use of both fiscal and monetary policy tools. The eurozone is expected to contract by 0.5 per

cent in 2012 (Table 23. 1).

The predominant reason for the subdued growth in advanced economies at this juncture remains the sovereign debt crisis that started in the peripheral economies of the eurozone, but from the latter half of 2011, started to adversely affect the major economies there, as well. Issues relating to medium-term fiscal consolidation, the exposure of European banks to public and private debt, and recurring differences in the ways to resolve the

crisis have continued to weigh on the global economic outlook as the eurozone accounts for close to one-fifths of global GDP.

Table 23.1: Growth of GDP (%) (Year on Year)

	World	Advanced economies	US	EU	UK	Eurozone	Germany	Japan	B	R	I*#	C*	S
2010	5.2	3.2	3.0	2.0	2.1	1.8	3.6	4.4	7.5	4.0	9.9	10.4	2.9
Q1			2.2	1.0	1.2	1.0	2.4	5.0	9.3	3.0	9.4	11.9	1.6
Q2			3.3	2.2	2.5	2.1	4.1	4.5	8.7	5.2	8.8	10.3	3.0
Q3			3.5	2.4	3.0	2.1	4.0	5.2	7.0	3.4	8.9	9.6	3.3
Q4			3.1	2.2	1.7	2.0	3.8	3.2	5.3	4.4	8.3	9.7	3.6
2011	3.8	1.6	1.8	1.6	0.9	1.5	3.0	-0.9	2.9	4.1	7.4	9.2	3.1
Q1			2.2	2.4	1.6	2.4	4.6	0.1	4.2	3.8	7.8	9.7	3.7
Q2			1.6	1.7	0.5	1.6	2.9	-1.7	3.3	3.5	7.7	9.5	3.3
Q3			1.5	1.4	0.4	1.3	2.6	-0.6	2.2	4.9	6.9	9.1	2.9
Q4			1.6	0.9	0.7	0.7	2.0	-1.0	na	na	6.1	8.9	na
2012 (P)	3.3	1.2	1.8	-0.1	0.6	-0.5	0.3	1.7	3.0	3.3	7.0	8.2	2.5

Source: Organization for Economic Cooperation and Development (OECD) Principal Global indicators and IMF WEO.

Notes : P Projection from IMF World Economic outlook January 2012 update.

na: not available. Growth rates may not necessarily correspond to country sources.

* Country website. EU is European Union. B,R,I,C,S stand for the separate countries of the BRICS grouping, i.e. Brazil, Russia, India, China, and South Africa. Q1, Q2, Q3, and Q4 stand for the first, second, third, and fourth quarters Aggregations for World and Advanced Economies use purchasing power parity weights.

India's GDP growth is in terms of factor cost whereas for other countries it is in terms

of market prices.

Volatility in capital flows resulting from the spillover effects of monetary policy choices and other uncertainties in the advanced financial markets further impacted exchange rates and made the task of macroeconomic management difficult in many emerging economies. This has brought out a new dimension of globalization in the post financial crisis world, where easy monetary policy in one set of countries may result in inflation elsewhere due to cross-border capital flows.

Unemployment situation in advanced economies in general, and the peripheral economies of the eurozone in particular, which had deteriorated in the wake of global crisis has not improved. The OECD Employment Outlook 2011 observed that with the recovery stalling, OECD unemployment remained high, with close to 44.5 million persons unemployed. The extent of unemployment has been varied across OECD countries, with

Spain exhibiting the highest unemployment rate (21.7 per cent). As per the OECD report, the main losers have been youth and temporary workers, some of whom have been getting out of the job market. The unemployment rate in the US has shown some improvement (8.7 per cent in Q4 2011 compared to 9.1 per cent in Q3 2011), but nevertheless remains high. The persistently high rates of unemployment in advanced countries, especially in the crisis affected countries of the eurozone, the inherent contradiction of fiscal consolidation (without worsening the contractionary tendencies) is having a social fallout in the peripheral economies and has sharply polarized public debate on the appropriate economic policies to be adopted.

The petering out of the revival of global growth in 2011 came on top of disruptions in supply-chain networks resulting from the devastating earthquake and tsunami in Japan (in March 2011). Later in the year (October and November), severe flooding in Thailand also disrupted some supply chains. Political uncertainties in some Middle East and North African countries have been another source of uncertainty apart from their obvious implications for oil prices. The severe uncertainty in the eurozone impacted the global financial markets leading to capital reversals to safe havens in December 2011.

At this juncture, in the short run, the global economy is being buffeted by multiple shocks emanating from various sources, economic, social, and geopolitical. The lower

global growth forecast by the IMF for most countries in 2012 perhaps reflects the repeated bouts of uncertainty arising from these diverse sets of factors. Nevertheless, India is projected to be the second-fastest-growing major economy (7 per cent) after China (8.2 per cent) as per the IMF. In the medium term, challenges for the global economy continue to emanate from the way the eurozone crisis is addressed. The high deficits and debts in Japan and the United States and slow growth in high income countries in general, have not been resolved. The looming risk to the global outlook is also on account of the geopolitical tensions centred on Iran that could disrupt oil supply and result in a sharp increase in oil prices and even disrupt supply routes.

While the current conjuncture is important for anticipating outcomes in the short to medium term, the current global situation is also a manifestation of certain long-term

developments and changes in the relative positions of the major economies that have now perhaps reached certain critical proportions.

○ WORLD TRADE

World merchandise trade value surpassed the pre-crisis (2008) level of US \$ 16 trillion, reaching US \$ 18.26 trillion in 2011 after an interregnum of two years. However, world trade volume decelerated sharply to 2.8 per cent in 2012 from 5.9 per cent in 2011 and 12.6 per cent in 2010 (Table 23.2). World exports fell by 0.2 per cent in the first three quarters of 2012 over the corresponding periods of 2011 as per World Trade Organization (WTO) statistics. As per the January 2013 update of the IMF, world trade volume is projected to grow by 3.8 per cent in 2013 which is down 0.7 percentage points

	2011	2012	Projections	
			2013	2014
World trade volume (goods and services)	5.9	2.8	3.8	5.5
Imports				
Advanced economies	4.6	1.2	2.2	4.1
Emerging market & developing economies	8.4	6.1	6.5	7.8
Exports				
Advanced economies	5.6	2.1	2.8	4.5
Emerging market & developing economies	6.6	3.6	5.5	6.9

Sources: IMF World Economic outlook Update, January 2013

Global economic uncertainty including doubts about the ultimate resolution of the crisis in the euro area, doubts about the pace of fiscal withdrawal in the US, challenges

to sustaining growth after the earthquake reconstruction rebound in Japan and trade disruptions with China, though of a passing nature, continue to cast their shadows on the trade growth of emerging and developing economies (EDEs) including India.

○ INDIA'S MERCHANDISE TRADE

India's merchandise trade increased exponentially in the 2000s decade from US\$ 95.1 billion in 2000-1 to US\$ 620.9 billion in 2010-11 and further to US\$ 793.8 billion in 2011-12. India's share in global exports and imports also increased from 0.7 per cent and

0.8 per cent respectively in 2000 to 1.7 per cent and 2.5 per cent in 2011 as per the WTO. Its ranking in the leading exporters and importers improved from 31 and 26 in 2000 to 19 and 12 respectively in 2011. While India's total merchandise trade as a percentage of the gross domestic product (GDP) increased from 28.2 per cent in 2004-5 to 43.2 per cent in 2011-12 as per provisional estimates, India's merchandise exports as a percentage of GDP increased from 11.8 per cent to 16.5 per cent during the same period.

▪ India's export growth

Bolstered by the measures taken by the government to help exports in the aftermath of the world recession of 2008 and also the low base effect; India's export growth in 2010-11 reached an all time high since Independence of 40.5 per cent. Though it decelerated in 2011-12 to 21.3 per cent, it was still above 20 per cent and higher than the compound annual growth rate (CAGR) of 20.3 per cent for the period 2004-5 to 2011-12. After registering very high growth of 56.5 per cent in July 2011, export growth started decelerating with a sudden fall to single digits in November 2011 as a result of the emerging global situation and then to negative figures from March 2012. Monthly export growth rates in 2012-13 (April-December) were negative except for a marginal positive growth in April 2012. For three months in 2012-13, exports declined year-on-year (YOY) by double digits with the largest decline recorded in July 2012 at -15.1 per cent. In January, 2013, there is a marginal positive growth of 0.8 per cent.

▪ Export growth and exchange rate changes

Export growth in dollar terms was negative at -4.9 per cent in 2012-13 (April-January), compared to 21.3 per cent growth in 2011-12 (full year). In rupee terms, it was positive at

9.1 per cent, though here too, there was a deceleration from the 28.3 per cent in 2011-12 (full year). India's export growth has almost continuously been above world export growth in the 2000s decade and in 2011. One issue that has been a topic of debate is whether India's export growth rate is dependent on world growth/trade or exchange rate.

There is a strong correspondence between India's export growth and world export growth (Figure 23.1). This is clearly visible in 2009 when there was a big dip in both world exports and India's exports. The relationship between changes in real effective exchange rate (REER) and India's export growth is not however as clear-cut as that with world trade.

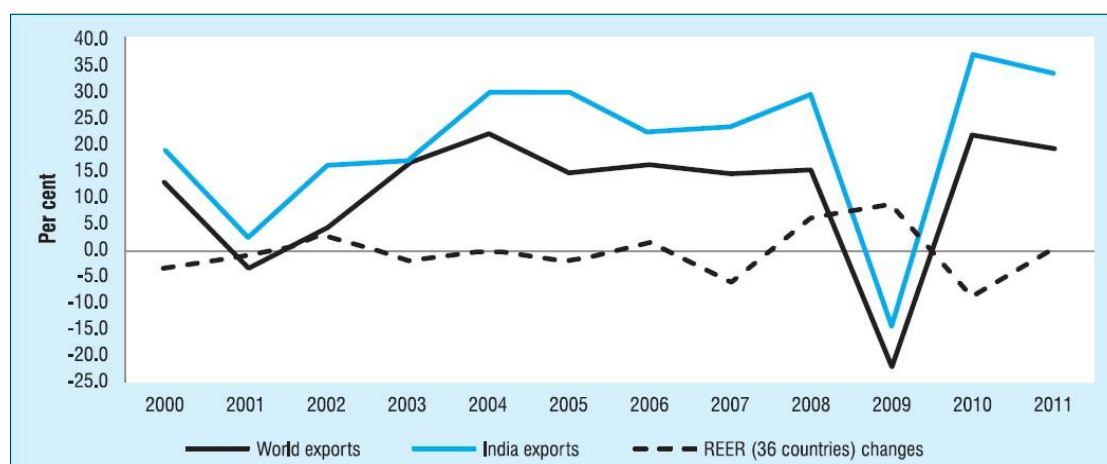


Figure 23.1: Growth of exports of World and India and REER changes

Source: <http://indiabudget.nic.in>

○ EXPORT PERFORMANCE OF INDIA AND EDES

The share of the select Emerging and Developing Economies (EDEs) in the US\$ 18 trillion world exports in 2011 has increased to a sizeable 41 per cent with a change in

share of 15.6 per cent over 2000. If the four newly Industrialized Asian Economies namely, Singapore, Hong Kong, Taiwan and Republic of Korea, which have now been classified under advanced economies by the IMF, are also included then the share would be 50.5 per cent. The performance of China is spectacular with its share in world exports increasing by 6.6 percentage points between 2000 and 2011, comprising 42.4 per cent of the total increase in EDEs share over this period, while India's rise in share of 1 percentage point constitutes only 6.5 per cent of the total increase. However, China's export growth rate at 20.3 per cent in 2011 was substantially lower than that of India.

India's export growth rate of 33.8 per cent in 2011 over and above the 37.3 per cent growth of 2010 is one of the highest in the world. India's share in world merchandise exports which started rising fast from 2004, reached 1.5 per cent in 2010 and 1.7 per cent in 2011. It declined marginally to 1.6 per cent in 2012 (January-October), mainly due to its relatively negative export growth of - 5.1 per cent compared to world export growth of

- 0.2 per cent (Table 23.3). In contrast China's share increased to 11.2 per cent in 2012 (January -October) with a positive export growth of 7.9 per cent.

Table 23.3: Export growth and share in world exports: India and other select countries

	Value (US\$ billion) 2011	CAGR 2000- 09	Growth rate %			Share in world exports (%)				change in shares 2011/ 2000
			Annual			2000	2010	2011	2012 (Jan- Oct.)	
			2010	2011	2012 (Jan- Oct.)					
EDEs	7400	12.3	28.8	24.9	1.8	25.4	39.2	41.0	41.7	15.6
<i>of which</i>										
China	1899	19.1	31.3	20.3	7.9	3.9	10.4	10.5	11.2	6.6
Russia	522	12.5	32.0	30.4	3.1	1.7	2.7	2.9	2.9	1.2
Mexico	350	3.6	29.8	17.3	7.0	2.6	2.0	1.9	2.1	-0.7
India	303	16.3	37.3	33.8	-5.1	0.7	1.5	1.7	1.6	1.0
Malaysia	228	5.4	26.2	14.8	-0.6	1.5	1.3	1.3	1.3	-0.3
Brazil	256	12.0	32.0	26.8	-5.2	0.9	1.3	1.4	1.3	0.6
Thailand	226	9.2	28.6	15.9	0.8	1.1	1.3	1.3	1.3	0.2
Indonesia	201	6.9	32.1	26.9	-6.2	1.0	1.0	1.1	1.0	0.1
South Africa	97	8.5	30.7	18.5	-9.8	0.5	0.5	0.5	0.5	0.1
NIAEs*										
Korea, Republic	557	8.6	29.0	19.3	-1.3	2.7	3.1	3.1	3.0	0.4
Hong Kong	429	5.2	22.5	9.9	1.4	3.2	2.6	2.4	2.4	-0.8
Singapore	410	7.8	30.4	16.4	0.3	2.2	2.3	2.3	2.3	0.1
Taiwan	308	3.6	34.8	12.2	NA	2.3	1.8	1.7	NA	-0.6
World	18033	7.7	22.0	19.4	-0.2	100.0	100.0	100.0	100.0	-

Source: Computed from IMF, International Financial Statistics, January 2013. Note: *

Newly industrialized Asian Economies, NA: Not Available.

Latest monthly growth rates of exports and imports of some of India's major trading partners have been low or negative. The EU's import growth has been negative for most of the months in 2012. There has been a slight but unsteady pick-up in import growth in the last two or three months in countries like the US, Hong Kong, and Singapore and in December 2012 in China.

- India's import growth

After recovering in 2010-11 from the previous year's fall, India's merchandise imports increased further to US\$ 489.2 billion with a growth of 32.3 per cent in 2011-12. This was due to the increase in growth of petroleum, oil, and lubricant (POL) imports by 46.2 per cent and non-POL imports by 26.7 per cent. POL imports (with a share of 31.7 per cent in India's total imports) registered a high growth mainly due to increase in import price of the Indian crude oil import basket by 31.5 per cent in 2011-12 as against 22 per cent in 2010-11 (Figure 23.2).

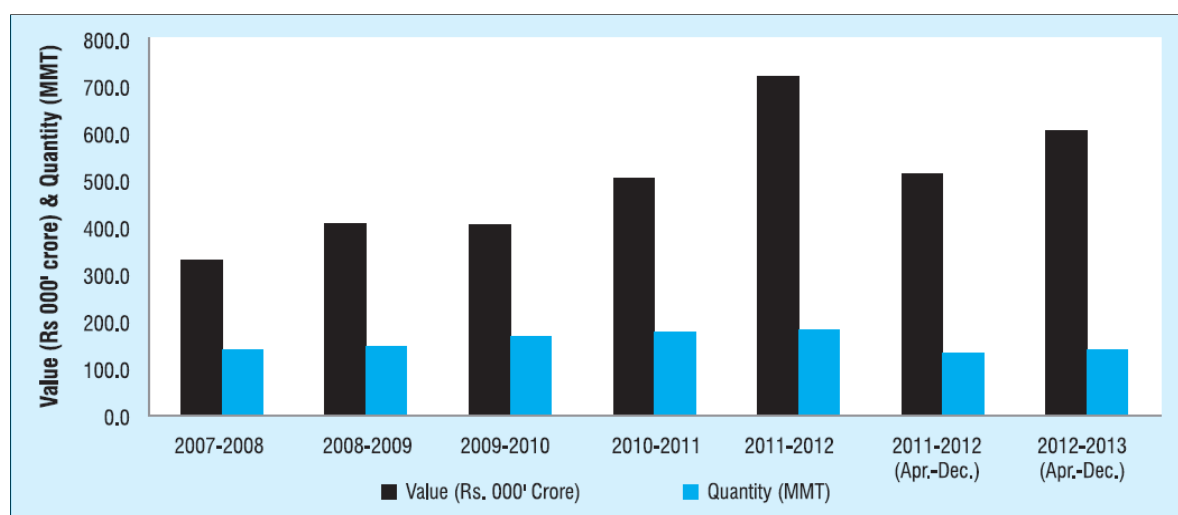


Figure 23.2: POL Imports

Source: Based on Ministry of Petroleum and Natural Gas data.

POL import volume growth decelerated from 14.9 per cent in 2009-10 to 3.7 per cent in 2010-11 and 3.5 per cent in 2011-12. International oil prices (Brent) which reached a high of US\$ 132.47/bbl in July 2008 declined sharply to US\$ 40.35 /bbl in December 2008, following the global recession. From 2009 onwards, oil price has been increasing

with intermittent volatility, reaching US\$ 125.33/bbl in March 2012 and falling marginally with volatility in the following months. Currently Brent oil price is hovering around US\$110/bbl. Gold and silver imports (with a share of 12.6 per cent in India's total imports) grew by 44.5 per cent in 2011-12. Gold imports alone accounted for 91.7 per cent of the total imports of gold and silver.

In 2011-12, gold imports grew by 38.8 per cent in value and 11.2 per cent in volume terms. Non-POL non bullion imports increased by 23.3 per cent in 2011-12 compared to 29 per cent in 2010-11. At US\$ 406.9 billion imports in 2012-13 (April-January) registered a growth of 0.01 per cent. During 2012-13 (April-December), POL imports at US \$ 125.2 billion grew by 12.8 per cent. Non-POL imports at US \$ 239.8 billion declined by 5.1 per cent and gold and silver imports at US \$ 39.3 billion declined by 14.7 per cent. Non-POL and non-bullion imports which basically reflect the imports of capital goods needed for industrial activity and imports needed for exports declined by 3.0 per cent.

○ TRADE DEFICIT

Trade deficit (on customs basis) reached a peak of US\$ 184.6 billion in 2011-12 from US\$ 118.6 billion in 2010-11 with the highest growth of 55.6 per cent since 1950-1. Moderate export growth and high import growth, particularly in POL imports due to high prices and high gold and silver imports, led to the highest-ever trade deficit in India since 1950-1, contributing to a high current account deficit (CAD) of 4.2 per cent of GDP. The trade deficit of US \$ 167.2 billion for 2012-13 (April-January) was 7.9 per cent higher than the US \$ 154.9 billion in 2011-12 (April- January). While POL imports grew by

46.2 per cent in 2011-12, POL export growth was relatively lower at 34 per cent due to lower growth in the quantum of POL exports by 3.8 per cent, resulting in net POL imports increasing to US \$ 99.3 billion in 2011-12. In 2012-13 (April-November), though POL import growth moderated to 11.7 per cent, POL export growth was negative at - 7.3 per cent which was also due to the decline in the volume of POL exports by - 0.9 per cent. As a result the share of net POL imports in total imports increased to 23.5 per cent in 2012-13 (April-November) compared to 20.3 per cent in 2011-12 (whole year).

○ WORLD TRADE IN SERVICES

Like world merchandise trade, world commercial services trade which was badly hit by the 2008 global crisis, crossed the pre-crisis level in 2011 to reach US\$ 4.17 trillion after a gap of two years. The export growth rate of commercial services which was at 11 per cent in 2000-5 and became negative at -12 per cent in 2009, has taken a full turn to reach 11 per cent again in 2011. As per the WTO's International Trade Statistics,

Europe recovered from its 4 per cent growth of commercial services exports in 2010 to 11 per cent in 2011, while North America maintained the same growth rate of 9 per cent.

The Commonwealth of Independent States (CIS) was the most dynamic region followed by South and Central America with 19 per cent and 13 per cent growth respectively in 2010. Asian economies saw their growth rates more than halved to 11 per cent in 2011 from 23 per cent in 2010 due to slower growth in transportation and other commercial services. All the three broad categories of commercial services, namely transport, travel, and other commercial services registered reasonably good growth in 2011.

In 2012, services trade growth has decelerated as is evident from the WTO's first quarter to third quarter data for 2012 which shows that export and import growths were zero per cent and 1 per cent in Q2 of 2012 and -2 per cent and -1 per cent in Q3 of 2012 over corresponding period of the previous year. Europe had a very high negative growth of -7 per cent in both exports and imports.

○ WTO NEGOTIATIONS AND INDIA

The Doha Round of trade negotiations in the WTO which began in 2001 remains unfinished due to differences among members on various issues. The Eighth Ministerial Meeting of the WTO which was held in December 2011 in Geneva provided political guidance to the members to resolve the issues involved. However, there was no significant progress in 2012. India is of the view that any early outcome of the negotiations should invariably address issues of interest to the developing countries, especially the least developed countries (LDCs) and the small vulnerable economies (SVEs). A Draft Consolidated Negotiating Text on Trade Facilitation was worked out by the WTO members on 14 December 2009. The Draft Text has since been revised

fourteen times (till December 2012) through discussions in the meetings of the Negotiating Group on Trade Facilitation (NGTF). India is actively engaged in these negotiations and has also tabled a few proposals on “Customs Cooperation”, “Rapid Alerts System of Customs Union”, and “Appeal Mechanism”. The Draft Text, however, lacks internal balance. The developed countries are holding up the laws and procedures of their own countries as benchmarks and want the developing countries to replicate them. Developing countries have by and large adopted a defensive approach in the negotiations. The developed countries and a few developing countries are making efforts to harvest 'Trade facilitation' for an early outcome, in time for MC9. India along with most of the developing countries wants issues of market access and trade facilitation to be balanced with developmental issues such as duty free quota, free market access for LDCs, and acceptance of the modalities for reducing cotton subsidies. The G33 group of countries, which is a coalition of 46 developing countries, including India, has tabled a proposal on food security in the WTO on 16 November 2012. The proposal is for an amendment to certain provisions of the WTO Agreement on Agriculture to allow developing countries greater flexibility in their public stockholding operations for food security purposes. The issue of food security is very important for India and any concession on the trade facilitation front needs to be balanced by acceptance of the G33 proposal in any package deal for MC9.

During the current year, some of the developed country members of the Information Technology Agreement (ITA) of WTO viz. the USA, European Union, and Japan, have proposed expansion of the agreement (called ITA-2) to increase the coverage of IT products on which customs duty would be bound at zero, addressing non-tariff measures, and expanding the number of signatory countries to include new signatories such as Argentina, Brazil, and South Africa. The proponents of ITA expansion have prepared a consolidated list containing around 350 IT products (combining products of interest to all proponents of ITA-2) on which tariff reductions are being sought. This is under active discussion in the WTO and India is carefully examining the proposal.

Negotiations in services have continued primarily in the plurilateral format. Intensive negotiations were held in 2009, 2010, and also till the first half of 2011. These efforts culminated in a report by the Chair of the Committee on Trade in Services - Special Session (CTS-SS) and all subsidiary bodies under the CTS in April 2011. The Chair's report puts forth two views. The developed countries' view is that further progress

on market access could include the binding of autonomous liberalization where possible, improved levels of access under commercial presence mode, that is, Mode 3 (including restrictions on foreign equity participation and forms of commercial presence), as well as a robust and satisfactory outcome in Mode 4 (presence of natural persons). The developing countries' view is that there is an imbalance in market access negotiations, as evidenced by the fact that developing country flexibilities have not been taken into account in other members' requests, sectors of export interest to developing

countries are not being fully reflected in developed members' offers; developing countries have already made a significant contribution to the Doha Round; and some plurilateral requests and recent proposals have embodied a level of ambition going beyond that agreed in Annex C of the Hong Kong Ministerial Declaration. India has already made considerable improvement in its revised offer (from 37 sub-sectors in the Uruguay Round to 95 in the Revised Offer). Some of the major developed country members have shown nil or little movement in their Mode 4 offers, which is an area of interest to us.

○ BILATERAL AND REGIONAL COOPERATION

While India has always stood for an open, equitable, predictable, non-discriminatory, and rule based multilateral trading system(MTS), it has also been active in recent years with regional trading arrangements (RTAs), to serve as 'building blocks' for achieving trade liberalization and complementing the MTS. So far, India has signed 10 free trade agreements (FTAs) and 5 preferential trade agreements (PTAs) and these FTAs/PTAs are already in force. Further, India is currently negotiating 17 FTAs, including review/expansion of some of the existing ones. In the current situation when WTO negotiations are stalled, world trade has slowed down, and the shadow of protectionist measures looms large, a strategy of diversifying technology intensive exports through the regional process could lead to further trade promotion with trade liberalization.

○ CHALLENGES AND OUTLOOK

Outlook

The prospects for world trade and India's trade are still uncertain. Some green shoots seem to have appeared with the import growth rates of the world and some of India's

important trading partners like the USA, China, and Hong Kong showing slight upward movement in the last two months. However, the Baltic Dry Index (BDI), a good proxy for the robustness of world trade, which started falling from its peak (in the last five years) of 11709 on 19 May 2008 has not recovered even halfway. The small bouts of recovery in the BDI, like the recent recovery in November-December 2012 which is among the highs in recent months, can in no way be compared to the highs of 2008. Even this upswing has been short-lived, being succeeded by a downswing in the beginning of January 2013 causing it to reach a low of 698 on 2 January 2013. There has since been a marginal recovery for the BDI to its current level of 792 (28.1.2013).

7.50 This also suggests that the outlook for India's merchandise trade and shipping services which are directly dependent on merchandise trade is still uncertain. While there has been some pick-up in import growth rates of some of our trading partners like the US, Hong Kong, Singapore and China in the last two months as stated earlier, a look at their import growth rates from India in recent months shows a rather mixed picture. While the US's and Japan's imports from India grew by 12.6 per cent and 1.8 per cent respectively in 2012 (January-November), China's and Hong Kong's imports from India fell by 19.6 per cent and 17.9 per cent respectively in 2012 (full year) and Singapore's imports from India fell by 8.3 per cent in 2012 (January-November).

Import moderation on the other hand may be limited despite fall in gold imports (as a result of the policy measures taken by the government), as international gold prices are still high and oil prices continue to hover around the US\$ 110 per barrel mark.

Services export growth being equally dependent on global growth and trade has been very erratic in the post global crisis period. On the other hand, if imports of services continue to rise and the positive balance of trade in services continues to fall as in the first half of 2012-13, the cushion available for lowering the trade deficit would be limited.

Challenges

The challenges for India on the trade front are many. While India has successfully diversified its export basket, more needs to be done on the product diversification front. It also has to reposition itself in its traditional areas of strength like textiles and leather & leather manufactures where it has lost considerable ground, while at the same time making forays into new areas. With multilateral trade negotiations stalled, and RTAs

on the rise, India also has to follow a strategic regional trading policy focusing on the potential technology-intensive items in the more important RTAs. Though geopolitical considerations are important, India may have to bargain more in its regional trade negotiations, particularly in cases where livelihood concerns of large pockets of the population are involved. There is also need to address the inverted duty structure in sectors like electronics, textiles, and chemicals and the artificial inverted duty structure caused by some FTAs/RTAs. On the services front, a gold mine of opportunity in sectors like tourism including health tourism is waiting to be tapped. The recent global slowdown has thrown up new challenges for India with its export growth being continuously negative since May 2012 compared to very high growth rates of even above 50 per cent in some months of the previous year. With limited fiscal space available for the government and with protectionist measures of trading partners showing signs of rising, the policy options left are more at the micro level. Thus there are many micro, port-specific and sector-specific issues that need urgent attention. These are related to infrastructure, trade facilitation, tax and tariffs, and credit, and can realistically be addressed in the short and medium term. Addressing these issues, as is currently being done by the government, can exponentially promote India's export growth.

23.17 SUMMARY

The big story of the last decade for India has been its arrival on the global scene. The Indian economy had broken free of the low-growth trap from the early 1980s. By the mid-1990s, following the economic reforms of 1991-3, India began to appear as a player of some significance in the global economy. Then, following the East Asian crisis of the late 1990s, and from the first years of the first decade of the 21st century there was no looking back. India's exports began to climb, its foreign exchange reserves, which for decades had hovered around 5 billion dollars, rose exponentially after the economic reforms and in little more than a decade had risen to 300 billion dollars. Indian corporations that rarely ventured out of India were suddenly investing all over the world and even in some industrialized countries. When, in 2009, the Group of 20 (G-20) was raised to the level of a forum for leaders, India was a significant member of this global policy group. After moderating in the two years following the global economic crisis, world trade in both goods and services reached and surpassed pre-crisis levels in 2011.

However, the deceleration in world growth and trade in 2012 and forecast of only a gradual upturn in global growth by international institutions portend a weak and slow recovery for world trade. India's exports, which had surpassed pre-crisis levels within a year in 2010-11 with a record 40.5 per cent growth, continued growing even in 2011-12, but were finally affected by the global slowdown in 2012-13 with exports declining even more at - 4.9 per cent in the first ten months than the -3.5 per cent recorded during the crisis-ridden year of 2009-10.

23.18 GLOSSARY

International Trade: Commercial transactions that cross the boundaries of countries.

Regional Cooperation: A system to enhance cooperation through established regional rules and institutions among states in the same region

23.14 COMPREHENSIVE QUESTIONS

Fill in the blanks

1. There is a concern that following the 2008 a slow start is happening in the process of global economic recovery, and the sovereign debt crisis in the Eurozone may persist for a while.

2. In December 2011, political guidance was provided to the members to address the issues discussed in the eighth meeting of the World Trade Organization held in

3. Discussions in services have primarily continued in a format.

23.15 ANSWER TO COMPREHENSIVE QUESTIONS

1. Financial Crisis 2. Geneva 3. Multilateral

23.16 SELF ASSESSMENT QUESTION

- (i) What do you mean by international environment? Explain.
- (ii) Write down about the present status of Global Economy.
- (iii) Explain the India's Merchandise Trade in view of World Trade.
- (iv) Give an overview about the growth of India's export-import.

- (v) How the WTO Negotiations affect the Indian economy? Discuss.
- (vi) What do you understand by bilateral and regional cooperation? Elaborate.
- (vii) Explain different challenges and prospects before Indian economy.

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UNIT-24 MULTILATERAL TRADING SYSTEM

BLUE PRINT OF UNIT

- 24.1 Introduction
- 24.2 Meaning of Multilateral Trading System
- 24.3 Multilateral Trading System in Historical Context
- 24.4 Principles of Multilateral Trading System
- 24.5 Multilateral Trading System and Global Governance
- 24.6 Multilateral Trading System and World Trade Organization
- 24.7 Statements Supporting Multilateral Trading System and the 9th Ministerial Conference of the World Trade Organization
- 24.8 Multilateral Trading System in Current Context
- 24.9 Benefits of Multilateral Trading System
- 24.10 Multilateral Trade Agreements in India
- 24.11 Summary
- 24.12 Glossary
- 24.13 Comprehension Questions
- 24.14 Answers to Comprehension Questions
- 24.15 Self-assessment Questions
- 24.16 Reference Books

Objectives:

- To understand the concept of Multilateral trading system in the international environment.
- To know the various rules and regulations about the multilateral trading system
- To understand the importance of multilateral trading system among the countries.
- To know about the benefits of the multilateral trading system.

24.1 INTRODUCTION

The Uruguay Round (UR) of the multilateral trade negotiations (MTNs), the latest, eighth, and most ambitious of a series of such negotiations, was formally concluded with the signing on April 15, 1994, at Marrakech, Morocco, of the Final Act, which embodies all the multilateral and plurilateral agreements of the round. The first round, held in Geneva in 1947, resulted in the General Agreement on Tariffs and Trade (GATT). The UR agreements extended multilateral rules and disciplines to trade in services, trade-related aspects of intellectual property rights, and investment measures. They also brought trade in agriculture and textiles back into the GATT. The Final Act included the decision to establish a formal organization called the World Trade Organization (WTO) "to provide the common institutional framework for the conduct of trade relations among its members in matters related to the (Uruguay Round) agreements. Ministers representing the 124 governments and the European communities that participated in the UR affirmed in their declaration at the signing of the Final Act "that the establishment of the World Trade Organization (WTO) ushers in a new era of global economic cooperation, reflecting the widespread desire to operate in a fairer and more open multilateral trading system for the benefit and welfare of their peoples."

- **MEANING OF MULTILATERAL TRADING SYSTEM**

A trading system that facilitates the exchange of financial instruments between multiple parties. It allows eligible contract participants to gather and transfer a variety of securities, especially instruments that may not have an official market. These facilities are often electronic systems controlled by approved market operators or larger investment banks. Traders will usually submit orders electronically, where a matching software engine is used to pair buyers with sellers.

- **THE MULTILATERAL TRADING SYSTEM IN HISTORICAL CONTEXT**

The great triumph of the General Agreement on Tariffs and Trade (GATT) was creating a prosperous multi-polar trading system from the uni-polar system that emerged from World

War II. The early decades of the GATT could be called the age of US enlightened self interest, in which the United States deployed inter alia generous development aid in

tandem with extensive liberalization of trade barriers protecting the US market to help rebuild the war- torn economies of Western Europe and thus provide a stable economic

base for democratic governance and a reliable buffer against Soviet expansionism. In the early decades of the postwar era, US trade policies were generous to its former military foes and strongly supported the evolving European Community. Similarly, in the GATT, US and European policy was generous to a fault to developing countries, permitting them effectively to “free ride” on the trading system without undertaking substantive commitments to reduce barriers to their markets. US and European trade barriers came down sharply during the eight rounds of GATT negotiations, leaving only a small number of important trade restrictions that benefit well-entrenched domestic interest groups. Agriculture was a notable exception to this reformist movement, and textiles and clothing trade escaped the sharpest cuts until its armor-plated quota regime rusted away in 2005. But there is no such thing as a free lunch in the GATT cafeteria. The cost of nonparticipation in the reciprocal negotiations (at least until the Uruguay Round) was significant: the GATT Rounds often left intact major barriers imposed by industrial countries that restricted competitive agricultural and manufactured exports of developing countries.

Thus, developing countries protected their own markets, but in turn had to accept the maintenance of high foreign trade barriers against their most competitive exports. Though such policies never yielded big economic rewards, they were politically convenient. Many developing countries relied on protected home markets and commodity exports to support modest growth; some followed a strategy of export-led growth and became platforms for the assembly and export of light manufactures. Their success in turn provoked a wave of new protectionism in developed markets via so-called voluntary export restraints, antidumping and countervailing duties, and special protection regimes like the Multi-Fiber Arrangement.

The Uruguay Round (1986–1994) deviated from this pattern by requiring that all the issues under negotiation be considered part of a “single undertaking” to which all participants had

to commit. This procedural rule dramatically reversed past negotiating dynamics. Developing countries could no longer be “free riders” as in past rounds. The addition of a proposal in the middle of the Uruguay Round to strengthen the institutional structure of the trading system by establishing a new World Trade Organization (WTO) underscored the importance of the single undertaking. Suddenly, developing countries had to accept the full complement of obligations (albeit with some special and

differential treatment) included in the Uruguay Round package to qualify for

membership in the new WTO. Saying no to the Uruguay Round accords was not an option, since all the big trading powers were switching to the new club. Changing institutions put developing countries in a unique and disadvantageous position and explains why they had to undertake commitments in some areas (e.g., intellectual property) that couldn't be fully implemented and enforced. The WTO was thus born with a "development deficit", one of several birth defects analyzed in a number of early WTO assessments (see, for example, Schott 2000). Note, however, that in current WTO negotiations the single undertaking now gives developing countries some leverage to push their own export interests – if US and EU officials do not address their priority demands, then they could simply prevent the Doha Round deal from closing. In a 180 degree reversal from the Uruguay Round precedent noted above, the single undertaking gives developing countries a stick in the closet; like most sticks, it is most valuable if threatened but not used.

• **PRINCIPLES OF MULTILATERAL TRADING SYSTEM**

According to WTO, the multilateral trading system dwells upon the following principles:

Trade without discrimination

Freer trade

Predictability through binding and transparency

Promoting fair competition

Encouraging development and economic reforms

These principles are explained in the following discussion.

a) Trade without discrimination

The basic idea behind non-discriminatory trade is to avoid any of the trading partners gaining any undue advantage or face undue disadvantage from the other trading partner(s). Sometimes, traders form cartels and engage in discriminatory trade practices. Multi-lateral trade must provide a level playing field in which all the participants get equal opportunities and also reap the benefits emerging out of the trade. This idea is translated in practice with the help of the following principles:

- Most favoured nation (MFN)
- National treatment

a) Most-favoured-nation (MFN): treating other people equally.

In order to ensure equality of opportunity, the countries signing the WTO agreements cannot normally discriminate between their trading partners, or grant someone a special favour (such as a lower customs duty rate for one of their products). In case some concession has to be given to the trade, the same has to be given to all the members of WTO and not to a few members. This principle is known as most-favoured-nation (MFN) treatment. It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

However, certain exceptions are allowed to this clause. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products that are considered to be traded unfairly from specific countries. And in services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners — whether rich or poor, weak or strong.

b) National treatment

According to this principle, the WTO members should not discriminate between the traders on the basis of their nationality. The WTO members must treat the foreigners and locals equally, i.e. the imported and locally-produced goods should be treated equally — at least after the foreign goods have entered the market. In practice it means that the imported goods must not face any kind of favour or disadvantage by extra concessions or extra duty and they must be allowed to compete into the markets, at par with the domestic goods. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of “national

treatment” (giving others the same treatment as one’s own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these.

National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

b) Freer trade

Multi-lateral trade can happen only when it is free from the bondages by way of tariff and non-tariff trade barriers. In order to restrict trade, particularly with other countries, the nations use barriers, such as the customs duties (or tariffs), import bans or quotas that restrict quantities selectively. Sometimes, the nations erect stringent procedural barriers which restrict the flow of goods and services across nations. Opening markets can be beneficial, but it also requires adjustment. The multilateral agreements must allow the countries to introduce changes gradually, through “progressive liberalization”. This can be done through negotiations, in which the trading nations understand each other’s viewpoint and then decide upon the means to have a freer trade.

c) Predictability: through binding and transparency.

The continuity of policy is a major concern of foreign investors. While much hype was created over allowing 100% FDI in multi-brand retail, no investor has come to India in this sector. The underlying reason is the lack of predictability of the Indian government. With the change in government, or even because of the pressure from the opposition or the allies, the government policies are likely to undergo a change. This dampens the investor confidence, who expect the policy framework of the nations to be stable and have a long-term perspective. Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice

and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable.

Recently, in India, there have been instances of Vodafone tax controversy, Jet-Etihad deal, which have seen unwarranted response of the government. These are the instances of lack of predictability, which is not in line with the spirit of multilateralism.

In the multi-lateral agreements, such as WTO, when countries agree to open their markets for goods or services, they “bind” their commitments. In case of goods, these bindings amount to ceilings on customs tariff rates. Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. In developed countries the rates actually charged and the bound rates tend to be the same.

A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In agriculture, 100% of products now have bound tariffs. The result of all this: a substantially higher degree of market security for traders and investors.

The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports

— administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries’ trade rules as clear and public (“transparent”) as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

d) Promoting fair competition

Multilateralism needs a system of rules dedicated to open, fair and undistorted competition. There may be tariffs and other forms of protection for the industry, but

these should operate within their limits. The earlier stated rules on non-discrimination

— MFN and national treatment, also aim at securing fair conditions of trade. Similarly, the members of multilateral agreements must desist from the unfair trade practices such as dumping (exporting at below cost to gain market share) and subsidies. The decision making process of the nations is a complex phenomenon and they place the national interest above all. They have their own norms of fair and unfair. Particularly in the area of agriculture, intellectual property, services, the fair competition can cause lots of hardships to certain sections of the people. Within the framework of the issues, the nations must aspire to promote fair competition, in which the trading partners gain synergy, without causing any undue benefits to either of the trading partners. For example, many of the other WTO agreements aim to support fair competition: in agriculture, intellectual property, services, for example. The agreement on government procurement (a “plurilateral” agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries.

e) Encouraging development and economic reform

The multilateral trade can be successful only if it promotes the economic development. The colonial system of multilateral trade led to impoverishment of one nation and prosperity of another. Such a system cannot work in the long run and the trade between two nations must lead to synergies for both. It must contribute to the process of economic development. The developing countries have lots of problems and they need help in economic reform. Like a good friend, multilateral trade agreements must also help them in implementing the economic reforms, which lead to a free trade between the nations. In 1991, India started the process of economic liberalization and the institutions promoting multilateral trade, such as IMF, WTO, etc., helped in implementing them. We see that after two decades of economic liberalization, there is tremendous growth in the trade and we have seen double digit growth of GDP. Multilateral trade has contributed to the economic development in India.

24.5 THE MULTILATERAL TRADING SYSTEM AND GLOBAL GOVERNANCE

Governance is a description of how global rules are put together, decided upon and implemented. The globalisation of markets has progressed far more rapidly than the evolution at global level of the institutions and mechanisms that are needed to shape market forces so as to produce outcomes that are compatible with the values held by our societies. When considering institutions for governance, they have to integrate three functions: underlying values (the set of values shared by the governed: easily defined, but not easily realised, particularly at the global level); efficiency; and legitimacy.

24.6 THE WTO AND GLOBAL GOVERNANCE

WTO is one of the pillars of the global system of economic governance as it underpins the liberalisation of the real economy - of goods, services and investment - which has contributed so effectively to global growth. The WTO has a substantial body of rules, including a very strong (some would say too strong) dispute settlement system, but its rulemaking machinery is heavy-handed and indeed sometimes chaotic - decisions reached by consensus, usually only at the intermittent biannual Ministerial meetings. The ultimate assistance Doha made to the global governance process was by not failing, by not cracking under some pretty serious pressures. At a time when after 11 September, the international community was looking, almost desperately, for a clear signal that the international system was still functioning, the WTO Ministerial was almost an object lesson on how to bring 142 nations with diverse interests to a conclusion on some very complicated issues. It can and does therefore contribute to building a strong platform for further international co- operation, particularly in the UN event on Financing for Development, which will take place in Monterey in March 2002, and in the World Summit on Sustainable Development in Johannesburg (Rio +10) later in that same year.

24.6 STATEMENT ON SUPPORTING THE MULTILATERAL TRADING SYSTEM AND WTO 9TH MINISTERIAL CONFERENCE:

(i) The APEC Ministers responsible for trade, gathering for the 19th meeting in Surabaya, Indonesia, on 20 – 21 April 2013, recognize the importance of international trade as the engine of growth, job creation and source of development. Thus, they reaffirm the commitment to strengthen a rules-based, transparent, non-discriminatory, open and inclusive multilateral trading system and reiterate the value and centrality of this system as embodied in the WTO.

(ii) They recognize the emerging opportunities and challenges in the global trading environment. International trade patterns have undergone changes and are now dominated by the rise of global value chains. This development presents an important avenue for trade, growth and diversification. However, the global economy is still in the tailwinds of the crisis, despite the modest rebound of trade growth in the first quarter of 2013. The determination to resist inward looking policies continues to faltering in some countries. This prevents effective participation in international trade and contributes to global economic challenges. To this end, the role played by the WTO is crucial.

(iii) The members reaffirm the pledge made by the leaders in Honolulu 2011 and Vladivostok 2012 against protectionism through a standstill which recommend that they extend through the end of 2016 and rollback of protectionist and trade-distorting measures. They remain committed to exercising maximum restraint in implementing measures that may be considered to be consistent with WTO provisions but have a significant protectionist effect and promptly rectify such measures, where implemented. They support the work of the WTO and other international organizations in monitoring protectionism and encourage them to continue and strengthen their work.

(iv) As noted by Ministers at MC8, the Doha Round is at an impasse. However, since that time, and in line with MC8 political guidance, APEC economies, along with other WTO members, have been fully exploring different negotiating approaches while respecting the principles of transparency and inclusiveness.

(v) There is broad convergence of view that the negotiation as it stands now is not on course to lead to a successful outcome at MC9 on 3 – 6 December 2013 in Bali. The members are deeply concerned about the state of play in the negotiations and call on WTO Members to change the quality and level of engagement in order to expeditiously and effectively advance the work. They encourage all Members, particularly major players, to work hard to bridge the gap in coming months, recognizing that the continued viability of the WTO's negotiating function is at serious risk. With the APEC economies representing more than half of world's GDP and 44% of world trade and accept our responsibility to make significant contribution to securing tangible results at MC9.

(vi) Sharing of the objective that the Bali package should encompass a trade facilitation agreement and agreement on some elements of agriculture and development, including issues of interest to LDCs. Commitment is made to promoting progress in the negotiations on these issues

(vii) A successful outcome at MC9 would be a stepping stone to future progress on other areas covered by the DDA negotiations and so would provide new confidence in the multilateral trading system. Achieving that outcome must be the priority of Members' work this year, but it cannot be the end. We reaffirm our commitment to build on the Bali package to achieve the full conclusion of the DDA and to continue the negotiation to address the remaining DDA issues post-Bali. In doing so, they continue to respect the Doha mandate and its development dimension.

(viii) Building on the progress to date, APEC Ministers Responsible for Trade call on ITA participants to swiftly conclude negotiations to expand the product coverage of the WTO ITA by the middle of the year and seek expanded membership of the ITA. A final ITA expansion outcome should be commercially significant, credible, pragmatic, balanced, and reflective of the dynamic technological developments in the information technology sector over the last 16 years. Such an outcome would support several APEC objectives, including strengthening the multilateral trading system, promoting connectivity, supporting regional economic integration, and driving economic development throughout APEC economies.

24.8 MULTILATERAL TRADING SYSTEM IN PRESENT CONTEXT

The outlook for economic growth and job creation remains a major concern in most countries. The global economy has continued to struggle over the review period, with negative consequences for both global and G-20 trade flows. The most recent forecast for 2013 shows continuation of 2012 with both world trade and output to expand slowly and below historical trends and averages. World trade is forecast to grow by 3.3% in 2013. Although this is higher than the 2% growth in 2012, it is still below the 20-year average of around 5%.

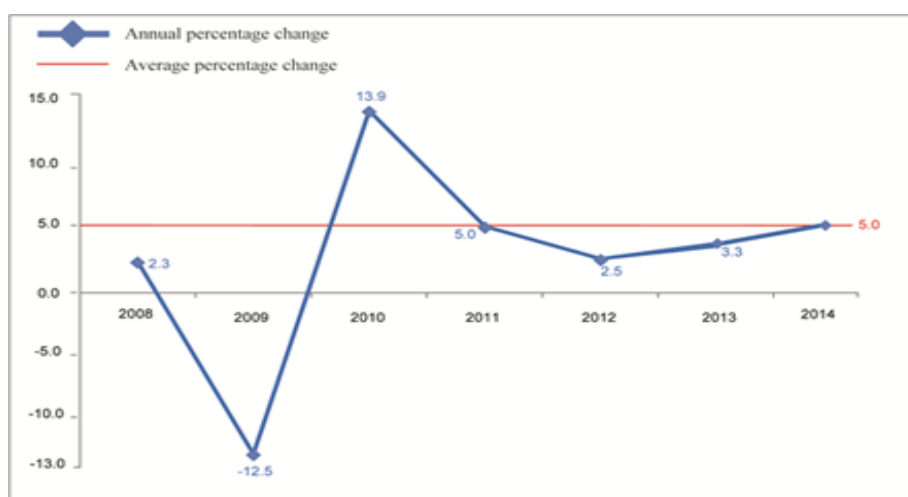


Chart 1 : Growth in volume of world merchandise trade 2008-2013 (annual percentage change)

Source : WTO Secretariat

1. Some G-20 economies continue to put in place trade restrictions

More than 100 trade-restrictive measures were implemented by G-20 economies over the past seven months, covering around 0.5% of G-20 merchandise imports, equivalent to 0.4% of world merchandise imports. The most frequent measures taken during this period were the initiation of trade-remedy actions, in particular of anti-dumping investigations, followed by tariff increases. It is important to highlight that in today's world of global value chains and fragmented production processes, exports depend more than ever on imports. Barriers to imports will thus inevitably be translated into higher costs for exporters.

Type of measure	Mid-May to mid-Oct 10 (5 months)	Mid-Oct 10 to Apr 11 (6 months)	May to mid-Oct 11 (6 months)	Mid-Oct 11 to mid-May 12 (7 months)	Mid-May to mid-Oct 12 (5 months)	Mid-Oct 12 to mid-May 13 (7 months)
Trade remedy	33	53	44	66	46	67
Import	14	52	36	39	20	29
Export	4	11	19	11	4	7
Other	3	6	9	8	1	6
Total	54	122	108	124	71	109
Average per month	10.8	20.3	18	17.7	14.2	15.6

Trade Restrictive Measures

2. G-20 Leaders need to act to reinforce the multilateral trading system

In a context of a fragile and uneven economic recovery and lower trade growth, it is all the more important that G-20 governments avoid making matters worse by adopting isolationist policies and measures that restrict trade which could engender dangerous reactions by their partners. Instead they should take positive steps to unlock the potential for trade to grow stronger by ensuring a successful outcome at the next Ministerial Conference in Bali. A deal on trade facilitation, coupled with an agreement on a range of agriculture and development issues, would send a signal that the WTO remains a relevant forum in shaping trade rules for the 21st century.

To overcome protectionist threats and to prevent a self-destructive lapse into economic nationalism, G-20 economies need to refocus their attention on reinforcing the multilateral trading system. Trade can once again be an engine of growth and a source of strength for the global economy rather than as a source of instability and tension. At this stage, the world economy needs all the help it can get, and trade is an important and viable option.

24.9 ADVANTAGES OF MULTILATERAL TRADING SYSTEM

- **Lower Prices**

This system reduce the tariffs between the countries which are part of the trade agreement. According to Harvard University, the World Trade Organization requires regional trade agreements to reduce tariffs between countries, but does

not allow these countries to increase tariffs on countries which do not participate. Tariff reductions allow people to purchase goods from other countries at lower prices. In India, the prices of many goods, particularly the durable goods have not risen and the consumers have benefited because of the multilateral trading.

- **International Export Advantages**

This system provides trade advantages for all countries in a region which improve their worldwide competitiveness, including in the markets of countries not included in the trade agreement. A car manufacturer that can purchase cheap steel from a country with which it has a regional trade agreement can sell cars elsewhere at a lower cost. Presently we live in the age of collaboration and synergy and the firms find it beneficial to concentrate on the core operations and outsource the rest. This results in getting the best bargain, and hence the reduction of costs, which passes on to the customers as reduced prices of the finished goods. From a nearly defaulting country, since 1991, India has build respectable foreign exchange reserves because of the international trade.

- **Increased Credibility**

In the eyes of the investors, India enjoys far more credibility than the earlier years, because of the proven track record of abiding by the multilateral agreements. As a mature democracy, with proper legislation and decision making systems in place, India is seen as a safer investment avenue as compared to many other countries and hence enjoys investor confidence. As a signatory to large number of multilateral trade agreements, India has established a track record and we see lots of joint ventures and foreign investments coming.

- **Dispute Resolution**

Multilateral trading system include processes to settle trade disputes. Countries come into conflict with one another over agricultural subsidies, dumping products at low prices, and currency manipulation. The trade agreement includes standardized arbitration rules and ensures that trade disputes are resolved according to consistent rules. According to Cornell University, trade agreements often specify the forum in which trade disputes are resolved, reducing disputes about which organization has jurisdiction over the trade dispute. A country which uses trade practices that harm a trading partner can be

legally punished according to the rules of a trade agreement. Brazil received authorization from the World Trade Organization, the WTO, to increase tariffs on U.S. cars and drugs, as well as reducing intellectual property protection for works created in the United States, because the United States provided subsidies, or export credits, to cotton producers, according to the U.S. Treasury. When the United States provides a subsidy to its cotton producers, this harms Brazilian cotton producers since the American cotton producers can charge lower prices on the cotton they sell in Brazil and still receive a profit. The WTO ruled that the export credit guarantees and payments to cotton producers which the United States government provided violate the terms of the trade agreement between the United States and Brazil.

- **Lesser Non-trade barriers (NBTs)**

Many nations resort to NBTs for protection of domestic trade. For example, India has faced lots of problems because on the pretext of using child labour, many developed nations had imposed a ban on the imports from India. However, by raising the voice at the multilateral forums, India has been able to build a favourable opinion and we see that there are far lesser trade barriers for Indian products into the overseas markets.

24.10 MULTILATERAL TRADE AGREEMENTS OF INDIA

India has been a signatory of a large number of trade agreements with a large number of nations and international agencies. According to the data available on the website of Ministry of Commerce, India has signed the following agreements:

- a. Agreement on implementation of India – Malaysia CECA
- b. Framework Agreement with ASEAN
- c. Framework agreement with Chile
- d. Framework Agreement with GCC States
- e. Framework Agreement with Thailand
- f. India EU Trade and Investment Agreement TIA
- g. India US Trade Policy Forum Joint Statement
- h. India and Australia Joint Free Trade Agreement Feasibility Study

- i. India Bangladesh Trade Agreement
- j. India Ceylon Trade Agreement
- k. India DPR Korea Trade Agreement
- l. India EU Strategic Partnership Joint Action Plan
- m. India Indonesia Joint Study Group Report
- n. India Maldives Trade Agreement
- o. India Mongolia Trade Agreement PDF download
- p. India New Zealand Joint Study Report PDF download
- q. India Pakistan Trading Arrangement PDF download
- r. India United States Commercial Dialogue
- s. Joint Communique for setting up the India Russia Joint Task Force
- t. MOU Between India And Indonesia On The Establishment Of Biennial Trade Ministers' Forum

24.11 SUMMARY

A free and fair multilateral trading system serves best the interests of any liberalising economy. The atmosphere of gloom around the multilateral trading system due to dim prospects of a successful conclusion of the Doha Round notwithstanding, global trade regime remains open and the institution in charge of it, the World Trade Organization, is in sound health. If anything, the Doha Round has been a victim of its own success: considerable de facto liberalization in agriculture has been achieved since the launch of the round. Second, to secure the future of the multilateral trading system, it is nevertheless crucial that the Doha Round is brought to a conclusion even if in a highly diluted form. The damage to the system from an outright failure will be very substantial. Finally, closing the Doha Round will require the United States leading the negotiations. Suggestions that as the largest merchandise exporter, China should now take the lead are frivolous.

24.12 COMPREHENSIVE QUESTIONS

- **Fill in the blanks**

1) The principle is to provide the same treatment to other nations that is given to our countrymen.

2) In the field of 100 percent products are subject to customs duty

3) Regular monitoring of national trade policies is maintained by

4) The full form of GATT is

- **(b) Indicate true/false**

1. In economic nationalism, to avoid self-destructive mistakes, G-20 economies need to refocus their attention on firmly implementing the multilateral trading system.

2. The World Trade Organization is an important institution of rules whose dispute resolution system is quite weak.

3. Developed countries have begun to allow almost all products to be imported from the least developed countries duty-free and quota-free.

24.13 ANSWER TO COMPREHENSIVE QUESTIONS

A) 1. National treatment, 2. Agriculture, 3. Trade Policy Review Mechanism
4. General Agreement on Tariffs and Trade (General Agreement on Tariffs and Trade) (GATT)

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

24.14 SELF- ASSESSMENT QUESTIONS

- (i) Describe the various advantages of multilateral trading systems.
- (ii) Discuss about the multilateral trading system in present scenario.
- (iii) Discuss the various aspects of the multilateral trading system in global governance.
- (iv) What are the principles of the multilateral trading system? Discuss.

24.15 BOOK REFERENCE

1. www.wto.org.in
2. Bhagirath Lal, “The WTO and the Multilateral Trading System - Past, Present and Future”, 3rd edition, Third World Network and Zed Books., New Delhi, 2003.
3. Kluwer Law International, “From Gatt to the Wto: The Multilateral Trading System in the New Millennium”, world trade organization, 2001.
4. www.unctad.org.in