SUBJECT: Business Environment

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# **BUSINESS AND ENVIRONMENT**

**Objective :** The students will be able to understand the concept of business environment its meaning, scope and importance.

#### Structure:

- 1.1 Introduction to Business
- 1.2 Business Environment: Emerging Order
- 1.3 Technological Environment
- 1.4 Economic Environment
- 1.5 Political Environment
- 1.6 Socio-Economic Environment
- 1.7 Natural Environment
- 1.8 Summary
- 1.9 Self Assessment Exercise
- 1.10 Suggested Readings

#### 1.1. INTRODUCTION TO BUSINESS

Business is an important institution in society. Be it for the supply of goods or services, creation of employment opportunities, offer of better

quality life, or contribution to the economic growth of a country, the role of business is crucial. So the first question arises in anyone's mind is what really a business is ? The following definition is an attempt to provide appropriate answer.

"A Business is nothing more than a person or group of persons properly organized to produce or distribute goods or services. The study of business is the study of activities involved in the production or distribution of goods and services-buying, selling, financing, personnel and the like".

Practically the above said definition is true but in theoretical sense it is incorrect. Before any activities can be considered in the business, there must exist both the goal of profit and the risk of loss. Thus Business can be accurately defined by K. Ashwathapa as "Complex field of commerce and industry in which goods and services are created and distributed in the hope of profit within a framework of laws and regulations".

**Understanding the Business:** To understand any business the critical step is to explore all the factors related to business and properly judging its impact on the business. There are many factors and forces which have considerable impact on any business. All these forces come under one word called environment. Hence understanding the business means understanding its environment. Environment refers to all external forces which have a bearing on the functioning of business.

From the micro point of view, a business is an economic institution, as it is concerned with production and/or distribution of goods and

services, in order to earn profits and acquire wealth. Different kinds of organizations (i.e., sole tradership, partnership, joint stock company and co-operative organization) are engaged in business and are operating from small scale, as in case of grocry in a start, to large scale, as in case of Tata Iron and Steel Co., Bajaj Auto, Maruti Udyog, and Reliance Industries. Whatever may be the nature and scale of operations, a business enterprise possesses the following characteristics:

- 1. Dealings in Goods and Services: The first basic characteristic of a business is that it deals in goods and services. Goods produced or exchanged, may be consumers' goods, such as bread, rice, cloth, etc. or producers' goods such as machines, tools, etc. The consumer goods are meant for direct consumption, either immediately, or after undergoing some processes, whereas the producers' goods are meant for being used for the purposes of further production. Producers' goods are also known as capital goods. Services include supply of electricity, gas, water finance, insurance, transportation, warehousing, etc.
- 2. **Production and/or Exchange:** Every business is concerned with production and exchange of goods and services for value. Thus, goods produced or purchased for personal consumption or for presenting to others as gifts do not constitute business, because there is no sale or transfer for value. For example, if a person cooks at home for personal consumption, it is not business activity. But, if he cooks for others in his 'dhaba', or restaurant and receives payment from them, it becomes his business.

- 3. Creation of form, time and place utility: All business activities create utilities for the society. Form utility is created, when raw materials are converted into finished goods and services. Place utility is created, when goods are transported from the place of production to the place of consumption. Storage of goods creates time utility. This helps in preserving the goods, when not required and making them available, when demanded by the consumers.
- 4. Regularity and Continuity in Dealings: Regularity of economic transactions is the essence of business. There should be continuity, or regularity of exchange of goods and services for money. An isolated transaction cannot be called a business. For example, if a person sells his flat and earns some profits, it cannot be called a business. But, if he purchases and sells flats regularly to earn his livelihood, it will be called his business.
- 5. **Profit Motive:** Another important feature of a business activity is its objective. The chief objective of a business is to earn reasonable profits or 'surplus' as it is called in case of public enterprises. The survival of a business depends upon its ability to earn profits. Every businessman wants to earn profits, to get return on his capital and to reward himself for his services. Actually, profit is the spur that helps in the continuation of the business. Profit is also essential for growth. Recreation clubs and religious institutions cannot be called business enterprises, as they have nothing to do with the profit motive.

The scope of business is very wide. It should not be confused with trade. 'Trade' simply denotes purchase and sale of goods, whereas 'business' includes all activities from production to distribution of goods and services. It embraces industry, trade and other activities like banking, transport, insurance, and warehousing which facilitate production and distribution of goods and services. According to F.C. Hooper, "The whole complex field of commerce and industry, the basic industries, processing and manufacturing industries, the network of ancillary services: distribution, banking, insurance, transport and so on, which serve and inter-penetrate the world of business as a whole, are business activities."

The business activities may be grouped under two broad headings, viz., (1) Industry and (2) Commerce. A business undertaking, which deals with growing, extracting, manufacturing, or construction is called an industrial enterprise. On the other hand, a business undertaking, which is concerned with exchange (buying and selling) of goods and services, or with activities that are incidental to trade, like transport, warehousing, banking, insurance and advertising, is called a commercial enterprise.

**Industry:** The activities of extraction, production, conversion, processing of products are described as industry. The products of industry may fall in any one of the following three categories:

(a) Consumers' Goods: Goods used by final consumers are called consumers' goods. Edible Oils, Cloth, Jam, Television, Radio, Scooter, Refrigerator, etc. come under this category.

- (b) **Producers' Goods:** Goods used for the production of other goods are described as producers' goods. Machine tools and machinery used for manufacturing other products come under this heading. These are also called capital goods.
- (c) Intermediate Goods: There are certain materials, which are the finished products of one industry and become the intermediate products of other industries. A few examples of this kind are the copper industry, aluminum industry, and plastic industry, the finished products of which are used in manufacturing electrical appliances, electricity wires, toys, baskets, containers, and buckets.

Broadly speaking, industrial activities may be classified into primary and secondary industries. Primary industry may be either extractive, or genetic, and secondary industry may be either manufacturing, or construction.

- (i) Extractive Industries: They extract, or draw out products from natural sources, such as earth, sea, air. The products of such industries are generally used by manufacturing and construction industries, for producing finished goods. Farming, mining, lumbering, hunting, fishing, etc, are some of the examples of extractive industries.
- (ii) Genetic Industries: Genetic means parentage, or heredity.

  Genetic industries are engaged in breeding plants and animals, for their use in further reproduction. For breeding plants, the nurseries are typical examples of genetic industries. In addition,

the activities of cattle-breeding farms poultry farms and fish hatchery come under the category of genetic industries.

- (iii) Manufacturing Industries: These are engaged in producing goods through the creation of form utility. Such industries are engaged in the conversion, or transformation of raw materials, or semi-finished products into finished products. The products of extractive industries generally become the raw materials of manufacturing industries. Factory production is the outcome of manufacturing industry.
- (iv) Construction Industries: They are concerned with the making or construction of buildings, bridges, dams, roads, canals, etc. These industries use the products of manufacturing industries, such as iron and steel, cement lime, mortar, etc. and also the products of extractive industries, such as stone, marble etc. The remarkable feature of these industries is that their products are not sold in the sense of being taken to the markets. They are constructed and fabricated at fixed sites.
- (v) Service Industry: There are several services such as transport, banking, insurance and warehousing, which are very important for satisfying human needs. They facilitate the production and distribution of business activity. A large number of business firms are engaged in transport, insurance and storage of goods and provision of banking and financial facilities to business units. Such firms are said to be engaged in service industries.

Commercial occupations deal with the buying and selling of goods, the exchange of commodities and distribution of finished products. James Stephenson has defined commerce as an organized system for the exchange of commodities and the distribution of finished products.

Commerce links producers and consumers. The main object of commerce, is to ensure smooth distribution of goods and services to satisfy the wants to consumers. It is the sum total of all those activities, which are concerned with the transfer of goods and services from the producers to the consumers. Thus, it includes exchange of goods and the services, which facilitate exchange of goods. These services are transport, banking, warehousing, insurance and advertising. Both trade, as well as aids to trade (i.e., services which facilitate trade) bridge the gap between producers and consumers.

"Environment factors or constraints", which Barry M. Richman and Melvyn Lopen", are largely if not totally, external and beyond the control of individuals institutional enterprises and their management. These are essentially the 'givens' within which firms and their managements must operate in a specific country and they vary, often greatly, from country to country".

William F. Glueck and L. R. Jauch gave an important characteristic of environment. "The environment includes factors outside the firm which can lead to opportunities for or threats to the firm. Although there are many factors, the most important of the sectors are socio-economic, technological, supplier, competitors and government.

Business Environment: It refers to all external forces which have a bearing on the functioning of the business. According to Barry M. Richman and Melvgn Copen "Environment consists of factors that are largely if not totally, external and beyond the control of individual industrial enterprise and their managements. These are essentially the 'givers' within which firms and their management must operate in a specific country and they vary, often greatly, from country to country".

William F. Glucck defines business environment "as the process by which strategists monitor the economic, governmental, market, supplier, technological, geographic, and social settings to determine opportunities and threats to their firms.

From the above definitions we can extract that business environment consists of factors that are internal and external which poses threats to a firm or these provide opportunities for exploitation.

In business all the activities are being organized and also carried out by the people to satisfy the needs of the consumers. So, it is an activity carried out by the people for the people which means people occupy a central place around which all the activities revolve. It means business is people and a human is always a dynamic entity who believes in change and it may be right to say that the only certainty today is change. It poses a huge challenge for today's and especially tomorrow's businessmen and managers to be aware of specific changes so as to keep themselves abreast with the latest happenings in the field of business to

maintain their survival and sustainability in the market. Therefore, the study of business environment is of atmost importance for the managers and practitioners.

There are two more factors which are not included in definition and which exercise considerable influence on business. They are physical or natural environment and global environment. Therefore, we will study the following environmental factors one by one.

- Global Environment
- Natural Environment
- Political Legal Environment
- Economic Environment
- Socio-Economic Environment
- Technological Environment

Business environment is becoming very complex day by day as some environmental issues such as deforestation, global warming, depletion of the ozone layer, pollution of land, air and water are no longer strictly the issues related to books and conferences. The leading politicians and managers around the world have picked up the environmental banner. The green marketing movement has been gaining momentum around the world. The businesses are challenged today to develop creative ways to make profits without unduly harming the existing environment. Considering the variety of these sources of change in the environment, global managers are challenged to keep themselves abreast and adjust as necessary. Some companies like Daewoo, Hyundai, Maruti, Tata and Hero-Honda in India, with their pollution prevention programmes are leading the way. Indeed, cleaning up the environment promises to generate whole new classes of jobs in the future.

Gone are the days when business was heavily protected and subsidized, licenses, quotas and restrictions were the order of the day. Now competition is the name of modern business. Businessmen always stand on the brink of a fear to eliminate from the market. They stand on their feet to cut down costs, to eliminate deficiencies and incessant improvement in the quality are order of the day. But by the competition, consumer is obviously benefited by the diverse openings of different competitors. According to Micheal Porter "aggressive home based suppliers and demanding local suppliers competing domestic rivals will keep each other honest in obtaining government support". Nowadays competition is not only from rival firms but also from the ever improving technology. For example, type writers have been completely wiped out from the market by the computers. Traditional postage telegrams are at the verge of elimination by the increasing use of internet services. So, today's business is witnessing the manifolds competition which was not prevalent in the past.

### 1.2. BUSINESS ENVIRONMENT: EMERGING ORDER

Internationalization or globalization of business has become a subject of very serious discussion in the national economic policies and corporate board room. International trade is growing faster than world output and international investment is growing much faster than global trade.

Nature of globalization: Globalization means several things to several people. For some it is a new paradigm - a set of fresh belief, working methods and economic, political and socio-cultural realities in which the previous assumptions are no longer valid. For developing countries, it means integration

with world economy. In simple economic terms, globalization refers to the process of integration of world into one huge market. Such unification calls for removal of all trade barriers among countries. Hence, globalization aims at removing isolations of different economies.

Globalization is a new phenomenon to India. We were for a long time content in serving internal market which has been vast. Domestic production was insufficient to feed the vast market. We were compelled to import in order to supplement domestic production. We were also exporting to other countries, but our exports were composed of traditional commodities and the direction was mainly erstwhile communist block. Globalization did hardly exist during past five decades. There are other reasons too, which made us within the country's boundaries. For a long time, we did not have industries of the number and magnitude to think of globalization. Vibrant economy filled with robust industries is a pre-requisite for internalization. Secondly, for the past five decades, we followed an economic policy which did not encourage competitive spirit among our industrialists. In the name of self-reliance, import substitution, swadheshi and economic sovereignty, we encouraged domestic industries to prosper, however inefficient they were. We gave those licenses, fixed quotas, imposed tariffs and offered subsidies generously. We put several restrictions on foreign companies desiring to enter Indian soil. This continued till 1990. In 1991, the new industrial policy paved the way for globalization in our economy. The number of global companies entered in India was 164 on 31st December 1991. Major Indian Industries also set their subsidiaries abroad. The major Indian player in global arena are Ranbaxy, Essar Gujarat,

Arvind Mills, Ballarpur Industries, UB, Reddy's lab and Aditya Birla Group. The process rate increased in late 90s and is now at its youth.

The world trade organization was established on Ist Jan. 1995. Governments had concluded the Uruguay Round Negotiations on 15th December 1993 and Ministers had given their political backing to the results by signing the final act at a meeting in Marrakesh, Morocco in April 1994. The 'Marrakesh Declaration' of 15th April 1994, affirmed that the results of the Uruguay Round Would "Strengthen the world economy and Income growth throughout the world". The WTO is the embodiment of the Uruguay Round results and the successor to the General Agreement on tariffs and trade. We briefly discuss the different types of business environment that need to be studied by a firm.

### 1.3 TECHNOLOGICAL ENVIRONMENT

Among all the segments of environment, technological environment exerts considerable influence on business. Thus this section requires more devotion.

J.K. Galbraith defines technology as a systematic application of scientific or other organized knowledge to practical tasks. During the last 150 years, technology has developed beyond anybody's comprehensions. Year 1983 was particularly considered by scientists as the year of scientific success. In this year scientists put a billion dollars technology into space, produced the world's first test-tube triplets and obtained evidence of another solar system. A major break through was achieved in the field

of genetic engg. to cure dwarfism. Technology, thus, is the most dramatic force shaping the destiny of people and business all over the world.

## Status of Technology in India

India, like any other third world country, attended political independence after prolonged colonial rule and exploitation. The country entered the modern world in a state of economic backwardness and poverty of a large section of people. It is obvious that technology must attend to the basic problems of food, clothing, health and housing of people. At the same time rapid industrial development through latest technology is necessary to catch up with advanced countries.

With these objectives in mind, Government of India set-up series of R & D establishments, space research centre, Medical research centres, agricultural research establishments, oil explorations centres, power development projects and the council of scientific and industrial research. Besides, several universities and institutes have been set-up to provide higher education in science, technology and management. As on today there are 4700 inter mediate/junior colleges, 144 universities, and 44 deemed universities in the country. Also there are more than 500 science and technological institutions, and 1080 in house research and development laboratories. There is also the Department of Science and Technology, an administrative wing of Government, to coordinate the activities of all research and technical activities in the country.

#### 1.4 ECONOMIC ENVIRONMENT

Economic environment refers to all those economic factors which have a bearing on the functioning of a business unit. Business depends on the economic environment for all the needed inputs. It also depends on the economic environment to sell the finished goods. Naturally, the dependence of business on the economic environment is total and it is not surprising because, as it is rightly said, business is one unit of the total economy.

It is difficult to be precise about the factors which constitute the economic environment of a country. But still there are some factors which have considerable influence. These factors are:-

- (a) Growth strategy
- (b) Economic system
- (c) Economic planning
- (d) Industry
- (e) Agriculture
- (f) Infrastructure
- (g) Financial and fiscal sector
- (h) Removal of regional imbalances
- (i) Price and distribution control
- (i) Economic Reforms

Out of the above said factors, two are of prime importance:-

- 1. Economic system
- 2. Industry
- 1. **Economic System :** The scope of a private business and the extent of government regulation of economic activities depend to a very large extent on the nature of economic system, which is an important part of

business environment. Broadly the economic system is divided into three groups.

- (a) Capitalism
- (b) Socialism
- (c) Communism

## (a) Capitalism

The system of capitalism stresses the philosophy of individualism believing in private ownership of all agents of production, in private sharing of distribution processes that determine the functions rewards of each participants, and in individual expression of consumer choice through a free market place. In its political manifestation, capitalism may fall in a range between extreme individualisms and anorchism (no government) and the acceptance of some state sanctions.

The capitalist system is also known as free enterprise economy and market economy.

Two types of capitalism may be distinguished, viz.,

- (i) The old, laissez-fair capitalism, where government intervention in the economy is absent or negligible; and
- (ii) The modern, regulated or mixed capitalism, where there is a substantial amount of government intervention.

### (b) Socialism

Under socialism, the tools of production are to be organized, managed and owned by the government, with the benefits occurring to the public. A strong public sector, agrarian reforms, control over private wealth and investment and national self reliance are the other planks of socialism. Socialism does not involve an equal division of existing wealth among the people, but advocates the egalitarian principle. It believes in providing employment to all and emphasizes suitable rewards to the efforts put in by every worker. Also called fabian socialism, this philosophy is followed in our country and other social democratic countries in the world.

## (c) Communism

Communism goes further to abolish all private property and property rights to income. The state would own and direct all instruments of production. Sharing in the distributive process would have no relationship to private property since this right would not exist. Alternatively called maxism, communism was followed in Russia, China and East European Countries.

The following table draws a comparison among three economic system.

Table. Capitalism, Socialism and Communism Compared

Characteristics	Capitalism	Socialism	Communism
Economic Markets	Freedom to compete with the right to invest	Limited competition with State-owned industries	Absence of competition with State-owned markets and industries.
Individual incentives	Profits and wages in relation to one's ability and willingness to work	Profits recognised Wages fairly in relation to efforts	Profits not allowed. Workers urged to work for the glory of the State.
Capital Sources	Capital invested by owners who may also borrow on credit. Capital may be reinvested from profits. Depreciation is legal	Obtained from owners and from State-issued bonds for State-owned industries. Depreciation permitted	State provides all resources to start business owned by the State. No depreciation
Labour	Workers are free to select an employer and an occupation	Workers allowed to select occupation. State planning encourages employment.	The State determines one's employer and employment.

Management	Managers are selected on the basis of ability. Managers have freedom to make decisions	Managers in State- owned industries are answerable to the State. Non-monetary rewards emphasised.	Key management must be party members. Absence of freedom to make decisions.
Business	Individual have the right to own a business and to contract with others.	State owns the basic industries. Other businesses may exist	State owns all productive capacity including communes.
Risk Assumption	Losses assumed by owners. May transfer business risks to other businesses through insurance	People assume risks of State-owned industries. Losses taken from taxes	Economic production owned by the State. Risks assumed by the State. Losses reduce standard of living.

**Source :** Vernon A Musselman and Eugene H Hughes, *Introduction to Modern Business-Issues & Environment*, p. 20)

In the mid-1960s, India had a better industrial base and possessed more prerequisites for industrial growth than south Korea, Malaysia, Taiwan, Thailand and Indonesia. Since then, the country has succeeded in creating a virtually autarkic economy where all outputs and factors were subject to rigid price and quantity controls; where investment was strictly rationed; where there were multiple barriers to entry, investment, foreign trade, and competition, and where the objective of the financial system was to supply subsidized development funds irrespective of returns. Consequently, all the countries, mentioned above, have overtaken India and are far ahead in industrial growth.

Table. Pattern of Resources allocation in India's plans

Heads of Development	I	II	III	IV	V	VI	VII	VIII
Agriculture & Irrigation	37.0	20.9	20.5	23.3	22.1	22.2	20.2	20.6
Power	7.6	9.7	14.6	18.6	18.8	16.7	17.4	18.7
Industry	4.9	24.1	22.9	19.7	24.3	26.5	23.7	18.8
Transport & communication	26.4	27.0	24.6	19.5	17.4	16.0	17.1	18.7

Social Services 24.1 18.3 17.4 18.9 17.4 18.6 21.6 23.2

Total 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0

(Source: Economic Survey and Planning Commission Annual Report 1995-96).

The various administrative controls are industrial licensing, industrial policies, MRTP and asset classification of monopolies, product reservation for small scale sector, Foreign Exchange Regulation Act (FERA), tariffs and quotas, the miniplant fetish, labour market rigidities, development finance and indege now availability and essentiality. These are explained as follows:-

Industrial policy is an important document which lays a wide canvas and sets a tone for implementing promotional and regulatory roles of the government. The term "industrial policy" refers to government's policy towards industries - their establishment, functioning, growth and management.

The policy indicate the respective areas of the large, medium and small scale sector. It also spell out government's policy towards foreign capital, labour, tariff and other related aspect. Naturally, the industrial development of a country is shaped, guided, fostered, regulated and controlled by its industrial policy.

Industrial policy is probably the most important document which indicates the relationship between the government and the business. But, it has no legal sanction and as such its violation can not be challenged in a court as is possible in the case of Fundamental Rights guaranteed by the constitution.

This policy was announced on 30th April 1956. The resolution of 1956 made the industrial policy. More socialist oriented and widened the scope of public sector. The resolution classified industries into three categories, having regard to the role which the state would play in each of them.

- (i) The first category contained industries "the future development of which will be the exclusive responsibility of the state". Industries in this category were listed in Schedule A of the resolution. Schedule A contained 17 industries. These included railways and air transport, arms and ammunitions, and atomic energy, which were to be developed as Central Government monopolies. In the remaining industries in Schedule A, the expansion of the existing privately-owned units, or the possibility of the state securing the cooperation of private enterprise in the establishment of new units where the national interest so required, was not produced. However, it was made clear that "whenever co-operation with private enterprise is necessary, the state will ensure, either through majority participation in the capital or otherwise, that it has the requisite powers to guide the policy and control the operations of the undertaking.
- (ii) In the second category were included 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 state. The industries included in the second category were listed in schedule B of the resolution. It contained 12 industries like machine tools, firo-alloys and tools, drugs, fertilizers, synthetic rubber, canbonisation of coal, chemical pulp, road transport and sea transport and aluminium and other non-ferrous metals not included in Schedule A.

(iii) the rest of industries were thrown open to the private sector but this did not prevent the state from starting any new undertaking. State will facilitate and encourage the development of these industries in the private sector by providing infrastructural facilities.

Ours is one of the few countries in the world where an entrepreneur is required to obtain an industrial license from the government before venturing into a new business.

A "Licence" is a written permission issued by Central Government to an industrial undertaking stating such details as the location, the article to be manufactured, production capacity and other relevant particulars. It is also subjected to a validity period within which the licensed capacity should be implemented. The general Objectives of Licensing are:

- a) To limit industrial capacity within the targets set by the plans.
- b) To direct investment in industries according to plan priorities.
- c) To regulate the location of industrial units so as to secure a balanced regional development.
- d) To prevent monopoly and prevention of concentration of wealth.
- e) To protect small scale industries against under competition from large scale industries.
- f) To foster technology and economic improvements in industries by ensuring units of economic size and adopting modern processes.

g) To encourage new entrepreneurs to start industrial units, broadening the entrepreneurial base.

The monopolies and Restrictive Trade Practices Act, 1969, brought into force from 1st June 1970, was a very controversial piece of legislation.

The principal objectives of the MRTP Act which extends to the whole of India except to the state of Jammu and Kashmir, viz. :

- i) Prevention of concentration of economic power to the common detriment.
- ii) Control of monopolistic, restrictive and unfair trade practices which are prejudicial to public interest.

The MRTP Act was significantly amended in 1982, 1984, 1985 and 1991. After the amendments the first objective has become irrelevant as the relevant provisions to achieve the objective have been deleted. The objectives now are:

- i) Controlling monopolistic trade practices.
- ii) Regulating restrictive and unfair trade practices.

A monopolistic trade practice is essentially a trade practice which represents the abuse of the market power in the production or marketing of goods, or in the provision of services, by charging unreasonably high prices, preventing or reducing competition, limiting technical development, deteriorating product quality, or by adopting unfair or deceptive practices.

Two tests will determine whether a trade practice is an MTP or not:

i) abuse of market power, and (ii) unreasonableness in any practice.

# Thus, the following are MTPs:

- 1. Maintaining the prices of goods or charges for any services at an unreasonable level.
- 2. Limiting technical development or capital investment to the common detriment.
- 3. Unreasonably preventing or lessening competition.
- 4. Allowing quality of goods produced, supplied or distributed or any service rendered to deteriorate.
- 5. Increasing unreasonably the cost of production of any goods or charges for provision or maintenance of services.
- 6. Increasing unreasonably the selling price of goods, or charges at which the services may be provided.
- 7. Increasing unreasonably the profits that are derived from the production, supply or distribution of any goods or the provision of any services.
- 8. Preventing or lessening competition in the production, supply or distribution of any goods or in the provision or maintenance of any services by adopting unfair methods of unfair practices.

Broadly speaking a trade practice which restricts or reduces competition may be termed as restrictive trade practice. The following are the RTPs as described by section 33(1) of the MRTP Act:

(a) Refusal to deal with persons or classes of persons: Any agreement which restricts or it likely to restrict by any methods, the persons or classes of persons to whom goods are sold or from whom goods are bought.

- **(b) Tie-in sales or full line forcing :** Any agreement requiring purchaser of goods, as a condition of such purchase, to purchase some other goods.
- (c) Exclusive dealing agreement: Any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of seller or any other goods.
- (d) Collective price fixation and tendering: Any agreement to purchase or sell goods or to tender for the sale or purchase of goods only at prices or terms and conditions agreed upon between the sellers or purchaser.
- **(e) Discriminatory Dealings:** Any agreement to grant or allow concession or benefits, including allowances, discounts, rebate or credit, in connection with or by reason of dealings.
- (f) Re-sale price maintenance: Any agreement to sell goods on condition that the prices to be charged on resale by the purchaser shall be the prices stipulated by the seller unless it is clearly stated that prices lower than those prices may be charged.
- **(g) Restriction on output or supply of goods :** Exclusive distributorship, territorial restriction and market sharing.
- (h) Control of manufacturing process.
- (i) Price control arrangements.
- (j) Governmental recognition of practice as restriction.
- **(k)** Residual restriction trade practices: Any agreement to enforce the carrying out of any such agreement as is referred to in the foregoing classes.

## Table. Differences between MTPs and RTPs

MTPs RTPs

<sup>1.</sup> Market power is sought to be misused 1. Competition is sought to be curbed.

Stress is on abusing market power.

- Stress is on preventing competition from its free play.
- 2. Commission can conduct enquiry on either (i) reference from the Central Government, or (ii) on its own knowledge or information.
- Commission can conduct enquiry on any of five bases: (i) a complaint from 25 or more consumers or dealers, (ii) reference from Central Government, (iii) reference from the State Government, (iv) the application of the Director General or (v) on its own knowledge of information.
- 3. Commission submits report about the findings to the Central Government.

  The power of making final order rests with the Central Government.
- 3. Commission itself can pass final order after enquiry.
- 4. Commission's role is advisory. It can only conduct enquiry.
- 4. Commission has the power of passing final order which is subject to appeal only to Supreme Court.
- 5. Consequences of indulging in an MTP are more serious. Apart from the order to prohibit the person concerned from indulging in an MTP the Central Government is empowered to pass orders to remedy or prevent any mischief resulting from the practice.
- 5. Consequences of indulging in an RTP are not very serious. A cease and desist order is passed and he relevant clauses of the RTP agreement are declared void.
- 6. With regard to the compliance of the final order, the Director General is required to report compliance of the cease-order within 90 days of the government order. The owner of the undertaking is also required to report compliance of the cease-order with in 90 days of the government order.
- 6. No such requirement in the case of RTPs unless a specific obligation has been imposed on the party concerned as part of the Commision's final order.
- 7. Agreements relating to MTPs need not be registered.
- 7. All agreements relating to specified restrictive trade practices are required to be furnished for registration to the Director-General.

The principle objective of the Foreign Exchange Regulation Act (FERA) is to prevent the outflow of Indian currency and to see that the foreign exchange legitimately due to India should be received.

In detail, the objectives of the Act are as follows:

i) To regulate certain payments.

- ii) To regulate dealings in foreign exchange and securities.
- iii) To regulate the transactions indirectly affecting foreign exchange.
- iv) To regulate import and export of currency and bullion.
- v) To conserve the foreign exchange resources of the country and to utilize the same in the interests of the economic development of the country.
- vi) To regulate holding of immovable property outside India.
- vii) To regulate employment of foreign nationals.
- viii) To regulate acquisition, holding etc. of immovable property in India.
- ix) To regulate foreign companies.

The Act applies to the whole of India and applies to all citizens of India outside India and to branches and agencies outside India of companies or bodies corporate registered in India. The Act came into force with effect from 1st Jan., 1974.

### 1.5 POLITICAL ENVIRONMENT

The influence of political environment of business is enormous. The political system prevailing in a country decides, promotes, fosters, encourages, shelters, directs and controls the business activities of that countries. A political system which is stable, honest, efficient and dynamic and which ensures political participation of the people, and assures personal security to the citizens, is primary factor for growth of any business.

Two basic political philosophies are in existence all over the world, viz., democracy and totalitarianism. In its pure sense, democracy refers to a political arrangement in which supreme power is vested in the people. Democracy may manifest itself in any of two fundamental manners. If each individual is given the right to rule and vote on every matter, the result is pure democracy which is not, however, workable in a complex society with a large constituency. Hence, the republican forms of organization follows whereby the public, in a democratic manner, elect their representatives who do ruling.

In totalitarianism, also called authoritarianism, individual freedom is completely subordinated to the power of authority of the state and concentrated in the hands of one person or in a small group which is not constitutionally accountable to the people. Societies ruled by a pressure clique - political, economy or military - or by a dictator plus most oligarchies and monarchies belong to this category. The doctrine of fascism and erstwhile Russian Communism Russian Communism are example of totalitarianism.

India is a democratic country. Our political system comprises three vital institutions:-

- 1. Legislature
- 2. Executive or government
- 3. Judiciary

## 1. Legislature

Out of three, legislature is most powerful political institution vested with such powers as policy making, law-makings, budget approving, executive control and acting as mirror of public opinion. The influence of legislature on business is considerable. It decides such vital aspects as the type of business activities, the country should have, who should own them, what should be their size of operation, what should happen to their earnings and other related factors.

### 2. Government as Executive

Also called the 'state' the term government refers to "the centre of political authority having the power to govern those it serves". For business consideration, we should know what are government's responsibilities to business.

Specifically, government's responsibilities towards business are as follows:

- a) Establishment and enforcement of law
- b) Maintenance of order
- c) Money and credit
- d) Orderly growth
- e) Infrastructure
- f) Information
- g) Assistance to small industries
- h) Transfer of technology
- i) Tariffs and Quotas

# 3. Judiciary

The third political institution is judiciary. Judiciary determines the manner in which the work of executives has been fulfilled. It settles the relationship between private citizens, on one hand, and between citizens and the government upon the other.

The power of the judiciary are of dual type:

- i) The authority of the courts to settle legal disputes.
- ii) Judicial review the authority of the courts to rule on the constitutionality of legislation.

### 1.6 SOCIO-ECONOMIC ENVIRONMENT

Social and cultural environment refers to the influence exercised by certain social factors which are "beyond the company's gate". All such factors comes under one head that is culture.

**Culture:** In its narrow sense culture is understood to refer to such activities as dance, drama, music and festivals. In its true sense culture is understood as that complex whole which includes knowledge, belief, art, morals, law, customs and other capabilities and habits acquired by individual as a member of a society.

The culture has two main characteristics:

i) Shared value

# ii) Passage of time

Culture of a society is shared by its members. Cultural ethos are passed from one generation to other generation. It is not confined to one particular period of time.

The interface between business and culture can be summarized as follows:

- a) Culture creates people.
- b) Culture determines goods and services.
- c) It defines people's attitude to business and to work.
- d) Explains the spirit of collectivism and individualism.
- e) Defines whether people are Ambitions or complacent.
- f) Education
- g) Family
- h) Authority
- i) Marriage
- j) Time Dimension
- k) Cultural Resources.

All the above said factors influence the business in one or other way. Hence it is important to understand all these factors for a successful business.

### 1.7 NATURAL ENVIRONMENT

Equally significant, but sadly ignored, are the factors like climate, minerals, soil, landform, rivers and oceans, coast lines, natural resources, flora and fauna etc. Which have considerable influence on the functioning of a business. It is the natural environment which decides the resources for any business.

Manufacturing, which is one of the aspects of business, depends on physical environment for inputs like raw material, labour of various skills, water, fuel etc. Trade between two regions of a nation or between two nations is the result of geographic factors. Because of natural factors, certain areas are more suitable for production of certain goods and other areas are in need of such goods. Transportation and communication, the main prop of business, depend to a larger extent on geographic factors. Uneven landforms, desserts, oceans, forest, rivers etc. are barriers to develop this vital infrastructure. Some businesses like mining of coal and ores, drilling of oil and most important agriculture which depends most on nature. Thus the impact of natural environment can not be ignored moreover it should be given top priority for any successful business.

#### 1.8 SUMMARY

Viewed in a broad way, the term business typically refers to the development and processing of economic values in society. The scope of business is very wide. It should not be confused with trade. 'Trade' simply denotes purchase and sale of goods, whereas 'business' includes all activities from production to distribution of goods and services. It embraces industry, trade and other activities like banking, transport, insurance, and warehousing which facilitate production and distribution of goods and services.

The business activities may be grouped under two broad headings, viz., (1) Industry and (2) Commerce. A business undertaking, which deals with growing, extracting, manufacturing, or construction is called an industrial enterprise. On the other hand, a business undertaking, which is concerned with exchange (buying and selling) of goods and services, or with activities that are incidental to trade, like transport, warehousing, banking, insurance and advertising, is called a commercial enterprise. Commerce is that part of business, which seeks to facilitate exchange of goods, by removing various hindrances, namely, those of persons through trade, finance through money and banking, of the place through warehousing and storage, and of lack of knowledge, through advertising.

India is a country of land and people. It has a huge customer base as well as world's most powerful brains. It is rich in its natural resources and is highly adaptive to changing business environment. In some areas like technology and political stability, it requires some wise steps. With all these virtues India has become a favourite destination of other countries to expand their business. India is expanding domestically as

well as globally to compete with other powerful business nations so as to get its desired share of world economic growth.

Business enterprise is a part of society and the business environment has direct relationship with the policy of the enterprise. The environment may impose several constraints on the enterprise. The enterprise on the other hand, has very little control over its environment. Therefore, the success of an enterprise depends to a very large extent on its adaptability to the environment, i.e., its ability to identify itself with the environment and fit in with the environmental framework. According to Hicks, "The firm can adjust to the environment, or if it has ability, change the environment."

Environment literally means the surrounding external objects, influences of circumstances under which someone or something exist. The environment of any organization is "the aggregate of all conditions, events and influences that surround and affect". Business environment exhibits many characteristics since it is complex, dynamic, multifaceted and it has far reaching impact. For all these reasons dividing environment into external and internal components enables us to understand it better. Every business enterprise thus consists of a set of internal factors and is confronted with a set of external factors.

A conscious identification of the relevant environment enables the organization to focus its attention on those factors which are initially related to its mission, purpose, objectives and strategies. Depending on its perception of the relevant environment, an organization takes into account those influences in its surroundings which have an immediate impact on its strategic management process. Having identified its relevant environment, an organization can systematically appraise it and incorporate the results of such an appraisal in

strategic planning. The environment of business is an extremely complex and dynamic phenomenon as the environmental factors vary from country to country. In order to cope with the complexity of the environment it is feasible to divide it into different components and sectors. Let us consider the importance of the study of the business environment:

- The study of the business environment helps an organization to develop its broad strategies and long-term policies.
- It enables an organization to analyze its competitors' strategies and thereby formulate effective counter strategies.
- Knowledge about the changing environment will keep the organization dynamic in its approach.
- Such a study enables the organization to foresee the impact of the socioeconomic changes at the national and international level on its stability.
- Finally, as a result of the study, executives are able to adjust to the prevailing conditions and thus influence the environment in order to make it congenial to business.

#### 1.9 SELF ASSESSMENT EXERCISE

- 1. Give a brief account of Indian business environment.
- 2. Discuss the major implications of MRTP and FERA acts on Indian business.
- 3. Narrate in brief the various Industrial Policy Resolutions.
- 4. Write short notes on:
  - i) Economic environment
  - ii) Natural environment

#### 1.10 SUGESTED READINGS

- 1. Indian Economy by Mishra & Puri.
- 2. Indian Economy by Rudderdalt.
- 3. Indian Economy by Tondon.

4. Business & Government by Francis Cherunelum.

**COURSE: BUSINESS ENVIRONMENT** 

COURSE CODE: MC-103 AUTHOR: SURINDER S. KUNDU

LESSON: 02.

**VETTER: PROF. M. S. TURAN** 

**OBJECTIVE** The present chapter explains the structure and working of WTO.

## **STRUCTURE**

- 2.1 Introduction
- 2.2 Fact File And Functions of WTO
- 2.3 WTO Structure
- 2.4 Working of WTO
- 2.5 Membership, Alliances and Bureaucracy
- 2.6 The WTO Secretariat and Budget
- 2.7 Summary
- 2.8 Self-Test Questions
- 2.9 Suggested Readings

# 2.1 INTRODUCTION

After World War II, several international measures were undertaken to liberalise trade and payments between nations. Plans for the creation of a liberal, multilateral system of world trade were started while the war was still in progress. Initiated for the most part by the United States, these plans envisaged a close economic cooperation among the nations in the fields of international trade, payments and investment. International Monetary Fund and International Bank for Reconstruction and Development (World Band) were set up. Similarly, International Trade Organisation (ITO) was sought to set up to deal with the international trade. In 1945, United States were called for convening of a United Nations conference for the purpose of negotiating the international trade charter and for the establishment of an international trade organisation. In December 1945, the US in

consultation with UK and Canada prepared a detailed draft trade charter. The suggested Charter was discussed in London during October-November of 1946. There were two major tasks for this discussion. First, was the completion of the draft trade for submission to UN Conference on Trade and Development scheduled for December 1947 in Hayana and second, a series of detailed negotiations among the principal countries of the preparatory committee to reduce tariffs and tariff preferences. The results took the form of a tariff schedule for each participating country. These tariff schedules together with those Articles of the Draft Charter that were required to protect the integrity of the trade concessions were combined in an instrument entitled the "General Agreement on Tariffs and Trade"-the GATT. All the participants of the preparatory committee signed the Final Act establishing GATT. GATT came into force in 1948 with a membership of 23 industrial countries. By the mid 1980s, its membership had enlarged 90 embracing as many as countries that accounted for over four-fifth of world trade. The ever-expanding group of contracting parties to the GATT, the number of countries joining GATT was 128 when WTO was created. Main activities of GATT may be summarized as: tariff bargaining, bargaining on non-tariff trade barriers, elimination of quantitative restrictions and settlement of disputes between contracting parties. GATT is based on four major provisions: (i) the rules of non-discrimination in trade relations between the contracting countries, (ii) commitment to observe negotiated tariff concessions, (iii) prohibitions against use of quantitative restrictions (quotas) on exports and imports, and (iv) special provisions to promote the trade of developing countries. The remaining provisions of GATT are concerned with exceptions to these general provisions, which include trade measures other than tariffs and quotas, and sundry procedural matters.

Uruguay Round took seven and a half years, almost twice the original schedule. By the end, 125 countries were taking part. It covered almost all trade, from toothbrushes to pleasure boats, from banking to telecommunications, from the plants to AIDS treatments. It was quite simply the largest trade negotiation ever, and most probably the largest negotiation of any kind in history. The seeds of the Uruguay Round were sown in November 1982 at a ministerial meeting of GATT members in Geneva. Although the Ministers intended to launch a major new negotiation, the conference was stalled on the issue of agriculture and was widely regarded as a failure. In fact, the work programme that the Ministers agreed; formed the basis for what was to become the Uruguay Round negotiating agenda. Nevertheless, it took four more years of exploring, clarifying issues and painstaking consensus building, before the Ministers agreed to launch the new round in September 1986, in Punta del Este, (Uruguay). They eventually accepted a negotiating agenda, which covered almost every outstanding trade policy issue. The talks were going to extend the trading system into several new areas, particularly, trade in services and intellectual property, and to reform the trade in the sensitive sectors of agriculture and textiles. Two years later, in December 1988, ministers met again in Montreal (Canada). The purpose was to clarify the agenda for the remaining two years, but the talks ended in a deadlock that was not resolved until officials met more quietly in Geneva the following April. Despite the difficulty, during the Montreal meeting, Ministers did agree a package of early results. These included some concessions on market access for tropical productsaimed at assisting developing countries, as well as a streamlined, which provided for the first comprehensive, systematic and regular reviews of national trade policies and practices of GATT members. The round was supposed to end when Ministers met once

: 39:

more in Brussels, in December 1990. But they disagreed on how to reform agricultural

trade and decided to extend the talks. Despite the poor political outlook, a considerable

amount of technical work continued, leading to the first draft of a final legal agreement.

The then GATT director general, Mr. Arthur Dunkel, who chaired the negotiations at

officials' level, compiled this draft "Final Act". It was placed on the table in Geneva in

December 1991. The text fulfilled every part of the Punta del Este mandate, with one

exception (it did not contain the participating countries' lists of commitments for cutting

the import duties and opening their services markets). The draft became the basis for the

final agreement. In November 1992, the EU and US settled most of their differences on

agriculture in a deal known informally as the "Blair House accord". By July 1993, the

"Quad" (US, EU, Japan and Canada) announced significant progress in negotiations on

tariffs and related subjects including market access. On 15 April 1994, the deal was

signed by ministers from most of the 125 participating governments at a meeting in

Marrakesh (Morocco).

The last round-the Uruguay Round-created a legal institution-the World Trade

Organization to replace the provisional GATT. The WTO is the only global international

organization dealing with the rules of trade between nations. At its heart are the WTO

agreements, negotiated and signed by a majority of the world's trading nations and

ratified by their Parliaments. The goal is to help the producers of goods and services, the

exporters, and the importers conduct their business smoothly.

2.2 FACT FILE AND FUNCTIONS OF WTO

Location: Geneva, Switzerland

Established: 1 January 1995

: 40:

Created by: Uruguay Round negotiations (1986-94)

Membership: 148 countries (on 13 October 2004)

Budget: 169 million Swiss francs for 2005

Secretariat staff: 630

Head: Supachai Panitchpakdi (director-general)

**FUNCTIONS:** 

Administering WTO trade agreements

Forum for trade negotiations

Handling trade disputes

Monitoring national trade policies

Technical assistance and training for developing countries

Cooperation with other international organizations

The WTO's main functions are to do with trade negotiations and the enforcement of negotiated multilateral trade rules (including dispute settlement). Special focus is given to four particular policies supporting these functions:

Assisting developing and transition economies

Specialized help for export promotion

Cooperation in global economic policy-making

Routine notifications when members introduce new trade measure or alter old

ones.

2.2.1 ASSISTING DEVELOPING AND TRANSITION ECONOMIES

Developing countries make up about three quarters of the total WTO membership.

Together with countries currently in the process of "transition" to market-based

economies, they play an increasingly important role in the WTO. Therefore, much attention is paid to the special needs and problems of developing and transition economies. The WTO Secretariat's Training and Technical Cooperation Institute organizes a number of programmes to explain how the system works and to help train government officials and negotiators. Some of the events are in Geneva, others are held in the countries concerned. A number of the programmes are organized jointly with other international organizations. Some take the form of training courses. In other cases individual assistance might be offered. The subjects can be anything from help in dealing with negotiations to join the WTO and implementing WTO commitments to guidance in participating effectively in multilateral negotiations. Developing countries, especially the least developed among them, is helped with trade and tariff data relating to their own export interests and to their participation in WTO bodies.

# 2.2.2 SPECIALIZED HELP FOR EXPORTING: THE INTERNATIONAL TRADE CENTRE

GATT established the International Trade Centre in 1964 at the request of the developing countries to help them promote their exports. It is jointly operated by the WTO and the United Nations, the latter acting through UNCTAD (the UN Conference on Trade and Development). The centre responds to requests from developing countries for assistance in formulating and implementing export promotion programmes as well as import operations and techniques. It provides information and advice on export markets and marketing techniques. It assists in establishing export promotion and marketing services, and in training personnel required for these services. The centre's help is freely available to the least-developed countries.

#### 2.2.3 THE WTO IN GLOBAL ECONOMIC POLICY-MAKING

An important aspect of the WTO's mandate is to cooperate with the International Monetary Fund, the World Bank and other multilateral institutions to achieve greater coherence in global economic policy-making. A separate Ministerial Declaration was adopted at the Marrakesh Ministerial Meeting in April 1994 to underscore this objective. The declaration envisages an increased contribution by the WTO to achieving greater coherence in global economic policy-making. It recognizes that different aspects of economic policy are linked, and it calls on the WTO to develop its cooperation with the international organizations responsible for monetary and financial matters - the World Bank and the International Monetary Fund. The declaration also recognizes the contribution that trade liberalization makes to the growth and development of national economies. It says this is an increasingly important component in the success of the economic adjustment programmes, which many WTO members are undertaking, even though it may often involve significant social costs during the transition.

## 2.2.4 TRANSPARENCY

Keeping the WTO informed: Often the only way to monitor whether commitments are being implemented fully is by requiring countries to notify the WTO promptly when they take relevant actions. Many WTO agreements say member governments have to notify the WTO Secretariat of new or modified trade measures. For example, details of any new antidumping or countervailing legislation, new technical standards affecting trade, changes to regulations affecting trade in services, and laws or regulations concerning the intellectual property agreement - they all have to be notified to the appropriate body of the

WTO. Special groups are also established to examine new free trade arrangements and the trade policies of countries joining as new members.

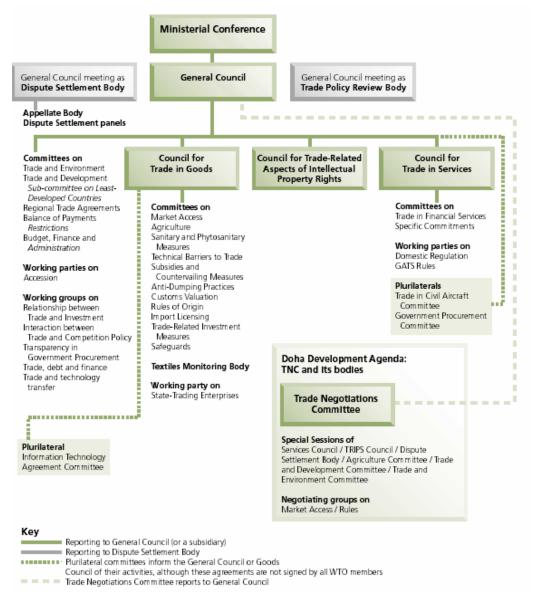
**Keeping the public informed:** The main public access to the WTO is the website, www.wto.org. News of the latest developments is published daily. Background information and explanations of a wide range of issues- including "Understanding the WTO"- are also available. And those wanting to follow the nitty-gritty of WTO work can consult or download an ever-increasing number of official documents, now over 150,000, in Documents Online. On 14 May 2002, the General Council decided to make more documents available to the public as soon as they are circulated. It also decided that the minority of documents that are restricted should be made public more quickly - after about two months, instead of the previous six. This was the second major decision on transparency. On 18 July 1996, the General Council had agreed to make more information about WTO activities available publicly and decided that public information, including derestricted WTO documents, would be accessible on-line. The objective is to make more information available to the public. An important channel is through the media, with regular briefings on all major meetings for journalists in Geneva — and increasingly by email and other means for journalists around the world. Meanwhile, over the years, the WTO Secretariat has enhanced its dialogue with civil society - non-governmental organizations (NGOs) interested in the WTO, parliamentarians, students, academics, and other groups. In the run-up to the Doha Ministerial Conference in 2001, WTO members proposed and agreed on several new activities involving NGOs. In 2002, the WTO Secretariat increased the

number of briefings for NGOs on all major WTO meetings and began listing the briefing schedules on its website. NGOs are also regularly invited to the WTO to present their recent policy research and analysis directly to member governments. A monthly list of NGO position papers received by the Secretariat is compiled and circulated for the information of member governments. A monthly electronic news bulletin is also available to NGOs, enabling access to publicly available WTO information.

# 2.3 WTO STRUCTURE

All WTO members may participate in all councils, committees, etc, except Appellate Body, Dispute Settlement panels, Textiles Monitoring Body, and plurilateral committees (see Graphics 2.1).

# **Graphics: 2.1**



The General Council also meets as the Trade Policy Review Body and Dispute Settlement Body

Source: www.wto.org.

The **Services Council's** subsidiary bodies deal with financial services, domestic regulations, GATS rules and specific commitments. At the General Council level, the **Dispute Settlement Body** also has two subsidiaries: the dispute settlement "panels" of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals.

Important breakthroughs are rarely made in formal meetings of these bodies, least of all in the higher-level councils. Since decisions are made by consensus, without voting, informal consultations within the WTO play a vital role in bringing a vastly diverse membership round to an agreement. One step away from the formal meetings is informal meetings that still include the full membership, such as those of the Heads of Delegations (HOD). More difficult issues have to be thrashed out in smaller groups. A common recent practice is for the chairperson of a negotiating group to attempt to forge a compromise by holding consultations with delegations individually, in twos or threes, or in groups of 20– 30 of the most interested delegations. These smaller meetings have to be handled sensitively. The key is to ensure that everyone is kept informed about what is going on (the process must be "transparent") even if they are not in a particular consultation or meeting, and that they have an opportunity to participate or provide input (it must be "inclusive"). One term has become controversial, but more among some outside observers than among delegations. The "Green Room" is a phrase taken from the informal name of the director-general's conference room. It is used to refer to meetings of 20–40 delegations. These meetings can be called by a committee chairperson as well as the director-general, and can take place elsewhere, such as at Ministerial Conferences. In the past delegations have sometimes felt that Green Room meetings could lead to compromises being struck behind their backs. So, extra efforts are made to ensure that the process is handled correctly, with regular reports back to the full membership. In the end, decisions have to be taken by all members and by consensus. No one has been able to find an alternative way of achieving consensus on difficult issues, because it is virtually impossible for members to change their positions voluntarily in meetings of the full

membership. Market access negotiations also involve small groups, but for a completely different reason. The final outcome is a multilateral package of individual countries' commitments, but those commitments are the result of numerous bilateral, informal bargaining sessions, which depend on individual countries' interests. (Examples include the traditional tariff negotiations, and market access talks in services.) So, informal consultations in various forms play a vital role in allowing consensus to be reached, but they do not appear in organization charts, precisely because they are informal. They are not separate from the formal meetings, however. They are necessary for making formal decisions in the councils and committees. Nor are the formal meetings unimportant. They are the forums for exchanging views, putting countries' positions on the record, and ultimately for confirming decisions. The art of achieving agreement among all WTO members is to strike an appropriate balance, so that a breakthrough achieved among only a few countries can be acceptable to the rest of the membership. Same people, different hats? No, not exactly. Formally, all of these councils and committees consist of the full membership of the WTO. But that does not mean they are the same, or that the distinctions are purely bureaucratic. In practice the people participating in the various councils and committees are different because different levels of seniority and different areas of expertise are needed. Heads of missions in Geneva (usually ambassadors) normally represent their countries at the General Council level. Some of the committees can be highly specialized and sometimes governments send expert officials from their capital cities to participate in these meetings. Even at the level of the Goods, Services and TRIPS councils, many delegations assign different officials to cover the different meetings.

## 2.4 WORKING OF WTO

The WTO is run by its member governments. All major decisions are made by the membership as a whole, either by ministers (who meet at least once every two years) or by their ambassadors or delegates (who meet regularly in Geneva). Decisions are normally taken by consensus. In this respect, the WTO is different from some other international organizations such as the World Bank and International Monetary Fund. In the WTO, power is not delegated to a board of directors or the organization's head. When WTO rules impose disciplines on countries' policies, that is the outcome of negotiations among WTO members. The members themselves under agreed procedures that they negotiated, including the possibility of trade sanctions, enforce the rules. But those sanctions are imposed by member countries, and authorized by the membership as a whole. This is quite different from other agencies whose bureaucracies can, for example, influence a country's policy by threatening to withhold credit. Reaching decisions by consensus among some 150 members can be difficult. Its main advantage is that decisions made this way are more acceptable to all members. And despite the difficulty, some remarkable agreements have been reached. Nevertheless, proposals for the creation of a smaller executive body - perhaps like a board of directors each representing different groups of countries - are heard periodically. But for now, the WTO is a member-driven, consensus-based organization.

The WTO continues GATT's tradition of making decisions not by voting but by consensus. This allows all members to ensure their interests are properly considered even though, on occasion, they may decide to join a consensus in the overall interests of the multilateral trading system. Where consensus is not possible, the WTO agreement allows

for voting - a vote being won with a majority of the votes cast and on the basis of "one country, one vote". The WTO Agreement envisages four specific situations involving voting:

- An interpretation of any of the multilateral trade agreements can be adopted by a majority of three quarters of WTO members.
- The Ministerial Conference can waive an obligation imposed on a particular member by a multilateral agreement, also through a three-quarters majority.
- Decisions to amend provisions of the multilateral agreements can be adopted through approval either by all members or by a two-thirds majority depending on the nature of the provision concerned. But the amendments only take effect for those WTO members, which accept them.
- A decision to admit a new member is taken by a two-thirds majority in the
   Ministerial Conference, or the General Council in between conferences.
  - Highest authority: the Ministerial Conference: So, the WTO belongs to its members. The countries make their decisions through various councils and committees, whose membership consists of all WTO members. Topmost is the ministerial conference, which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements.
  - Second level: General Council in three guises: Day-to-day work in between the ministerial conferences is handled by three bodies:
    - The General Council
    - The Dispute Settlement Body

The Trade Policy Review Body

All three are in fact the same - the Agreement Establishing the WTO states they are all the General Council, although they meet under different terms of reference. Again, all three consist of all WTO members. They report to the Ministerial Conference. The General Council acts on behalf of the Ministerial Conference on all WTO affairs. It meets as the Dispute Settlement Body and the Trade Policy Review Body to oversee procedures for settling disputes between members and to analyze members' trade policies.

- Third level: councils for each broad area of trade, and more: Three more councils, each handling a different broad area of trade, report to the General Council:
  - The Council for Trade in Goods (**Goods Council**)
  - The Council for Trade in Services (Services Council)
  - The Council for Trade-Related Aspects of Intellectual Property Rights
     (TRIPS Council)

As their names indicate, the three are responsible for the workings of the WTO agreements dealing with their respective areas of trade. Again they consist of all WTO members. The three also have subsidiary bodies. Six other bodies report to the General Council. The scope of their coverage is smaller, so they are "committees". But they still consist of all WTO members. They cover issues such as trade and development, the environment, regional trading arrangements, and administrative issues. The Singapore Ministerial Conference in December 1996 decided to

create new working groups to look at investment and competition policy, transparency in government procurement, and trade facilitation. Two more subsidiary bodies dealing with the plurilateral agreements (which are not signed by all WTO members) keep the General Council informed of their activities regularly.

Fourth level: down to the nitty-gritty: Each of the higher-level councils has subsidiary bodies. The Goods Council has 11 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures and so on). Again, these consist of all member countries. Also reporting to the Goods Council is the Textiles Monitoring Body, which consists of a chairman and 10 members acting in their personal capacities, and groups dealing with notifications (governments informing the WTO about current and new policies or measures) and state trading enterprises.

# 2.5 MEMBERSHIP, ALLIANCES AND BUREAUCRACY

All members have joined the system as a result of negotiation and therefore membership means a balance of rights and obligations. They enjoy the privileges that other member countries give to them and the security that the trading rules provide. In return, they had to make commitments to open their markets and to abide by the rules — those commitments were the result of the membership (or "accession") negotiations. Countries negotiating membership are WTO "observers". Any state or customs territory having full autonomy in the conduct of its trade policies may join ("accede to") the WTO, but WTO members must agree on the terms. Broadly speaking the application goes through four stages: **Firstly,** The government applying for membership has to describe all aspects of its trade and economic policies that have a bearing on WTO agreements. This is

submitted to the WTO in a memorandum, which is examined by the working party dealing with the country's application. These working parties are open to all WTO members; **Secondly, when the working party has made sufficient progress on principles** and policies, parallel bilateral talks begin between the prospective new member and individual countries. They are bilateral because different countries have different trading interests. These talks cover tariff rates and specific market access commitments, and other policies in goods and services. The new member's commitments are to apply equally to all WTO members under normal non-discrimination rules, even though they are negotiated bilaterally. In other words, the talks determine the benefits (in the form of export opportunities and guarantees) other WTO members can expect when the new member joins. (The talks can be highly complicated. It has been said that in some cases the negotiations are almost as large as an entire round of multilateral trade negotiations.); **Thirdly**, once the working party has completed its examination of the applicant's trade regime, and the parallel bilateral market access negotiations are complete, the working party finalizes the terms of accession. These appear in a report, a draft membership treaty ("protocol of accession") and lists ("schedules") of the member-to-be's commitments. **Finally,** the package, consisting of the report, protocol and lists of commitments, is presented to the WTO General Council or the Ministerial Conference. If a two-thirds majority of WTO members vote in favour, the applicant is free to sign the protocol and to accede to the organization. In many cases, the country's own parliament or legislature has to ratify the agreement before membership is complete.

Representatives of member governments undertake the work of the WTO, but its roots lie in the everyday activity of industry and commerce. Trade policies and negotiating positions are prepared in capitals, usually taking into account advice from private firms, business organizations, farmers, consumers and other interest groups. Most countries have a diplomatic mission in Geneva, sometimes headed by a special ambassador to the WTO. Officials from the missions attend meetings of the many councils, committees, working parties and negotiating groups at WTO headquarters. Sometimes expert representatives are sent directly from capitals to put forward their governments' views on specific questions.

Increasingly, countries are getting together to form groups and alliances in the WTO. In some cases they even speak with one voice using a single spokesman or negotiating team. This is partly the natural result of economic integration — more customs unions, free trade areas and common markets are being set up around the world. It is also seen as a means for smaller countries to increase their bargaining power in negotiations with their larger trading partners. Sometimes when groups of countries adopt common positions consensus can be reached more easily. Sometimes the groups are specifically created to compromise and break a deadlock rather than to stick to a common position. But there are no hard and fast rules about the impact of groupings in the WTO. The largest and most comprehensive group is the **European Union** (for legal reasons known officially as the **"European Communities"** in WTO business) and its 15 member states. The EU is a customs union with a single external trade policy and tariff. While the member states coordinate their position in Brussels and Geneva, the European Commission alone speaks for the EU at almost all WTO meetings. The EU is a WTO member in its own right as are each of its member states.

A lesser degree of economic integration has so far been achieved by WTO members in the Association of South East Asian Nations (ASEAN) - Brunei Darussalam, Indonesia, Malaysia, Myanmar, Philippines, Thailand and Singapore. (The three remaining members, Cambodia, Laos and Viet Nam, are applying to join the WTO.) Nevertheless, they have many common trade interests and are frequently able to coordinate positions and to speak with a single voice. The role of spokesman rotates among ASEAN members and can be shared out according to topic. MERCOSUR, the Southern Common Market (Argentina, Brazil, Paraguay and Uruguay, with Bolivia and Chile as associate members), has a similar set-up.

More recent efforts at regional economic integration have not yet reached the point where their constituents frequently have a single spokesman on WTO issues. An example is the North American Free Trade Agreement: NAFTA (Canada, US and Mexico). Among other groupings which occasionally present unified statements are the African Group, the least-developed countries, the African, Caribbean and Pacific Group (ACP) and the Latin American Economic System (SELA).

A well-known alliance of a different kind is the **Cairns Group**. It was set up just before the Uruguay Round began in 1986 to argue for agricultural trade liberalization. The group became an important third force in the farm talks and remains in operation. Its members are diverse, but sharing a common objective - that agriculture has to be liberalized — and the common view that they lack the resources to compete with larger countries in domestic and export subsidies.

The Cairns Group from four continents, members ranging from OECD countries to the least developed: Argentina, Australia, Bolivia, Brazil, Canada, Chile, Colombia, Costa

Rica, Guatemala, Indonesia, Malaysia, New Zealand, Paraguay, Philippines, South Africa, Thailand, and Uruguay

## 2.6 THE WTO SECRETARIAT AND BUDGET

The WTO Secretariat is located in Geneva. It has around 550 staff and is headed by a director-general. Its responsibilities include:

- Administrative and technical support for WTO delegate bodies (councils, committees, working parties, negotiating groups) for negotiations and the implementation of agreements.
- Technical support for developing countries, and especially the least developed.
- Trade performance and trade policy analysis by WTO economists and statisticians.
- Assistance from legal staff in the resolution of trade disputes involving the interpretation of WTO rules and precedents.
- Dealing with accession negotiations for new members and providing advice to governments considering membership.

Some of the WTO's divisions are responsible for supporting particular committees: the Agriculture Division assists the committees on agriculture and on sanitary and phytosanitary measures, for example. Other divisions provide broader support for WTO activities: technical cooperation, economic analysis, and information, for example. The WTO budget is over 150 million Swiss francs with individual contributions calculated on the basis of shares in the total trade conducted by WTO members. Part of the WTO budget also goes to the International Trade Centre.

A director-general heads the WTO Secretariat. Divisions come directly under the director-general or one of his deputies (see graphics 2.2).

# **Graphics: 2.2**

Director-general Supachai Panitchpakdi	Office of the director-general: administrative support for (disputes) Appellate Body, Textiles Monitoring Body
Deputy director-general Roderick Abbott	Administration and General Services Division: budget, finance, administration and human resources Informatics Division Language Services and Documentation Division Market Access Division: Goods Council, market access, tariffs, trade facilitation (simplification of trade procedures), customs valuation, non-tariff measures, import licensing, rules of origin, preshipment inspection Trade and Environment Division: trade and environment, technical barriers to trade, etc Trade Policies Review Division: trade policy reviews, regional trade agreements
Deputy director-general Kipkorir Aly Azad Rana	Development Division: trade and development, least-developed countries Economic Research and Statistics Division Training and Technical Cooperation Institute Technical Cooperation Audit Textiles Division Trade and Information Centre and Library: helping developing countries, members without representatives in Geneva, and others to participate fully; the WTO library
Deputy director-general Francisco Thompson-Flòres	Agriculture and Commodities Division: agriculture, sanitary and phytosanitary measures, etc Council and Trade Negotiations Committee Division: General Council, Dispute Settlement Body, Trade Negotiations Committee (DDA), etc External Relations Division: relations with intergovernmental and non-governmental organizations, protocol Intellectual Property Division: TRIPS, competition and government procurement Trade and Finance Division: TRIMs, trade and investment, trade, debt and finance, balance of payments, links with IMF and World Bank, etc
Deputy director-general Rufus Yerxa	Accessions Division: negotiations to join the WTO Information and Media Relations Division Legal Affairs Division: Dispute settlement, etc Rules Division: anti-dumping, subsidies, safeguards, state trading, civil aircraft, etc Trade in Services: GATS etc.

Source: www.wto.org.

## 2.7 SUMMARY

The principle and agreement of WTO have very significant impact on the business environment. The Uruguay Round substantially expanded the scope of the international trade negotiation by including services, intellectual property rights and trade related aspects of investment measures, as against only goods in the past. With effect from January 1, 1995, GATT was replaced by a permanent organisation, WTO. WTO is GATT plus a lot more. Under the GATT there was only one major agreement-GATT. Under the WTO, there are agreements related to three major areas - GATT, GATs, TRIPs. Further, WTO is more powerful and effective organisation than GATT. It has a more effective dispute settlement mechanism.

# 2.8 SELF-TEST QUESTIONS

- 1. What do you mean by the working of WTO?
- 2. What is the origin of WTO? Explain.
- 3. Detail the functions of WTO.
- 4. Explain the structure of WTO.
- **5.** Explain the process to become a member of WTO.

## 2.9 SUGGESTED READINGS

- Cherrunilam, Francis, (2003), Business Environment, New Delhi: Vikas
   Publishing House Private Limited.
- Rao, M.B. (2001), "WTO & International Trade", New Delhi: Vikas Publishing House Private Limited.
- WTO (2005), "WTO Reports", http://www.wto.org/english.htm, March.

SUBJECT: Business Environment

COURSE CODE: MC-103 Author: Dr. Karam Pal LESSON: 03 Vetter: Dr. B S Bodla

## VARIOUS ASPECTS OF BUSINESS ENVIRONMENT

**Objective :** The objective of this lesson is to acquaint the students about the business environment and its various aspects/constituents.

#### Structure:

- 3.1 Introduction
- 3.2 Constituents of Business Environment
  - 3.2.1 Internal Environmental Factors
  - 3.2.2 External Environmental Factors
- 3.3 Summary
- 3.4 Self Assessment Exercise
- 3.5 Suggested Readings

## 3.1 INTRODUCTION

Today a greater attention is given to the environmental analysis as it is an essential prerequisite for a successful business journey. But prior to that we should look into the term 'business'. In the lay man's language "business is an activity through which one earns profit". According to Prof. L.H. Hanney, "Business means human activity directed towards producing or acquiring wealth through buying and selling goods". But

this definition does not cover certain rules and regulations framed by the government from time to time to regulate the business activities.

K. Ashwathappa defines the business that "It is a complex field of commerce and industry in which goods and services are created and distributed in the hope of profit within a framework of laws and regulations". Thus business is an economic activity performed by human connected with the production and exchange of goods and services with a profit motive under the laws and regulations of the country. Now let's discuss business environment.

## 3.2 CONSTITUENTS OF BUSINESS ENVIRONMENT

Every business firm consists of a set of internal factors and it also confronts with a set of external factors. The present figure gives you a more clear and comprehensive picture about the different factors.

#### **BUSINESS ENVIRONMENT**

#### 3.2.1 Internal Environment

There are number of factors which influence the various strategies and decisions within the organization's boundaries. These factors are known as internal factors and are given below:

- **Human Resources:** It involves the planning, acquisition, and (a) development of human resources necessary for organizational success. It points out that people are valuable resources requiring careful attention and nurturing. Progressive and successful organizations treat all employees as valuable human resources. The organization's strengths and weaknesses is also determined by the skill, quality, morale, commitment and attitudes of the employees. Organizations face difficulties while carrying out modernizations or restructuring process by the resistance of employees. So, the issues related to morale and attitudes should seriously be considered by the management. Moreover, global competitive pressures have made the skillful management of human resources more important than ever. The support from the different levels of employees support the management in the different decisions and their implementations.
- (b) Company Image: One company issues shares and debentures to the public to raise money and its instruments are over subscribed while the other company seeks the help of different intermediaries like underwriters to generate finance from the public. This difference underlies the distinction between the images of the two

companies. The image of the company also matters in certain other decisions as well like forming joint ventures, entering contracts with the other company or launching of new products etc. Therefore, building company image should also be a major consideration for the managers.

- carried out by the single entrepreneur or in the formation of partnerships. Now it has reshaped itself into the formation of company where it is run and controlled by the board of directors who influence almost every decision. Therefore, the composition of board of directors and nominees of different financial institutions could be very decisive in several critical decisions. The extent of professionalisation is also a crucial factor while taking business decisions.
- (d) Physical Assets: To enjoy economies of scale, smooth supply of produced materials, and efficient production capacity are some of the important factors of business which depends upon the physical assets of an organization. These factors should always be kept in mind by the managers because these play a vital role in determining the competitive status of a firm or an organization.
- (e) R & D and Technological Capabilities: Technology is the application of organized knowledge to help solve problems in our society. The organizations which are using appropriate technologies enjoy a better competitive advantage than that of their

competitors. The organizations which do not possess strong Research and Development departments always lag behind in innovations which seems to be a prerequisite for success in today's business. Therefore, R & D and technological capabilities of an organization determine a firm's ability to innovate and compete.

- base of marketing resources like talented marketing men, strong brand image, smart sales persons, identifiable products, wider and smooth distribution network and high quality of different services, make an effortless inroads in the target market. The companies which are having so strong basis can also enjoy the fruits of brand extension, form extension and new product introduction etc. in the market.
- **(g) Financial Factors:** The performance of the organization is also affected by the certain financial factors like capital structure, financial position etc. Certain strategies and decisions are determined on the basis of such factors. The ultimate survival of organizations in both the public and private sectors is dictated largely by how proficiently available funds are managed.

So, these were some of factors related to the internal environment of an organization. These factors are generally regarded as controllable factors because the organization commands control over these factors and can modify or alter as per the requirement of the organization.

#### 3.2.2 External Environment

Companies operate in the external environment that forces and shape opportunities as well as threats. These forces represent "noncontrollable", which the company must monitor and respond to. SWOT (Strengths, weaknesses, opportunities and threats) analysis is very much essential for the business policy formulation which one could do only after examination of external environment. The external business environment consists of macro environment and micro environment.

**Micro Environment :** The company's immediate environment where routine activities are affected by the certain actors. Suppliers, marketing intermediaries, competitors, customers and the publics operate within this environment. It is not necessary that the micro factors affect all the firms. Some of the factors may affect a particular firm and do not disturb to the other ones. So, it depends that to what type of industry a firm belongs. Now let's discuss in brief some of the micro environmental factors.

(a) Suppliers: The supplier to a firm can alter its competitive position and marketing capabilities. These can be raw material suppliers, energy suppliers, suppliers of labour and capital. The relationship between suppliers and the firm epitomizes a power equation between them. This equation is based on the industry conditions and the extent to which each of them is dependent on the other. For the smooth functioning of business, reliable source of supply is a prerequisite. If any kind of uncertainties prevail regarding the supply of the raw materials, it often compels to a firm to maintain a high inventory which ultimately leads to the higher cost of

production. Therefore, dependence on a single supplier is a risky venture. Because of the sensitivity of the issue, firm should go to develop relations among the different suppliers otherwise it could lead to a chaotic situation. Simultaneously firms should reduce the stock so as to reduce the costs.

- (b) Customers: According to Peter F. Drucker "the motive of the business is to create customers", because a business survives only due to its customers. Successful companies recognize and respond to the unmet needs of the consumers profitably and in continuous manner. Because unmet needs always exist, companies could make a fortune if they meet those needs. For example it is the era when we could witness the increasing participation of women in the different jobs which has already given birth to the child care business, increased consumption of different durable items like microwave ovens, washing machines and food processors etc. A firm should also target the different segments on the basis of their tastes and preferences because to depend upon a single customer is often risky. So, monitoring the customer sensitivity is a pre condition for the success of business.
- (c) Competitors: A firm's products/services are also affected by the nature and intensity of competition in an industry. A firm should extend its competitive analysis to include substitutes also besides scanning direct competitors. The objective of such an analysis is to assess and predict each competitors response to changes in the firm's strategy and industry conditions. This kind of analysis not

only ensures the firm's competitive position in the market but also able to pick up as its major rival in the industry. Besides the existing competitors, it is also necessary to have an eye on the potential competitors who may join the industry although forecasting of such competitors is a difficult task. Thus an analysis of competition is critical for not only evolving competitive strategy but also for strengthening a firm's capabilities.

- Marketing Intermediaries: Marketing intermediaries provide a (d) vital links between the organization and the consumers. These people include middlemen such as agents or brokers who help the firm to find out its customers. Physical distribution firms such as stockiest or warehouse providers or transporters ensure the smooth supply of the goods from their origin to the final destination. There are certain marketing research agencies which assist the organization in finding out the consumers so that they can target and promote their products to the right consumers. Financial middlemen are also there who carry out to finance the marketing activities such as transportation and advertising etc. A firm should ensure that the link between organization and intermediaries is appropriate and smooth because a wrong choice of the link may cost the organization heavily. Therefore, a continuous vigil of all the intermediaries is a must.
- **(e) Publics:** an organization has to confront with many types of publics during its life time. According to Cherrunilam "A public is any group that has an actual or potential interest in or impact on

an organization's ability to achieve its interests". The public includes local publics, media publics and action groups etc. The organizations are affected by the certain acts of these publics depending upon the circumstances. For example if a business unit is establishment in a particular locality then it has to provide employment to the localites at least to the unskilled labour otherwise local group may harm to that very business or they will interrupt the functioning of the business. The media public has also to be taken into confidence because some time they tarnish the image of the organization unnecessarily. Simultaneously media public may disseminate vital information to the target audience. Action groups can also create hindrances in the name of exploitation of consumers or on the issue of environmental pollution. The business suffers due to their activities.

Therefore, their concern should also be kept in mind. Albeit, it is wrong to think that all publics are threats to the business yet their concerns should be considered up to a certain level.

**Macro Environment:** With the rapidly changing scenario, the firm must monitor the major forces like demographic, economic, technological, political/legal and social/cultural forces. The business must pay attention to their casual interactions since these factors set the stage for certain opportunities as well as threats. These macro factors are, generally, more uncontrollable than the micro factors. A brief discussion on the important macro environmental factors are given below:

**Demographic Environment :** The first macro environmental factor that businessmen monitor is population because business is people and they create markets. Business people are keenly interested in the size and growth rate of population across the different regions, age distribution, educational levels, household patterns, mixture of different racial groups and regional characteristics. For determining the success of the business and to sustain in the market, incessant watching of these demographic factors is a prerequisite. To enter into a particular segment, a marketer needs to understand the age composition in that very segment so as to decide the optimal marketing mix and also take certain strategic decisions related to it. For example, if the youth form a large proportion of the population, it is but natural for firms to develop their products according to the requirement of this group. Besides the age, it is also necessary to break up population according to sex-wise and also the role of women. Today we can observe that more and more women have taken to work and professions and hence it can be seen that many time saving appliances are available in the market. Each gender group has different range of product and service needs and media and retail preferences, which helps marketers fine-tune their market offers.

(a)

There is yet another dimension of population changes which a businessman needs to address. For example, occupation and literacy profile of the targeted segment. The higher literacy level will imply a more demanding consumer as he is in the touch of the various media which acquaint him with many information on the other hand low literacy make the marketers look for other method of communication. The occupation of the population also affects the choice of the products range and media habits. Any significant moves of the population from one area to another, rural to urban, is another important environmental factor which determines the marketing attention. For example, the movement from north-India to South-India will reduce the demand for warm clothing and home heating equipment on the one hand and will increase the demand for air conditioning on the other hand. So, the companies that carefully analyze their markets can find major opportunities.

- (b) Economic Environment: Besides people, markets require purchasing power and that depends upon current income, savings, prices, debt and credit facilities etc. The economic environment affects the demand structure of any industry or product. The following factors should always be kept in mind by the business people to determine the success of the business.
  - (i) Per capita income
  - (ii) Gross national product
  - (iii) Fiscal and monitory policies
  - (iv) Ratio of interest changed by different financial institutions
  - (v) Industry life cycle and current phase

# (vi) Trends of inflation or deflation

Each of the above factors can pose an opportunity as well as threat to a firm. For example, in a developing economy, the low demand for the product is due to the low income level of the people. In such a situation a firm or company can not generate the purchasing power of the people so as to generate the demand of the products. But it can develop a low priced product to suit the low income market otherwise it will be slipped out from the market. Similarly, an industry gets a number of incentives and support from the government if it comes under the purview of priority sector whereas some industries face tough task if they are regarded as inessential ones.

In the industry life cycle, timing is every thing when it comes to making good cycle-sensitive decisions. The managers need to make appropriate cutbacks prior to the onslaught of recession because at that time sales is bound to decline which leads to increasing inventories and idle resources and that is costly situation. On the other hand, business people cannot afford to get caught short during a period of rapid expansion. This is where accurate economic forecasts are a necessity and therefore, a manager must pay careful attention to the major economic changes.

(c) **Technological Environment :** Technology is a term that ignites passionate debates in many circles these days. According to some people technology have been instrumental for environmental

destruction and cultural fragmentation whereas some others view that it has been the main cause to economic and social progress. But no doubt it has released wonders to world such as penicillin, open-heart surgery, family planning devices and some other blessings like automobile, cellular phones and internet services etc. It has also been responsible for hydrogen bomb and nerve gas. But the businesses that ignored technological developments, had to go from the world map. For example, in India, cars like Ambassador and Premier had to go from the scene because of obsolete technology. Likewise, containerized movement of goods, deep freezers, trawlers fitted with freezers etc. have affected the operations of all firms including those involved in seafood industry. Now it has been ensured that perishable goods can be transported in a safer manner. Explosion in information technology have made the position of some firms vulnerable. The life cycle of the products have reduced and expectations of the consumers are becoming higher and higher due to all these technological changes. But to cope up with this kind of scenario, a continuous vigil of the happenings and adequate investment on R & D department is to be earmarked by the marketer. Marketers must also be aware of certain government regulations while developing and launching new products with latest technological innovations.

(d) Political/Legal Environment: Business decisions are strongly affected by developments in the political and legal environment.
This environment is consists of laws, regulations and policies that

influence and limit various organizations. Sometimes these laws create opportunities for the business but these also pose certain odds or threats at the other time. For example, if the government specifies that certain products need mandatory packaging then it will boost the cardboard and packaging companies but it will add to the cost of the product. Regulations in advertising, like a ban on advertisement of certain products like liquor, cigarettes and pan masalas and hoarding of food products, gas and kerosene are the reality of today's business. Business legislations ensure specific purposes to protect business itself and the society as well like unfair competitions, to protect consumers from unfair business practices and to protect the interest of the society from unbridled business behaviour. In India business is regulated through certain laws like Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act), Foreign Exchange and Regulation Act, 1973 (FERA), Partnership Act 1932, Consumer Protection Act, 1986 (CPA), and Companies Act, 1956 etc. A businessman needs to understand the various policies and political ideologies because these things have a profound impact on the functioning and success of the business.

(e) Social-cultural Environment: Society shapes the beliefs, values, norms, attitudes, education and ethics of the people in which they grow up and these factors exercise a great influence on the businesses which by far are beyond the company's control. All these factors are classified as social-cultural factors of the business. The buying and consumption pattern of the people are

very much determined by these factors and cost of ignoring the customs, tastes and preferences etc. of the people could be very high for a business. Consumers depend on cultural prescriptions to guide their behaviour, and they assume that others will behave in ways that are consistent with their culture. Culture unites a group of people in a unique way and support the group's unity. As consumers, people expect that businessman will deliver according to the values, customs and rituals of the existing culture. As the business is going global day by day and the world is at the verge of 'global village' the need for developing understanding cultural differences has become an essential element to survive in such a scenario.

Therefore, the marketers who wish to be the part of the ongoing process need to understand the process of acculturation so that they can develop ways to handle the consumers of different cultures. People's attitudes toward business is also determined by the culture. What is right and what is wrong are basic to all businesses and for doing or not doing a particular work is judged on the basis of prevalent culture and also determines certain ethical code of conduct.

Despite the pervasive nature of culture, not all the people within a society think, feel, and act the same way. Every society has subculturesgroup of people that share values but exhibit them in different ways. Within a society such as the India, there are the different tastes and preferences of the different starta like a Punjabi or a north Indian has altogether different preferences then that of a South Indian in the name

of certain products especially in case of food and clothing and the shrewd marketers have always capitalized on this kind of opportunities. Hence, a thorough understanding of social-cultural environment is imperative to be successful.

#### 3.3 SUMMARY

Business environment can be classified into two major categories: the economic environment and the non-economic environment. The economic environment consists of factors like the fiscal policy, the monetary policy, the industrial policy, the physical limits on output, the price and income equation, nature of the economic system, the pace of the economic development, etc.

The non-economic environment refers to social, cultural and political, legal, technological factors, etc. Despite this segregation, the economic environment has economic implications. In today's business environment, considerable sell and dexterity is required in adjusting, coping with and managing the environment of business. This becomes more so due to the changing nature of today's business context.

Business environment refers to all factors that have a direct or indirect bearing on the functioning of the business. Every business firm encounters with a set of internet and external factors. The internal environment consists of the factors which influence the various strategies and decisions which happen within an organization's

boundaries. These factors include human resources, company image, management structure, physical assets, technological capabilities, marketing resources, and financial factors. The external environment comprises of micro and macro environmental factors. Micro environment is just and immediate environment of the firm which include suppliers, consumers, competitors, intermediaries and publics. These factors are generally regarded as controllable factors because the organization commands control over these factors and can modify or alter as per the requirements of the organization.

The businessmen must monitor the major macro environmental factors which include demographic, economic, political/legal, technological and social/cultural factors. In the demographic environment, marketers must be aware of growth of population, composition of age, educational levels and geographic shifts in population. In the economic arena, they need to focus on per capita income, distribution of income, saving pattern and credit availability etc. In the technological factors, accelerating pace of technological changes, opportunities for innovation and increased regulations of the government towards adopting technology are the main concerns to be monitored. In the political/legal factors, businessmen must work within the laws and regulations so as to protect their as well society's interest. Finally, in the social/cultural environment, marketers must understand the prevalent culture and its nature and must address the needs of different subcultures within a society. A continuous and vibrant monitoring of the environment is indispensable for business growth. The environment in which an organization exists could be broadly divided into two parts: external and internal environment. We began by

aging an understanding of the concept of environment. This is done through a description of four important characteristics of the environment leading its external and internal parts.

We see how the external environment, especially that part which is more relevant to an organization can be divided into different components. For the purpose of understanding and analysis we have discussed many components of the external environment - social, political, economic, regulatory, market, supplier and technological. For each component we have explained through appropriate illustrations, the type of factors and influences which operate in that part of the environment. The significance of these factors for the strategic management of the organization has also been highlighted.

Organizational strategic capability could be understood in terms of strengths and weaknesses existing in the different functional areas of an organization. We have considered five such areas - finance, marketing, operations, personnel and general management. For each of these, we have mentioned the important factors influencing them and through examples clarified the nature of the various functional capability factors.

Environmental analysis is a crucial part of the strategic management process. If the environment is ignored (or partially ignored) by strategic decision makers, the process cannot be effective. Effective strategists try to anticipate what is coming or attempt to influence the environment in favourable directions.

The environmental strategic analyst interrelates with the formation of objectives, the generation of alternative strategies and the other aspects of strategic management.

#### 3.4 SELF ASSESSMENT EXERCISE

- 1. What is business environment? Write down its main ingredients.
- 2. Define business environment? Discuss in brief the factors that constitute business environment.
- 3. "Firms which systematically analyze and diagnose the environment are more effective than those which don't". Elucidate.
- 4. Discuss how the demographic and technological trend that could affect the future of the business.
- 5. Describe the various external factors that influence the business policy of an organization.
- 6. Explain the various internal factors that influence business policies.

### 3.5 SUGGESTED READINGS

- K. Ashwathappa, Business Environment for Strategic Management, Himalaya Publishing House, Mumbai.
- 2. Francis Cherrunilam, Business Environment, Himalaya Publishing House, New Delhi.
- 3. S.K. Misra and V.K. Puri, Indian Economy, Himalaya Publishing House, New Delhi.

4. B.B. Tandon and K.K. Tandon, Indian Economy, Tata McGraw Hill, New Delhi.

SUBJECT: Business Environment

COURSE CODE: MC-103 Author: Ms. Richa Verma LESSON: 04 Vetter: Dr. Karam Pal

# GLOBALISATION: TRENDS AND ISSUES

**Objective:** The objective of this lesson is to make the students aware about the concepts of

globalization and the related issues.

### **Lesson Structure**

- 4.1 Introduction
- 4.2 What is Globalization?
- 4.3 Unparalleled Growth, Increased Inequality: 20<sup>th</sup> Century Income Trends
- 4.4 Developing countries: How deeply integrated?
- 4.5 Does Globalization Increase Poverty and Inequality?
- 4.6 How Can the Poorest Countries Catch Up More Quickly?
- 4.7 Does Globalization Harm Workers' Interests?
- 4.8 Are Periodic Crises an Inevitable Consequence of Globalization?
- 4.9 The Role of Institutions and Organizations
- 4.10 Indian Economy: Recent Trend of Globalization and Liberalization
- 4.11 A Look to Current Phase of Globalization
- 4.12 Summary
- 4.13 Self Assessment Exercise

### 4.14 Suggested Reading

## 4.1 Introduction

The term "globalization" has acquired considerable emotive force. Some view it as a process that is beneficial—a key to future world economic development—and also inevitable and irreversible. Others regard it with hostility, even fear, believing that it increases inequality within and between nations, threatens employment and living standards and thwarts social progress. This brief offers an overview of some aspects of globalization and aims to identify ways in which countries can tap the gains of this process, while remaining realistic about its potential and its risks.

Globalization offers extensive opportunities for truly worldwide development but it is not progressing evenly. Some countries are becoming integrated into the global economy more quickly than others. Countries that have been able to integrate are seeing faster growth and reduced poverty. Outward-oriented policies brought dynamism and greater prosperity to much of East Asia, transforming it from one of the poorest areas of the world 40 years ago. And as living standards rose, it became possible to make progress on democracy and economic issues such as the environment and work standards.

By contrast, in the 1970s and 1980s when many countries in Latin America and Africa pursued inward-oriented policies, their economies stagnated or declined, poverty

increased and high inflation became the norm. In many cases, especially Africa, adverse external developments made the problems worse. As these regions changed their policies, their incomes have begun to rise. An important transformation is underway. Encouraging this trend, not reversing it, is the best course for promoting growth, development and poverty reduction.

The crises in the emerging markets in the 1990s have made it quite evident that the opportunities of globalization do not come without risks—risks arising from volatile capital movements and the risks of social, economic, and environmental degradation created by poverty. This is not a reason to reverse direction, but for all concerned—in developing countries, in the advanced countries, and of course investors—to embrace policy changes to build strong economies and a stronger world financial system that will produce more rapid growth and ensure that poverty is reduced.

How can the developing countries, especially the poorest, be helped to catch up? Does globalization exacerbate inequality or can it help to reduce poverty? And are countries that integrate with the global economy inevitably vulnerable to instability? These are some of the questions covered in the following sections.

### 4.2 What is Globalization?

Economic "globalization" is a historical process, the result of human innovation and technological progress. It refers to the increasing integration of economies around the world, particularly through trade and financial flows. For developing counties, it means integration with the world economy. In economic terms, globalization refers to the

process of integration of world into one huge market. Such unification calls for the removal of all trade barriers among countries. Even political and geographical barriers become irrelevant. The term sometimes also refers to the movement of people (labor) and knowledge (technology) across international borders. There are also broader cultural, political and environmental dimensions of globalization that are not covered here.

At its most basic, there is nothing mysterious about globalization. The term has come into common usage since the 1980s, reflecting technological advances that have made it easier and quicker to complete international transactions—both trade and financial flows. It refers to an extension beyond national borders of the same market forces that have operated for centuries at all levels of human economic activity—village markets, urban industries, or financial centers.

Markets promote efficiency through competition and the division of labor—the specialization that allows people and economies to focus on what they do best. Global markets offer greater opportunity for people to tap into more and larger markets around the world. It means that they can have access to more capital flows, technology, cheaper imports, and larger export markets. But markets do not necessarily ensure that the benefits of increased efficiency are shared by all. Countries must be prepared to embrace the policies needed, and in the case of the poorest countries may need the support of the international community as they do so.

A company which has gone global is called a Multinational (MNC) or a Transnational (TNC). An MNC is, therefore, one that, by operating in more than one country, gains through Research and Development, leading to substantial production, marketing and

financial advantages in its costs and reputation that are not available to purely domestic competitors. The global company views the world as one market, minimize the importance of national boundaries, raises capital and markets, wherever it can do the job best. Globalization encompasses the following:

- It is a conglomerate of multiple units (located in different parts of the globe) but all linked by common ownership.
- Giving up the distinction between the domestic market and foreign market and developing a global outlook of the business.
- Multiple units draw on a common pool of resources such as money, credit, information, patents, trade names and control systems. Thus, global orientation of organizational structure and management culture.
- Locating the production and other physical facilities on a consideration of the global business dynamics, irrespective of national considerations.
- The units respond to some common strategy. Basing product development and production planning on global market considerations.
- Global sourcing of factors of productions, i.e. raw materials, components, machinery/technology, finance etc., are obtained from best the best source anywhere in the world.

Companies which have adopted a global outlook stop "thinking of themselves as national marketers who venture abroad and start thinking of themselves as global marketers. Nestle international is an example of an enterprises that has become multinational. It sells its products in most countries and manufactures in many. Besides managers and shareholders

are from many nations. The other MNCs whose names can be mentioned here are IBM, GE, McDonald, Ford, Shell, Philips, Sony and Uniliver etc.

# 4.3 Unparalleled Growth, Increased Inequality: 20<sup>th</sup> Century Income Trends

Globalization is not just a recent phenomenon. Some analysts have argued that the world economy was just as globalizes 100 years ago as it is today. But today commerce and financial services are far more developed and deeply integrated than they were at that time. The most striking aspect of this has been the integration of financial markets made possible by modern electronic communication.

The 20<sup>th</sup> century saw unparalleled economic growth, with global per capita GDP increasing almost five-fold. But this growth was not steady the strongest expansion came during the second half of the century, a period of rapid trade expansion accompanied by trade and typically somewhat later, financial liberalization. In the inter-war era, the world turned its back on internationalism or globalization as we now call it and countries retreated into closed economies, protectionism and pervasive capital controls. This was a major factor in the devastation of this period, when per capita income growth fell to less than 1 percent during 1913-1950. For the rest of the century, even though population grew at an unprecedented pace, per capita income growth was over 2 percent, the fastest pace of all coming during the post-World War boom in the industrial countries.

The story of the 20<sup>th</sup> century was of remarkable average income growth, but it is also quite obvious that the progress was not evenly dispersed. The gaps between rich and poor

countries, and rich and poor people within countries, have grown. The richest quarter of the world's population saw its per capita GDP increase nearly six-fold during the century, while the poorest quarter experienced less than a three-fold increase. Income inequality has clearly increased. But, as noted below, per capita GDP does not tell the whole story.

# 4.4 Developing countries: How deeply integrated?

Globalization means that world trade and financial markets are becoming more integrated. But just how far have developing countries been involved in this integration? Their experience in catching up with the advanced economies has been mixed. In some countries, especially in Asia, per capita incomes have been moving quickly toward levels in the industrial countries since 1970. A larger number of developing countries have made only slow progress or have lost ground. In particular, per capita incomes in Africa have declined relative to the industrial countries and in some countries have declined in absolute terms. Consider four aspects of globalization:

• Trade: Developing countries as a whole have increased their share of world trade—from 19 percent in 1971 to 29 percent in 1999. But there is great variation among the major regions. For instance, the newly industrialized economies (NIEs) of Asia have done well, while Africa as a whole has fared poorly. The composition of what countries export is also important. The strongest rise by far has been in the export of manufactured goods. The share of primary commodities in world exports—such as food and raw materials—that are often produced by the poorest countries, has declined.

- Capital movements: what many people associate with globalization, sharply increased private capital flows to developing countries during much of the 1990s. It also shows that (a) the increase followed a particularly "dry" period in the 1980s; (b) net official flows of "aid" or development assistance have fallen significantly since the early 1980s; and (c) the composition of private flows has changed dramatically. Direct foreign investment has become the most important category. Both portfolio investment and bank credit rose but they have been more volatile, falling sharply in the wake of the financial crises of the late 1990s.
- Movement of people: Workers move from one country to another partly to find better employment opportunities. The numbers involved are still quite small, but in the period 1965-90, the proportion of labor forces round the world that was foreign born increased by about one-half. Most migration occurs between developing countries. But the flow of migrants to advanced economies is likely to provide a means through which global wages converge. There is also the potential for skills to be transferred back to the developing countries and for wages in those countries to rise.
- Spread of knowledge (and technology): Information exchange is an integral, often overlooked, aspect of globalization. For instance, direct foreign investment brings not only an expansion of the physical capital stock, but also technical innovation. More generally, knowledge about production methods, management techniques, export markets and economic policies is available at very low cost, and it represents a highly valuable resource for the developing countries.

The special case of the economies in transition from planned to market economies they too are becoming more integrated with the global economy are not explored in much depth here. In fact, the term "transition economy" is losing its usefulness. Some countries (e.g. Poland, Hungary) are converging quite rapidly toward the structure and performance of advanced economies. Others (such as most countries of the former Soviet Union) face long-term structural and institutional issues similar to those faced by developing countries.

# 4.5 Does Globalization Increase Poverty and Inequality?

During the 20th century, global average per capita income rose strongly, but with considerable variation among countries. It is clear that the income gap between rich and poor countries has been widening for many decades. The most recent *World Economic Outlook* studies 42 countries (representing almost 90 percent of world population) for which data are available for the entire 20<sup>th</sup> century. It reaches the conclusion that output per capita has risen appreciably but that the distribution of income among countries has become more unequal than at the beginning of the century.

But incomes do not tell the whole story; broader measures of welfare that take account of social conditions show that poorer countries have made considerable progress. For instance, some low-income countries, e.g. Sri Lanka, have quite impressive social indicators. One recent paper finds that if countries are compared using the UN's Human Development Indicators (HDI), which take education and life expectancy into account, then the picture that emerges is quite different from that suggested by the income data alone.

Indeed the gaps may have narrowed. A striking inference from the study is a contrast between what may be termed an "income gap" and an "HDI gap". The (inflation-adjusted) income levels of today's poor countries are still well below those of the leading countries in 1870. And the gap in incomes has increased. But judged by their HDIs, today's poor countries are well ahead of where the leading countries were in 1870. This is largely because medical advances and improved living standards have brought strong increases in life expectancy.

But even if the HDI gap has narrowed in the long-term, far too many people are losing ground. Life expectancy may have increased but the quality of life for many has not improved, with many still in abject poverty. And the spread of AIDS through Africa in the past decade is reducing life expectancy in many countries.

This has brought new urgency to policies specifically designed to alleviate poverty. Countries with a strong growth record, pursuing the right policies, can expect to see a sustained reduction in poverty, since recent evidence suggests that there exists at least a one-to-one correspondence between growth and poverty reduction. And if strongly propoor policies for instance in well-targeted social expenditure are pursued then there are a better chance that growth will be amplified into more rapid poverty reduction. This is one compelling reason for all economic policy makers, including the IMF, to pay heed more explicitly to the objective of poverty reduction.

# 4.6 How Can the Poorest Countries Catch Up More Quickly?

Growth in living standards springs from the accumulation of physical capital (investment) and human capital (labor), and through advances in technology (what economists call total factor productivity). Many factors can help or hinder these processes. The experience of the countries that have increased output most rapidly shows the importance of creating conditions that are conducive to long-run per capita income growth. Economic stability, institution building, and structural reform are at least as important for long-term development as financial transfers, important as they are. What matters is the whole package of policies, financial and technical assistance, and debt relief if necessary. Components of such a package might include:

- Macroeconomic stability to create the right conditions for investment and saving;
- Outward oriented policies to promote efficiency through increased trade and investment;
- Structural reform to encourage domestic competition;
- Strong institutions and an effective government to foster good governance;
- Education, training, and research and development to promote productivity;
- External debt management to ensure adequate resources for sustainable development.

All these policies should be focused on country-owned strategies to reduce poverty by promoting pro-poor policies that are properly budgeted including health, education, and strong social safety nets. A participatory approach, including consultation with civil society, will add greatly to their chances of success. Advanced economies can make a vital contribution to the low-income countries' efforts to integrate into the global economy:

- *By promoting trade*. One proposal on the table is to provide unrestricted market access for all exports from the poorest countries. This should help them move beyond specialization on primary commodities to producing processed goods for export.
- By encouraging flows of private capital to the lower-income countries, particularly
  foreign direct investment, with its twin benefits of steady financial flows and technology
  transfer.
- By *supplementing more rapid debt relief* with an increased level of new financial support.

  Official development assistance (ODA) has fallen to 0.24 percent of GDP (1998) in advanced countries (compared with a UN target of 0.7 percent). As Michel Camdessus, the former Managing Director of the IMF put it: "The excuse of aid fatigue is not credible indeed it approaches the level of downright cynicism at a time when, for the last decade, the advanced countries have had the opportunity to enjoy the benefits of the peace dividend."

The IMF supports reform in the poorest countries through its new Poverty Reduction and Growth Facility. It is contributing to debt relief through the initiative for the heavily indebted poor countries.

## 4.7 Does Globalization Harm Workers' Interests?

Anxiety about globalization also exists in advanced economies. How real is the perceived threat that competition from "low-wage economies" displaces workers from high-wage jobs and decreases the demand for less skilled workers? Are the changes taking place in

these economies and societies a direct result of globalization? Economies are continually evolving and globalization is one among several other continuing trends.

- One such trend is that as industrial economies mature, they are becoming more service-oriented to meet the changing demands of their population.
- *Another* trend is the shift toward more highly skilled jobs.

But all the evidence is that these changes would be taking place not necessarily at the same pace with or without globalization. In fact, globalization is actually making this process easier and less costly to the economy as a whole by bringing the benefits of capital flows, technological innovations, and lower import prices. Economic growth, employment and living standards are all higher than they would be in a closed economy.

But the gains are typically distributed unevenly among groups within countries, and some groups may lose out. For instance, workers in declining older industries may not be able to make an easy transition to new industries.

What is the appropriate policy response? Should governments try to protect particular groups, like low-paid workers or old industries, by restricting trade or capital flows? Such an approach might help some in the short-term, but ultimately it is at the expense of the living standards of the population at large. Rather, governments should pursue policies that encourage integration into the global economy while putting in place measures to help those adversely affected by the changes. The economy as a whole will prosper more from policies that embrace globalization by promoting an open economy, and, at the same time, squarely

address the need to ensure the benefits are widely shared. Government policy should focus on two important areas:

- education and vocational training, to make sure that workers have the opportunity to acquire the right skills in dynamic changing economies; and
- well-targeted social safety nets to assist people who are displaced.

## 4.8 Are Periodic Crises an Inevitable Consequence of Globalization?

The succession of crises in the 1990s—Mexico, Thailand, Indonesia, Korea, Russia, and Brazil—suggested to some that financial crises are a direct and inevitable result of globalization. Indeed one question that arises in both advanced and emerging market economies is whether globalization makes economic management more difficult (Box 1).

Clearly the crises would not have developed as they did without exposure to global capital markets. But nor could these countries have achieved their impressive growth records without those financial flows.

These were complex crises, resulting from an interaction of shortcomings in national policy and the international financial system. Individual governments and the international community as a whole are taking steps to reduce the risk of such crises in future.

At the **national level,** even though several of the countries had impressive records of economic performance, they were not fully prepared to withstand the potential shocks that could come through the international markets. Macroeconomic stability, financial

soundness, open economies, transparency, and good governance are all essential for countries participating in the global markets. Each of the countries came up short in one or more respects.

#### Box 1. Does globalization reduce national sovereignty in economic policy-making?

Does increased integration, particularly in the financial sphere make it more difficult for governments to manage economic activity, for instance by limiting governments' choices of tax rates and tax systems, or their freedom of action on monetary or exchange rate policies? If it is assumed that countries aim to achieve sustainable growth, low inflation and social progress, then the evidence of the past 50 years is that globalization contributes to these objectives in the long term.

In the short-term, as we have seen in the past few years, volatile short-term capital flows can threaten macroeconomic stability. Thus in a world of integrated financial markets, countries will find it increasingly risky to follow policies that do not promote financial stability. This discipline also applies to the private sector, which will find it more difficult to implement wage increases and price markups that would make the country concerned become uncompetitive.

But there is another kind of risk. Sometimes investors—particularly short-term investors—take too sanguine a view of a country's prospects and capital inflows may continue even when economic policies have become too relaxed. This exposes the country to the risk that when perceptions change, there may be a sudden brutal withdrawal of capital from the country.

In short, globalization does not reduce national sovereignty. It does create a strong incentive for governments to pursue sound economic policies. It should create incentives for the private sector to undertake careful analysis of risk. However, short-term investment flows may be excessively volatile.

Efforts to increase the stability of international capital flows are central to the ongoing work on strengthening the international financial architecture. In this regard, some are concerned that globalization leads to the abolition of rules or constraints on business activities. To the contrary—one of the key goals of the work on the international financial architecture is to develop standards and codes that are based on internationally accepted principles that can be implemented in many different national settings.

At the **international level,** several important lines of defense against crisis were breached. Investors did not appraise risks adequately. Regulators and supervisors in the major financial centers did not monitor developments sufficiently closely. And not enough information was available about some international investors, notably offshore financial institutions. The result was that markets were prone to "herd behavior"—sudden shifts of investor sentiment and the rapid movement of capital, especially short-term finance, into and out of countries.

The international community is responding to the global dimensions of the crisis through a continuing effort to strengthen the architecture of the international monetary and financial system. The broad aim is for markets to operate with more transparency, equity, and efficiency. The IMF has a central role in this process, which is explored further in separate fact sheets.

# 4.9 The Role of Institutions and Organizations

National and international institutions, inevitably influenced by differences in culture, play an important role in the process of globalization. It may be best to leave an outside commentator to reflect on the role of institutions:

"...That the advent of highly integrated commodity and financial markets has been accompanied by trade tensions and problems of financial instability should not come as a surprise, the surprise is that these problems are not even more severe today, given that the extent of commodity and financial market integration is so much greater.

"One possibility in accounting (for this surprise) is the stabilizing role of the institutions built in the interim. At the national level this means social and financial safety nets. At the international level it means the WTO, the IMF, and the Basle Committee of Banking Supervisors. These institutions may be far from perfect, but they are better than nothing, judging from the historical correlation between the level of integration on one hand and the level of trade conflict and financial instability on the other."

### 4.10 Indian Economy: Recent Trend of Globalisation and Liberalisation

For the Indian economy to grow with equality and economic justice, the informal sector, home-based production and cottage industries need to achieve high growth with policy and institutional support. The contribution of these sectors to any economy cannot be ignored. This is especially true for a country like India, as they are important sources of employment and income for many families. They have 40 percent share in the total industrial output, 35 percent in exports, and over 80 percent in employment. However, many of such sectors are not doing well in this era of globalisation, which encompasses economic liberalisation. It has been found that in order to overcome the challenges and avail opportunities of globalisation and economic liberalisation, these sectors and associated entrepreneurs need institutional support for technology upgradation, infrastructure support for market penetration, and adequate working capital finance from the banking sector.

India embarked upon the process of economic liberalisation in 1991. Since then liberalization has exposed all industrial units including small home-based enterprises in the informal sector to the inherent risks of free market competition. Globalisation has intensified the market

competition by allowing imports and multinational corporations. The reform process of the Indian economy has a far reaching impact on Indian informal sector. Most of the problems, during this era of economic liberalisation, arise due to the unorganised nature of the sector, lack of data and information, use of low technology and poor infrastructure of the sector.

The setting up of the WTO (World Trade Organization) in 1995 has intensified global competition. The World Trade Organization regulates multilateral trade and enforces its member countries to remove import quotas and other import restrictions, and to reduce import tariffs. In addition, countries, especially the developing countries, are asked to stop subsidies to exports as well as to domestic production. As a result, every single individual enterprise in India, small or large, whether exporting or serving the domestic market, has to face competition.

In India, selective dereservation of some SSI products and removal of QRs (Quantitative Restrictions) have started taking place with a view to enhancing exports and competing effectively in the global market. Out of 836 items reserved for production under SSI, 162 items have been dereserved and almost all the items are placed on the OGL (open general license) list of imports. This opens up the possibility of direct competition in the domestic market with the imports of high quality goods from the developed countries and cheap products from the other less developed countries.

Competition in the domestic market would further be intensified with the arrival of multinational companies as the restrictions on foreign direct investment have been removed. Removal of quantitative restrictions and lowering tariffs are creating a serious impact on the small and informal sector, leading to closure of some units and consequent displacement of

labour. In view of several desirable socio-economic objectives, Abid Hussain Committee made out a strong case for support and promotional policies to encourage the development of SSIs left to free market forces. The committee recommended to effectively addressing the problems faced by the SSI units.

The silver lining amidst the fierce competition lies in exploiting the opportunities of globalization in terms of outsourcing, sub- contracting and ancillarisation of the products manufactured by corporate. To be able to face competition in a level playing ground the Indian informal sector needs to be endowed with technological upgradation and modernisation. In the changing economic scenario, it is the knowledge-based technology, organization and information which will be able to improve the quality and competitiveness of products and thus help to face competition from imports. The free economy will usher in accessibility to bigger markets, greater linkages for SSI with larger companies and marketing outfits, improved manufacturing techniques and processes.

However, the sector is afraid of adopting new technology because of the huge initial capital investment and adjustment of production process, uncertain input supply, marketing prospect and profit of the products manufactured with new technology. Other major impediments are lack of knowledge of technology sourcing, evaluation and demonstration facilities, lack of surveys and feasibility studies etc. Therefore, for the development of this sector there needs to be a major thrust on technology intervention in clusters which offers the small units an opportunity and easier access to get acquainted with new technologies.

Civil society and government agencies can play a significant role in educating small units about the changes in the business environment and the necessity of going in for technological upgradation. Civil society organizations are mostly unable to come to a platform for conducting meaningful dialogues (exchange of information and views), taking forward the outcomes at appropriate levels and disseminate the learning to their respective constituencies. Thus, there is the need to facilitate the process of learning (through exchange of information and views) for policy advocacy at different levels. This will go a long way to instill trust and confidence in these units.

### 4.11 A Look to Current Phase of Globalization

Globalization, of course, is not a new phenomenon. The period 1870 to 1913 experiences a growing trend towards globalization. The new phase of globalization which started around mid 20<sup>th</sup> century became very wide spread, more pronounced and over charging since the late 1980s by getting more momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalize international trade and investment and the technological and communication revolutions. There are several similarities and differences between the two phases of globalization. The Human Development Report, 1999, mentioned the following as the new features of current phase of globalization:

## 1) New Market

- Growing global markets in services- banking, insurance, transport.
- New financial markets- deregulated, globally linked, working around the clock, with action at a distance in real time, with new instruments as derivatives.

- Deregulation of antitrust laws and proliferation of mergers and acquisitions.
- Global consumers market with global trends.

### 2) New Actors

- Multinational corporations integrating their production and marketing, dominating food production.
- The World Trade Organization- the first multilateral organization with authority to enforce national governments' compliance with rules.
- An international criminal court system in the making.
- A booming international network of NGOs.
- Regional blocs proliferating and gaining importance- European union, Association of South-East Asian Nations, Mercosur, North American Free Trade Association, Southern Africa Development Community, among many others.
- More policy coordination groups- G-7, G-40, G-22, G-77, OECD.

### 3) New Rules and Norms

- Market economic policies spreading around the world, with greater privatization and liberalization than in earlier decades.
- Widespread adoption of democracy as the choice of political regime.
- Human rights conventions and instruments building up in both coverage and number of signatories and growing awareness among people around the world.
- Consensus goals and action agenda for development.

- Conventions and agreements on the global environment- biodiversity, ozone layer, disposal of hazardous wastes, desertification, and climate change.
- Multilateral agreement in trade, taking on such new agenda as environmental and social conditions.
- New multilateral agreement for services, intellectual property, communications, more binding on national governments than any previous agreements.
- The Multilateral Agreement on Investment under debate.

### 4) New (Faster and Cheaper) Tools of Communication

- Internet and electronic communication linking many people simultaneously.
- Cellular phones.
- Fax machines
- Faster and cheaper transport by air, rail and road.
- Computer aided design.

### 4.12 Summary

As globalization has progressed, living conditions (particularly when measured by broader indicators of well being) have improved significantly in virtually all countries. However, the strongest gains have been made by the advanced countries and only some of the developing countries. That the income gap between high-income and low-income countries has grown wider is a matter for concern. And the number of the world's citizens in abject poverty is deeply disturbing. But it is wrong to jump to the conclusion that globalization has caused the divergence, or that nothing can be done to improve the

situation. To the contrary: low-income countries have not been able to integrate with the global economy as quickly as others, partly because of their chosen policies and partly because of factors outside their control. No country, least of all the poorest, can afford to remain isolated from the world economy. Every country should seek to reduce poverty. The international community should endeavor—by strengthening the international financial system, through trade, and through aid—to help the poorest countries integrate into the world economy, grow more rapidly, and reduce poverty. That is the way to ensure all people in all countries have access to the benefits of globalization.

### 4.13 Self Assessment Exercise

- What do you mean by Globalization? Bring out the nature and causes for globalization of industry.
- 2. Discuss the issues involved in globalization.

# 4.14 Suggested Readings

- 1. Aswathappa, K., *Business Environment for Strategic Management*, Himalaya Publication House, Mumbai.
- 2. Wheeler, B.O. Business: An Introduction.
- 3. Cherrunilam, Francis, *Business Environment*, Himalaya Publication House, New Delhi.

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Su	bject: Business Environment		
L	sson: 05		
	ECONOMIC SYSTEM: DDOCESS OF DEFORMS		

**Objective** – This lesson is intended to impart the knowledge about the reforms in economic system in India. This lesson presents an overview of what has been achieved in India's Current reforms and identify the emerging issues and explore the prospects for further reform. The economy has emerged stronger recording consistently high growth rates. As a result of these reforms India will not only become a rapidly advancing economy but also a human society that will be at the peak of human development.

### **Structure**

- 5.1 Introduction
- 5.2 Meaning of economic reforms of new economic policy
- 5.3 Need for Economic Reforms and New Economic Policy
- 5.4 Origin of Economic reforms
- 5.5 Main Features of Economic Reforms and New Economic Policy
  - 5.5.1 Liberalisation
  - 5.5.2 Privatisation
  - 5.5.3 Globalisation
- 5.6 Macroeconomic Reforms and Structural Adjustments
  - 5.6.1 Fiscal Reforms
  - 5.6.2 Banking Sector Reforms
  - 5.6.3 Capital Market Reforms
  - 5.6.4 Insurance Sector Reforms
- 5.7Some Achievements of Economic Reforms

- 5.8Criticisms of New Economic Policy
- 5.9Questions for Discussions

References

#### 5.1 Introduction

The performance of the Indian economy in the last decade has been remarkable. This can be partly attributed to the ongoing economic reforms. Since 1991, Government of India has introduced diverse economic reforms in order to pull the country out of the economic crisis and to accelerate the rate of growth. The reforms have embraced almost all aspects of the country's economy. Policies relating to industrial licensing, trade and foreign investment have undergone major changes. In addition, significant macroeconomic adjustments have also taken place. Economic institutions too have undergone significant change; the banking sector and capital markets in particular, have been major targets of the change. And finally, structural adjustments covering areas like subsidies, the price Mechanism and the public sector have also taken place. Collectively, these reforms aim at modernisation of the country's industrial system, removal of unproductive controls, strengthening of private investment, including foreign investment and integration of India's economy with the global economy. In one word, it can be said that allround opening up of the country's economy has been the essence of the reforms. All these economic reforms are known as new Economic Policy. Accordingly, New Economic Policy refers to all those different economic reforms introduced since July 1991 or policy measures and changes which aim at increasing productivity and efficiency by creating an environment of competition in the economy.

### **5.2 Meaning of economic reforms**

Economic reforms or new economic policy refers to various policy measures and changes introduced since 1991. The common objective of all these measures is to improve productivity and efficiency of the economy by creating a more competitive environment therein.

The reforms can be classified into two broad categories:

• Liberalisation, privatisation and globalisation measures.

• Macroeconomic reforms and structural adjustments.

Changes in the sphere of industrial licensing policy and foreign trade as well as foreign investment policies belong to the first category. Reforms touching the macro economy and economic institutions plus structural adjustments covering areas like subsidies, price environment and public sector, belong to the second category. All these initiatives are collectively referred to as the New Economic Policies (NEP).

### 5.3 Need for Economic Reforms or New Economic Policy

About five decade's back (1st April 1951) India had commenced its journey to economic development on the path of socialistic pattern of society and mixed economy. So far India has completed 9 five-year plans. There is no denying the fact that in these five decades Indian economy has achieved many successes but the number of failures is by no means small. During the period of planning public sector was given utmost importance. Private sector was largely kept under government control. Trade and industry were subjected to many restrictions. Bureaucracy and red tapism were the normal features of the economy. The cumulative effect of all this was that in the end of June 1991, country landed in an unprecedented economic crisis. Reserves of foreign exchange were just sufficient to pay for two week's imports. New loans were not available. Large amounts were being withdrawn from the accounts of non-residential Indians (NRIS). Faith of international community in Indian economy was shaken. Industrial progress was on reverse gear and prices were sky rocketing. In order to pull the economy out of economic crisis and to put it on the path to rapid and steady economic growth, it was most essential to correct financial disequilibrium, curb rising prices, correct adverse balance of payments and replenish foreign exchange reserves. To achieve all these objectives, introduction of economic reforms or an appropriate economic policy was considered inevitable.

Need for economic reforms or New Economic Policy was felt mainly because of the following reasons.

1. **Increase in Fiscal Deficit:** prior to 1991, fiscal deficit of the government had been mounting year after year on account of continuous increase in its non-development expenditure. **Fiscal** 

deficit means difference between the total expenditure and total receipts minus loans. It is equivalent to total borrowings by the government. In 1981-82, it was 5.4 per cent of gross domestic product (GDP). In 1990-91, it rose to 8.4 per cent of GDP. With a view to meeting fiscal deficit, the government is obliged to raise loans and pay interest thereon. Thus, due to persistent rise in fiscal deficit there was a corresponding rise in public debt and interest payment liability. In 1980-81, interest payment on public debt amounted to 10 per cent of total government expenditure. In 1991, amount of interest liability rose further to 36.4 percent of total government expenditure. There was serious apprehension that the government was fast heading for **debt trap**.

- 2. Increase in Adverse Balance of Payments: balance of payment is the difference between total exports and total imports of a country. When total imports exceed total exports, the balance of payments becomes adverse. Government granted diverse kinds of incentives and concessions to the exporters under export promotion program, yet the export did not rise to the desired extent. It was mainly due to the fact that in international market our exports could not complete in price and quality. All this was the direct result of the policy of protection so liberally pursued by the government and for so long. As against slow growth of exports there was rapid increase in imports. As a result, balance of payments deficit increased very much. Deficit of balance of payments had been rising continuously since 1980-81. For instance, in 1980-81,balance of payments on current account was adverse to the tune of Rs. 2,214 crore and it rose in 1990-91 toRs.17367crore. To meet this deficit large amount of foreign loans had to be obtained.
- 3. Gulf Crisis: On account of Iraq war in1990-91, prices of petrol shot up. India used to receive huge amount of remittances from Gulf countries in foreign exchange all that stopped totally. Gulf crisis thus further accentuated already adverse balance of payments position. This has increased balance of payments deficit very much.
- 4. **Fall in Foreign Exchange Reserves:** in 1990-91India's foreign exchange reserves fell to such a low level that the same were not enough to pay for an import bill for even 10 days. Foreign exchange reserves that were Rs. 8151 crore in 1986-87 declined sharply to Rs. 6252 crore in 1989-90. The situation grew so acute that Chandrashekhar government had to mortgage country's gold to discharge its foreign debt servicing obligation.

- 5. **Rise in prices:** in India prices continued to rise very high. Average annual rate of inflation increased from 6.7 per cent to 16.7 per cent. Main reason for inflation or annual rate of increase in prices was rapid increase in the supply of money. This, in turn, was due to excessive resort to deficit financing by the government. Deficit financing implies borrowing from Reserve Bank of India by the government to meet its deficit. Bank offered this loan by printing new currency notes. Cost of production takes an upward jump due to high rate of inflation. It adversely affects domestic and foreign demand for our products.
- 6. Poor Performance of Public Sector Undertakings (PSU): In 1951 there were just 5 enterprises in public sector in India but in 2001 their number rose 232. Several thousand crores of public funds were invested therein. In the initial 15 years their functioning was quite satisfactory but thereafter most of these suffered losses. Because of their poor performance. Public sector undertakings degenerated into liability.

On account of the above compelling factors, it became inevitable for the government to adopt New Economic Policy. It was all the more necessary to increase industrial output and attract foreign capital.

### **5.4 Origin of Economic reforms**

The phrase is commonly used to describe the events, post <u>1991</u>. The country however has seen a number of distinct eras, which had definite differences from the economic practices of the previous eras. In a sense, economic reform can be said to have started with the first large scale integration of the country from many small kingdoms and provinces to a large entity under one government.

Economic Reform in India can be primarily divided into the following eras.

- 1. The Pre-British Era
- 2. The British Era
- 3. The Nehruvian Era
- 4. The Nationalist Era
- 5. The Post-Reform Era

#### The Pre-British Era

This was a period in Indian history where for the fist time, large areas of the land was brought under the control of a single entity either the <u>Lodhis</u>, The <u>Suris</u> or the <u>Mughals</u>. Though coinage and commerce with neighboring states was practiced, it is in this era that noticeable use of macroeconomic stimuli like building of roads, tombs and gardens was introduced (most likely

unconsciously). Large scale building projects like the <u>Grand Trunk Road</u> (2500 kilometers long - 16th Century), <u>Tuglakabad</u>, <u>Fatepur Sikri</u>, <u>Taj Mahal</u> were carried out in this period. This lead to urbanization of alternate locations and creation of skilled <u>labor pools</u>, concentrated around these cities. This process started with the Suris (notably Sher Shah Suri) and ended with <u>Aurangazeb</u>.

#### The British Era

Even under the <u>Delhi</u> rulers, India was not fully integrated under one government. The Western and Southern parts of the country were still outside the influence of the Delhi Empire. With the arrival and the rapid establishment of the <u>British East India Company</u> as a single trading block, the economic landscape changed. With the Company influencing decisions in different parts of the country, there was a general direction given to the governance and to the economy as such. The British soon formalized the <u>colonization</u> of the country and with this, the economic policies began to reflect those of the British Empire.

Large scale trading with other countries, formation of industries like textile and steel happened in this era. This also saw the discovery of petroleum and the setting up of a refinery in Digboi, Assam.

The British Era was characterized by the country growing into an economic block and also by industrialization of many parts of the country notably <u>Bombay</u> (now Mumbai), <u>Calcutta</u> (Kolkata) and <u>Madras</u> (Chennai).

#### The Nehruvian Era

This era started out with the independence and was marked by a high degree of uncertainty with respect to the direction the country had to take. Nehru was enamoured by the Socialist model of development and envisioned an economy directed by the government. The country under him adopted the Socialist model of development. This marked, in a sense, a reform from the British economic model. Under this model a Planning Commission was set up and a process of generating <u>five-year Plans</u> was initiated.

The central idea was that the country had to progress in orderly steps. The first plan focused on Agriculture and the second on Industries. Though Agriculture remained shackled by lack of labor reform, industrialization picked up in a big way. The large industrial institutions that today form the *Navratnas* had their roots in this period, either as separate companies or as departments in the respective ministries.

Macroeconomically, this period was important in that the country saw a large amount of investment in the infrastructure sector. This period saw large projects like dams, steel plants, refineries, fertilizer plants, hydel power stations etc. being built. This era also saw the

establishment of the premier education institutes of India, like the <u>Indian Institute of Technology</u>, the <u>Regional Engineering Colleges</u>, which focused on development of human capital. These institutions of this era have formed the backbone for supply of the manpower to the technology sector.

The initial success was not matched and the country was not able to generate enough capital to sustain growth. Planning estimates often went awry and delays became commonplace. Subsequent to the Chinese War of 1962 the economy was in shambles and the reform in agriculture had failed. India by this time had to depend on aid of food from the US and other countries. The PL-480 wheat from the US had become a symbol of the collapse of this mode of development. Year1960 alone saw \$1524 Million in aid from US Aid.

### The Nationalist Era

The period after Nehru was politically fluid and notable reforms did not happen immediately. After <u>Indira Gandhi</u> became the Prime Minister, the economic process in the country changed direction. Till this period, the state was primarily a planner of the growth, with high degree of private participation. From this period onward the state became the planner and the executor of macroeconomic policies.

This period saw the success of the Green Revolution, which effectively freed India from starvation. There was lesser dependence on aid.

Mrs. Gandhi had a deep suspicion of foreign companies and this lead to the nationalization of all foreign owned companies. Primarily the nationalization was done in the Banking and the Refining Sector. This period saw the formation of large companies in these sectors. Notably Indian Oil Corporation, Hindustan Petroleum and Bharat Petroleum. The <u>State Bank of India</u> became a parent organization for these banks and all banking was brought under the Reserve Bank of India.

During the seventies, India moved closer to the Socialist bloc and the development was often in collaboration with these countries. A number of Indian companies tied up with Russian or Soviet Bloc companies to manufacture products in India. This lead to some degree of high technology finding its way into the Indian industries. However, this period was characterized by the near total withdrawal of Western companies from India.

Despite near complete food sufficiency, this period saw very little overall development of the country. An emergency saw a change of government resulting in a non-Congress coalition

forming the government. This government introduced a two-year planning process understanding the requirement of faster change in plan allocations. The government collapsed and the later government under Mrs. Gandhi went back to the five-year plans.

The major successes in this period were the development in space and nuclear frontiers.

After the assassination of Mrs. Gandhi in 1984, <u>Rajiv Gandhi</u> became the Prime Minister. The overwhelming majority for this government allowed for some bold decision on the economic front. This period saw the opening up of the telecom sector and the focus on high technology.

Though there were some positives, the general impact of this period has been largely negative. Investment stagnated and to fund government investment, tax rates were very high, (more than 50% in some cases). The savings rate was also poor. To further fund and sustain its expenditure, government had to rely on internal and external debt. The debt figures were huge and most of the new aid and debt was going towards servicing these debts.

The First <u>Gulf War</u> saw high oil prices and the Indian economy, largely dependent of Gulf oil was on the verge of collapse. There was a debt repayment crisis and the forex reserves were near zero. This period saw India pledging its gold to boost up reserves. With this balance of payment crisis the nationalist period also came to an end.

## The Post-Reform Era

The balance of payment crisis in the early 90s prompted a re-think on the economic direction that the country was taking. In 1991, the Forex reserves of the country went down to as low as \$ 1 Billion (enough for just 2 weeks of imports) and the inflation touched 17% in the month of August. The fiscal deficit was nearly 10% of the GDP and the Current Account Deficit nearly 3% of the GDP. Unlike earlier economic crisis felt, which were primarily of supply in nature, this was a monetary crisis.

The response to this crisis was measured and comparatively painless on the economy. India undertook short-term stabilization measures and long term economic reform in the wake of this crisis.

In the short term, India engaged in some stabilization measures. The primarily included, pledging of gold to meet short tem payment, a de-valuation of the rupee, tightening of imports, change in monetary policy and some international loans. This process succeeded in ensuring that the crisis was tided over.

Once the short term was dealt with India embarked on structural reform of the economy.

#### 5.5 Main Features of economic Reforms or New Economic Policy

#### 5.5.1 Liberalisation

Liberalisation of the economy means to free it from direct or physical controls imposed by the government. Prior to 1991, government had imposed several types of controls on Indian economy, e.g., industrial licensing system; price control or financial control on goods, import license, foreign exchange control, restrictions on investment by big business houses, etc. these had dampened the enthusiasm of the entrepreneurs to establish new industries. These controls had given rise to corruption, undue delays and inefficiency. Economic reforms therefore made a bid to reduce restrictions imposed on the economy. Economic reforms were based on the assumption that market forces could guide the economy in a more effective manner than government control.

# **Measures Taken for Liberalisation**

Following measures have been taken under economic reforms for liberalisation of Indian economy:

- 2. Abolition of Industrial Licensing and Registration: The New Industrial Policy (NIP) is the first part of the liberalisation measures. Under the NIP, industrial licensing has been greatly liberalised. All industries, except a few specified ones, have been de-licensed under the NIP and liberated from the clutches of control in a bid to eliminate the obstacles to industrial growth. De-licensing of passenger car industry, bulk drugs industry, consumer electronics industry, etc. became landmarks and several new players entered these industries. Industries for which licenses are still necessary are: Liquor, b) Cigarette, c) Defence equipment's, d) Industrial Explosives, e) Dangerous Chemicals, f) Drugs. Small Scale Industry (SSI) dereservation, however, has not made much progress.
- 3. 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 government, at the time of taking investment decisions.
- 4. **Freedom for Expansion and Production to Industries:** as a result of liberalisation policy, industries have been given the following freedom:

- a) Prior to liberalisation under the provisions of old policy at the time of granting license government used to fix maximum limit of production capacity. No industry could produce beyond this limit. Now this limit has been removed.
- b) Producers are now free to produce any thing on the basis of demand in the market. Previously, only those goods could be produced which were mentioned in the licence.
- 5. **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 tiny industries has also been increased to Rs. 25 lakh.
- 6. Freedom to import Capital Goods: under the policy of liberalisation. Indian industries will be free to buy machines and raw materials from abroad in order to expand and modernise themselves.

#### 5.5.2 Privatisation

In the context of economic reforms, privatisation means allowing the private sector to set up more and more of such industries as were previously reserved for public sector. Under it, existing enterprise of the public sector are either wholly or partially sold to private sector.

# Measures adopted for Privatisation

Following measures were adopted in respect of privatisation under economic reforms:

Contraction of Public Sector: Initially in the economic development of India, public sector was accorded prime importance. As observed by Dr. Manmohan Singh, priority was given to public sector in the hope that it would help capital accumulation, industrialisation, development and removal of poverty. But none of these objectives could be realised. Policy of contraction of public sector was therefore adopted under the new economic reforms. Number of industries exclusively reserved for public sector was sector was reduced from 17 to 4. Government has been divesting its stake in public sector undertakings in the light of the redefinition of its role from being a provider of goods and services to that of a policy-maker and facilitator. Between 1991-2002 the Government has privatized assets worth US\$ 6.3 billion.

At present the Government is considering disinvestment of the Shipping Corporation of India, State Trading Corporation, Minerals and Metals Trading Corporation, among others. One of the biggest privatization programs that the Government has initiated is the leasing of international airports at the four metropolitan cities of Delhi, Mumbai, Chennai, and Kolkata.

Globalisation means integrating the economy of a country with the economies of other countries under conditions of freer flow of trade and capital and movement of persons across borders.

"Globalisation may be defined as a process associated with increasing openness, growing economic interdependence and deepening economic integration in the world economy."

# Main components of Globalisation of Indian economy are as under:

- 1. Increase in Foreign Investment: under economic reforms, limit of foreign capital investment has been raised from 40 per cent to 51 per cent. In 47 high priority industries foreign direct investment to the extent of 51 per cent will be allowed without any restriction and redtapism. Export trading houses will also be allowed foreign capital investment upto 51 per cent. In this regard Foreign Exchange Management act (FEMA) will be enforced.
- 2. **Devaluation:** in order to promote exports under the policy of globalisation, Indian rupee was devalued. In July 1991, rupee was devalued to the extent of 20 per cent on an average. The objective was export promotion, import substitution and attraction of foreign capital.
- 3. **Reduction in tariffs:** in order to render Indian economy beneficial internationally, custom duties and tariff imposed on imports and exports are being reduced gradually.
- 4. Export Promotion: several measures have been taken to meet the deficit of balance of payments. Exports have been promoted. Special facilities like abolition of export duties, cheaper export credit and cuts in import duty have been provided to the exports in order to increase the share of Indian exports in world trade. The government also enhanced the duty drawback in respect of a large number of items. The greater flow of bank finance to the export sector at concessional rate also enhanced the competitiveness of exports.
- 5. **Rupee made Convertible:** the government brought in partial convertibility of the rupee in 1992-93 and full convertibility on the trade account in 1993-94. The move supported the intention to give exchange rate mechanism its due role in regulating the trade flow. It also served to encourage exports.

#### 5.6 Macroeconomic Reforms and Structural Adjustments

The government brought about a series of macroeconomic corrections, reforms of economic institutions and structural adjustments. These included the followings:

- Fiscal reforms
- Banking Reforms
- Capital market reforms
- Containment of inflation and public debt
- Phasing out of subsidies, dismantling of price controls and introduction of market-driven price environment.
- Public sector restructuring
- Exit policy

#### **5.6.1 Fiscal Reforms**

The fiscal reforms centered around reduction of fiscal deficits. Fiscal reforms mean increasing the revenue receipts and reducing the public expenditure of the government in a manner that production and economic welfare are not adversely affected. Its main objective was to reduce fiscal deficit that stood at 8.5 percent of GDP in 1990-91, to 4 per cent. Several reforms has been to undertake to achieve this objective, e.g., control over public expenditure, increase in taxes, sale of share of public sector enterprise and increased price of public sector products.

# Taxation System Reforms

Taxation system was made more scientific and rational. In respect **direct tax reforms**, the government by and large tried to follow the recommendations of the **Chelliah Committee**. The committee had suggested moderate rates, wider tax base and improved compliance. The government scaled down corporate tax as well as personal income tax rates over two to three years. In the 1997-98 budgets, the maximum income tax rate was cut to 30 per cent from 40 per cent; and then lowers to 10 per cent from 15 per cent. The direct tax revenue as a percentage of GDP increased from 2.1 per cent in 1990-91 to 2.6 per cent in 1998-99. With the direct tax reforms, mergers and acquisitions (M&As) became easier. The government had relaxed norms of carry forward and set-off of accumulated loses and depreciation. De-mergers were also made tax neutral.

As regards indirect taxes reforms, the main aim was to reduce the multiplicity of duty rates and rationalize the rate structure in both excise and customs duties. There were also substantial

reductions in the actual tariffs in respect of both excise and customs duties. Peak customs duty has been brought down to 20% for all products except agro and dairy products. Customs and excise duties on a number of items were reduced in January 2004. The Government is committed to reduce the tariffs further.

## **5.6.2 Banking Sector Reforms**

The recommendations of the Narasimham Committee formed the basis of the banking sector reforms. The government carried out a phased reduction of Statutory Liquidity Ratio (SLR) and permitted a measure of freedom and flexibility to the banks in their operations. The government also went in for partial disinvestment of its equity in the nationalised banks. It also cleared the way for the setting up of a new private sector banks I the country.

# **5.6.3 Capital Market Reforms**

Number of development has taken place in the Indian capital market with the launching of financial reforms since July 1991. In the process the capital market is being rebuilt. Some of the important developments that have taken place in the Indian market (or the reforms that have been announced by the Central Government) are as below:

- 1. Setting up of Securities and Exchange Board of India (SEBI) with autonomous power as a regulatory authority over various constituents of the Capital market.
- 2. Abolition of the office of the Controller of Capital Issues (CCI) in 1992, which means that the pricing of new issues on the capital market will not be bureaucratically dictated.
- 3. Launching of Over the Counter Exchange Of India (OTCEI) a place permitting smaller companies to raise funds.
- 4. Introduction of Screen-based System: till 1994, trading on the stock market in India was based on the open outcry system. With the establishment of the National Stock Exchange in 1994, India entered the era of screen-based trading. Within a short span of time, screen-based trading has removed the open outcry system on all the stock exchanges in the country. The key features of this system are as follows:
  - Buyers and sellers place their orders on the computer.
  - The computer constantly tries to match mutually compatible orders on price and time priority.

- The list of unmatched orders is displayed on the screen. Put differently, it is open for inspection to all traders.
- 5. Another important reform is the introduction of electronic delivery of securities facilitated by depositories. A depository is an institution, which dematerialises physical certificates and effects transfer of ownership by electronic book entries. Traditionally trades in India were settled by physical delivery. This means that the securities had to physically move from the seller to the seller's broker, from the seller's broker to buyer's broker (through the clearing house of the exchange or directly), and from the buyer's broker to the buyer. Further, the buyer had to lodge the securities with the transfer agents of the company and the process of transfer took one to three months. This led to high paperwork cost created bad paper risk. To enable the creation of depositories to facilitate dematerialised trading in India, the central government passed the Depositories act, 1996. The National Securities Depositries Limited (NSDL), India's first depository, was set up in 1996. It was followed by the Central Securities Depositories Limited (CDSL). Both the depositories, the NSDL in particular, have recorded a significant growth in their operations.
  - SEBI has made settlement of trades in dematerialised (popularly called demat) form compulsory for all the stock exchanges in country. This means that if you want to buy or sell shares on any exchange you have to do it only in the dematerialised form.
- 6. Shifting to rolling settlement was another important reform. Till recently share transactions in India were settled on the basis of a weekly account period. (On the Bombay Stock Exchange the account period was Monday to Friday and on the National Stock Exchange the settlement account period was Wednesday to Tuesday.) This meant that purchases and sales during an account period could be squared up and at the end of the account period, transactions could be settled on a net basis. For example, if you bought 100 shares of Infosys on Bombay Stock Exchange on a Monday, at Rs. 5000 a share and sold 95 shares of Infosys on at RS. 5050 on the Friday of that week, you were required to take delivery for only 5 shares by paying RS. 20250 (Purchases consideration of RS. 500000-Sale consideration of RS. 479750) at the end of Account Period.

The weekly settlement system along with the badla system of carrying forward transactions from one account period to the next led to unbridled speculative activity and periodic market crisis. So, SEBI decided to introduce rolling settlement in important scrips with effect from

1<sup>st</sup> January 2002. Under a rolling system each day constitutes an account period and its trades are settled after a few days. For example, under the T+5 rolling settlement, which was introduced initially, the trades were settled after 5 days. With effect from April 1, 2002, the T+3 settlements system was introduced. At present T+2 settlement cycle exist.

#### **5.6.4 Insurance Sector Reforms**

Opening up of the insurance sector is another important element of the reforms. This came much later in the long sequence of reforms. The Malhotra Committee report on the liberlisation of the insurance sector, had earlier recommended that foreign insurance companies be allowed to operate in India preferably in Collaboration with Indian Companies. The Insurance Regulatory and Development Authority (IRDA) Act was passed by parliament in 1999. The Act paved the way for the entry of private sector, including foreign private sector, into the insurance business, which had been a government monopoly for decades. The move broke the monopoly of the LIC IN Life insurance and that of the GIC in health and general insurance.

The new Act provides statutory backing to the IRDA and seeks to entrust it with the responsibility of regulating the insurance business in the country. Under the Act, foreign equity up to 26 per cent is allowed in domestic insurance companies. It stipulates a minimum paid-up capital of Rs. 100 crore each for companies in life insurance and general insurance.

#### **5.7 Some Achievements of Economic Reforms**

The moment economic reforms were announced in July 1991, there was a feeling that the government was loosening some of the controls. The difficulties and delays associated with the earlier system of controls were now expected to vanish. Fourth largest economy (US\$ 3 trillion GDP) in terms of Purchasing Power Parity after USA, China and Japan. The fundamentals of the Indian economy have become strong and stable. The macro-economic indicators are at present the best in the history of independent India with high growth, healthy foreign exchange reserves, and foreign investment and robust increase the fundamentals of the Indian economy have become strong and stable. The macro-economic indicators are at present the best in the history of

independent India with high growth, healthy foreign exchange reserves, and foreign investment and robust increase in exports and low inflation and interest rates.

In addition, some of the major achievements of economic reforms can be summed up as follows:

- 1. Growth rate of the economy in terms of GDP growth picked up and reached a peak rate of 8.4 per cent in 2002-03. A unique feature of the transition of the Indian economy is that it has become the second fastest growing economy of the world in the year 2003 04. In the financial year 2004 05 the GDP growth has averaged 6.9% (estimated). India has recorded one of the highest growth rates in the 1990s. The target of the 10th five-year Plan (2002-07) is 8% growth rate.
- 2. India's services sector grew by 9.4% in 2004-05. Foreign direct investments have increased from less than 0.05 per cent of GDP to more than 0.4 over cent of GDP in 2002-03.
- 3. The foreign exchange reserves have reached a record level of US\$ 138.84 billion in June 2005. The comfortable situation of forex reserves has facilitated further relaxation of foreign exchange restrictions and a gradual move towards greater capital account convertibility. According to IMF (2003 report) India's Forex Policies are in line with global best practices.
- 4. The foreign exchange reserve has increased rapidly. In 1990-91, the foreign exchange reserves were enough to finance imports for 2.5 months. In 2002-03, they are enough to finance imports for11 months. Foreign Exchange Reserves (US\$ 138.84 bn) now far exceed Foreign Debt (US\$ 113 bn as on September 2004).
- 5. Short-term is less 4 of debt than the per cent reserves. In March 1991 Forex Reserves including gold stood at \$5.8bn as against external debt of \$83 billion. The external debt to GDP ratio has improved significantly from 38.7% in 1992 to 17.8% in end of March 2004. This is one of the lowest among developing economies. External debt in December 2004 was 120.9 billion US dollars. Of these long-term NRI deposits are \$ 27 billion, commercial borrowings \$ 24 billion, multilateral debt \$ 31 billion, and bilateral debt \$ 18 billion.
- 6. The rate of industrial growth also started rising from 1993-94 onwards. It reached at peak rate of 6.7 per cent in 2002-03.
- 7. Average rate of inflation has been reduced considerably, from nearly 13.6 per cent in 1991-92 to around 3.4 per cent in 2002-03.

- 8. The Government has decided to (1) discontinue receiving aid from other countries except the following nine: Japan, UK, Germany, USA, EU, France, Italy, Canada and the Russian Federation and (ii) to make pre-payment of all bilateral debt owed to all the countries except the ones mentioned above. Since July 2003, India has become a net creditor to IMF, after having been a borrower in the past.
- 9. The Government has written off debts of US\$ 30 million due from seven heavily indebted countries as part of the "India Development Initiative" announced in February 2003. The interest rate continues to be reduced and is around 6%. This is the lowest in the last thirty years and it is stimulating consumption and investment.
- 10. Thanks to the introduction of screen-based trading and electronic delivery, the stock market has been veritably transformed. Their combined effect has been to reduce the transaction costs in India's stock market dramatically.
- 11. India is becoming a production base and an export hub for diverse goods, from agricultural products to automobile components to high-end services. Indian firms are now part of global production chains importing sub-assemblies, adding value to them and re-exporting them.
- 12. Taking advantage of its pool of high-quality scientific talent, international corporations have established large R&D centers in India. All these strengths have resulted in a greater integration of the Indian economy with the world economy. Trade has risen from 21 per cent to 33 per cent of India's GDP in a decade.

# 5.8 Criticisms of New Economic Policy

- 1. **Fiscal deficits continue to soar as the root cause remains:** though, reduction of fiscal deficit was high on the reform agenda, the efforts did not lead to much result, as the endeavor was not sustained. While the gross fiscal deficit of the central and state government which reflects the net borrowing requirement of government, had declined from 9.2 per cent of GDP in the crisis year of 1990-91 to 6.2 per cent. Only by tackling subsidies, government non-plan expenditure and public debt and interest burden can the country bring down its fiscal deficit. In India subsidies have been on the high side.
- 2. **Problem of unemployment:** unemployment has increased with New Economic Policy.

**Table 2** Employment in the Organised Sector (in Million persons)

	1981	1990	2000	
Public Sector	·	·	·	
Total	15.484	18.772	19.314	
Manufacturing	1.502	1.870	1.531	
Construction	1.089	1.134	1.092	
Private Sector		·		
Total	7.395	7.582	8.646	
Manufacturing	4.545	4.457	5.085	
Construction	.072	.068	.057	

**Source:** *Economic Survey*, 2001-2.

Increase in employment in the public sector was much higher during the 'planned' regime of the 1980s than during the liberalization phase of the 1990s. This is true for both the manufacturing and the construction sector. In the private sector, although the total generation of employment was higher during the 1990s, in the construction sector it has failed.

In manufacturing if we look at the detail we can see that the employment actually went down from 6.85 million in 1998 to 6.62 million in 2000; in agriculture employment went down from 1.49 million in 1992 to 1.42 million in 2000; in mining it went down from 1.12 million in 1994 to 1.01 million in 2000. The only sector that has showed improvement is the service sector, where employment went up from 17.53 million in 1990 to 18.92 million in 2000.

#### 3. GROWTH OF MONOPOLY HOUSES

Liberalization measures have benefited a minuscule section of the society. They have encouraged growth of monopoly houses reflected in rapid growth of their assets. For example, assets of Tatas increased from RS 85,310 million in 1991 to RS 474,460 million in 1998-99, that is, in just eight years. Over the same period assets of Reliance rose from RS 360,00 million to RS 337,570 million and that of Essar rose from RS 7,560 million to RS 171,450 million. Likewise other industrial houses also registered phenomenal growth in their assets.

Economic 'reforms' particularly the liberalization measures have enabled private companies to earn huge profits even during the latter half of the nineties when industrial growth was sluggish. In the year 2000, net profits of Reliance industries, the largest private sector company increased by 41.3 per cent. Net profits of Tata Steel rose by 49.7 per cent, of Grashim industries by 43.3 per cent and of Hindustan Lever by 27.8 per cent. Among the top 10 private sector companies Telco and Larsen and Toubro were the only companies which failed to register an increase in their profits in the year 2000.

#### 4. RUINATION OF AGRICULTURE & PDS

The government in a way has rendered the Public Distribution System (PDS) irrelevant. People have been divided into two categories - those below the poverty line (BPL) and those above the

poverty line (APL). A large number of people above the poverty line are really poor but the issue prices of foodgrains, which were fixed for them under the PDS, are either equal to the prices prevailing in the market or even higher.

For the people BPL the issue price of wheat was raised from RS 250 per quintal in 1997-98 to RS 450 per quintal in 2000-01. Likewise, the issue price of rice has been raised from RS 350 per quintal to RS 565 per quintal. At these increased issue prices of foodgrains most of the rural poor now find it difficult to purchase their monthly quota of ration. The food subsidy has been drastically reduced and the results are there for everyone to see. In July 2002, 63 million tonnes of foodgrains were lying in the warehouses of the Food Corporation of India and yet the people were dying of starvation in the rural areas.

Two major factors are responsible for the present ruination of agriculture in this country. First, in its eagerness to reduce fiscal deficit the government has substantially reduced the development expenditure in agriculture. Secondly, import liberalization has contributed in a big way reduction in the prices of agricultural products. Having failed in getting remunerative prices for their products, many farmers have curtailed their farm operations, which in turn have increased unemployment among the agricultural workers. Import liberalization is thus a major cause of the existing plight of the peasantry. Suicides by many farmers in the recent past reflect the consequences of the liberalization measures.

#### 5.9 SUMMARY

To grow the economy the Government of India has introduced various diverse economic reforms. The various policies which undergone major changes have been discussed here. Some light is also thrown at New Economic Policy.

#### 5.10 Questions for discussion

- 1. What is meant by economic reforms? What was the need of Economic Reforms? Explain the main features of Economic Reforms.
- 2. What do liberalization, privatization and globalization of Indian Economy mean?
- 3. Discuss the circumstances under which the Government of India opted for Liberalization Programme.
- 4. What is meant by privatization? Explain the main features of privatization in India.
- 5. What do you mean by globalization of Indian Economy? Discuss its features.
- 6. Discuss the reforms in finance sector since 1991.

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**Subject : Business Environment** 

Lesson: 06

# PROFILE OF INDIAN ECONOMY IN 21st CENTURY

**Objective** – This lesson is intended to impart the knowledge about the profile of Indian economy in 21<sup>st</sup> century. India is proving herself as a growing economy in new millennium.

# Structure

- 6.1 Introduction
- 6.2 Issues and priorities for India
- 6.3 The three sectors of Indian Economy
- 6.4 Vat
- 6.5 Summary
- 6.6 Questions for Discussions
- 6.7 References

#### **6.1 INTRODUCTION**

Economics experts and various studies conducted across the globe envisage India and China to rule the world in the 21st century. For over a century the United States has been the largest economy in the world but major developments have taken place in the world economy since then, leading to the shift of focus from the US and the rich countries of Europe to the two Asian giants- India and China.

The rich countries of Europe have seen the greatest decline in global GDP share by 4.9 percentage points, followed by the US and Japan with a decline of about 1 percentage points each. Within Asia, the rising share of China and India has more than made up the declining global share of Japan since 1990. During the seventies and the eighties, ASEAN countries and during the eighties South Korea, along with China and India, contributed to the rising share of Asia in world GDP.

According to some experts, the share of the US in world GDP is expected to fall (from 21 per cent to 18 per cent) and that of India to rise (from 6 per cent to 11 per cent in 2025), and hence the latter will emerge as the third pole in the global economy after the US and China.

By 2025 the Indian economy is projected to be about 60 per cent the size of the US economy. The transformation into a tri-polar economy will be completed by 2035, with the Indian economy only a little smaller than the US economy but larger than that of Western Europe. By 2035, India is likely to be a larger growth driver than the six largest countries in the EU, though its impact will be a little over half that of the US.

India is slated to become the third largest economy with a share of 14.3 per cent

of global economy by 2015 and gradually become the "third pole" and growth driver by 2035.

India, which is now the fourth largest economy in terms of purchasing power parity, will overtake Japan and become third major economic power within 10 years.

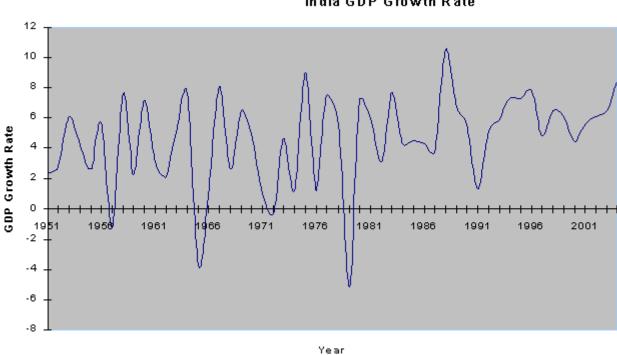
# 6.2 ISSUES AND PRIORTIES FOR INDIA

As India prepares for becoming an economic superpower, it must expedite socioeconomic reforms and take steps for overcoming institutional and infrastructure bottlenecks inherent in the system. Availability of both physical and social infrastructure is central to sustainable economic growth.

Since independence Indian economy has thrived hard for improving its pace of development. Notably in the past few years the cities in India have undergone tremendous infrastructure up gradation but the situation is not similar in most part of rural India. Similarly in the realm of health and education and other human development indicators India's performance has been far from satisfactory, showing a wide range of regional inequalities with urban areas getting most of the benefits. In order to attain the status that currently only a few countries in the world enjoy and to provide a more egalitarian society to its mounting population, appropriate measures need to be taken. Currently Indian economy is facing these challenges:

- Sustaining the growth momentum and achieving an annual average growth of 7-8 % in the next five years.
- Simplifying procedures and relaxing entry barriers for business activities.

- Boosting agricultural growth through diversification and development of agro processing.
- Expanding industry fast, by at least 10% per year to integrate not only the surplus labour in agriculture but also the unprecedented number of women and teenagers joining the labour force every year.
- Developing world-class infrastructure for sustaining growth in all the sectors of the economy.
- Allowing foreign investment in more areas
- Effecting fiscal consolidation and eliminating the revenue deficit through revenue enhancement and expenditure management.
- Empowering the population through universal education and health care.



Fig(6.1) India - a growing economy

India GDP Growth Rate

A growth rate of above 8% was achieved by the Indian economy during the year

2003-04 and in the advanced estimates for 2004-05, Indian economy has been predicted to grow at a level of 7 %. Growth in the Indian economy has steadily increased since 1979, averaging 5.7% per year in the 23-year growth record. (However in comparison to many East Asian economies, having growth rates above 7%, the Indian growth experience lags behind.) Many factors are behind this robust performance of the Indian economy in 2004-05. High growth rates in Industry & service sector and a positive world economic environment provided a backdrop conducive to the Indian economy. Another positive feature was that the growth was accompanied by continued maintenance of relative stability of prices. However, agriculture fell sharply from its 2003-04 level of 9 % to 1.1% in the year 2004-2005 primarily because of a bad monsoon. Thus, there is a paramount need to move Indian agriculture beyond its centuries old dependency on monsoon. This can be achieved by bringing more area under irrigation and by better water management.

Because of the continuos weakening of the US dollar for the last two years, (caused mainly by widening US deficits), Indian Rupee has steadily appreciated vis-à-vis US dollar. Though, this trend saw a brief reversal during may-august 2004. The latest Re/\$ Exchange rate (March 2005) stood close to 44. Despite strengthening nominally against US \$, Rupee depreciated against other major non-dollar currencies. Thus, the Real Effective Exchange rate of the Rupee depreciated and this trend continued until end 2004. This resulted into Indian export being cheaper and more competitive.

A strong Balance of Payment (BOP) position in recent years has resulted in a steady accumulation of foreign exchange reserves. The level of foreign exchange reserves crossed the US \$100 billion mark on Dec 19, 2003 and was \$142.13 billion on March 18, 2005. The capital inflows, current account surplus and the valuation gains arising from appreciation of the major non-US dollar global

currencies against US dollar contributed to such a rise in Forex reserves.

The current account of BOP having been in surplus since 2001-02, turned into deficit in the first half of the current year( April-September 2004-05). Growth momentum in exports was maintained; India's exports during Apr-Nov registered a growth of 24% from the last period but India's position was down from 30th to 31st rank in the top exporting countries of the world.

The main contributors to capital account surplus were the banking capital inflows, foreign institutional investments and other capital inflows. Alike current account, capital account too witnessed decline. The capital account surplus in April-September was also down by around US \$ 1.5 million.

The downward trend in interest rates continued in 2004-05, with bank rate standing at 6% as on Dec 10, 2004. Banks recovery management improved considerably with gross NPAs declining from Rs 70861 crore in 2001-02 to Rs 68715 in 2002-03. During the current financial year (up to December 10, 2004) incremental gross bank credit increased by 20.5 per cent (exclusive of conversion, 16.6 per cent) as compared with a growth of 5.9 per cent in the same period of the previous year. Non-Food credit during the financial year so far, registered a growth of 20.5 per cent (exclusive of conversion, 16.5 per cent) as compared with an increase of 8.4 per cent during the same period of the last year indicated a positive outlook. Equity market return was 85% in 2003-04, second highest in Asia. With continued higher corporate earnings in 2004-05, the sensex crossed 6800 mark in March 2005 but high stock market volatility remained higher in India compared to other Asian countries. The expectation of sensex crossing 7000 mark is not yet realized. Fiscal deficit of states & center was decreasing in early 90s but due to rise in fiscal deficit in recent years, corrective measures have been adopted. The fiscal deficit decreased to 7.9% in 2004-05

from a 9.4% of GDP in 2003-04. According to recent estimates, fiscal deficit in April-October 2004 is 45.2 per cent of BE compared with 56.0 per cent of BE in the corresponding period last year. This was the broad picture of Indian economy; however it is imperative to look at the sectoral performance for a better grasping of the Indian economy.

# 6.3 THE THREE SECTORS OF INDIAN ECONOMY

# 6.3.1 Agriculture

More than 58% of country's population depends on agriculture, a sector producing only 22% of GDP. The agriculture and allied sector witnessed a growth of 9.1% in 2003-04, which fell steeply to 1.1% in the fiscal year 2004-05. Favourable monsoon facilitated an impressive growth rate of 9.6% in 2003-04 on the back of negative growth in the preceding year. However, deficient rainfall from the southwest monsoon is primarily responsible for the significant fall in kharif crops production in the current year.

While looking at some of the agricultural products, one finds that India is the largest producer of Tea, jute and jute like fibre. India is not only the largest producer but also largest consumer of tea in the world. India accounts for around 14% of the world trade in tea. Indian tea is exported in various forms such as bulk tea, packet tea, tea bags, instant tea etc, to more than 80 countries of the world. Among livestock cattle and buffalo are found maximum in India. Indian total milk production is highest in the world. India has also the privilege of having the 1st rank in total irrigated land in area terms in the world. Among cereals production, India is placed third, having second largest production in wheat and rice and the largest production in pulses. However, the full potential of Indian agriculture as a profitable activity hasn't been realized yet. Agriculture upliftment will not only benefit farmers and a large section of the rural poor, but also will give fillip to overall growth of the economy through the backward and forward

linkages of agriculture with the rest of the economy.

Priority must be given to livestock's & fisheries, horticulture, organic farming, commercial crops and agro-processing, as these are the potential areas of high growth. Further, rationalization of minimum support price regime and introduction of other risk- mitigation measures, improvements in rural infrastructure are essential for sustaining high agricultural growth. It is conceived that reforms in legislations, strengthening R&D and improvements in post harvest management technologies will give a required boost to Indian agriculture. While acceleration in agriculture growth to 4 - 4.5% is imperative, even with such growth rate; share of agriculture in total GDP is likely to reduce further. Therefore, there is a need to absorb excess agricultural labour in other sectors, notably industry and service sector. Rapid growth of agro - processing industry close to the agricultural production centers can bring about this shift without moving people from rural to urban areas. Also, public investment in agriculture needs to be augmented, especially in rural infrastructure, irrigation, and agricultural research & development. Better access to institutional credit for more farmers, is also high on priority list. The New trade policy gives focus to agriculture and all the hurdles will in Indian agriculture be crossed gradually.

# 6.3.2 Industry

Index of industrial production which measures the overall industrial growth rate was 10.1% in October 2004 as compared to 6.2% in October 2003. The double digit growth in Industrial Production was aided by a robust growth of 11.3% in the manufacturing sector followed by mining and quarrying and electricity generation. But industrial production saw a decline in Dec 2004 when IIP dipped to 8 %. Thus one of the critical challenges facing Indian economic policy consists in devising strategies for sustained industrial growth. Final phase-out of the MFA and India's conformity with the international intellectual property system from Jan

1st Jan 2005, have been two significant developments in the world of commerce & industry.

Textile industry is the largest industry in terms of employment. From the current US \$37 billion to \$85 billion by 2010 creation of 12 million new jobs in the textile sector and modernization & consolidation for creating a globally competitive textile industry. With the phasing out of quota regime under MFA, from Jan 1st 2005, developing countries including India with both textile & clothing capacity may be able to prosper. Automobile sector has demonstrated the inherent strengths of Indian labour and capital. The pharma industry and the IT industry are two sunrise sectors for India. Among the sectors that have experienced the greatest transformation in India, the pharmaceutical is perhaps the most significant.

India's WTO involvement during the last decade has encouraged our pharma companies to adopt a strategy of R & D based innovative growth. Indian pharma exports were 14000 crore Rupees & accounts for more than a third of the industry's turnover. Apart from manufacture of drugs, the pharma industry offers huge potential for outsourcing of clinical research. A vast pool of scientific and technical personnel & recognized expertise in medical treatment & health care are India's strength, India can take advantages of its strength once patent protection is given to the result of the researches. By participating in the international system of intellectual property protection, India unlocks for herself vast opportunities in both exports as well as her potential to become a global hub in the area of R & D based clinical research outsourcing, particularly in the area of bio-technology.

The three main sub sectors of industry viz. mining & quarrying, manufacturing, and electricity, gas & water supply recorded growths of 5%, 8.8% and 7.1%

respectively. Apart from infrastructure, particularly adequate and reliable power supply at reasonable cost and transportation facilities, there is need for stepped up investment in manufacturing. Industry needs to grow rapidly not only to boost the overall growth rate in the economy but also to generate gainful employment for the existing unemployed, as well as the new entrants. In a diverse range of industrial activities, several Indian firms have succeeded in getting integrated into global production chains and realized rapid growth of exports. This experience suggests that with appropriate scale, investment and technology, rapid industrial growth is indeed possible.

#### 6.3.3 Services

Service sector has maintained a steady growth pattern since 96-97, except into a fall in 2000-01. Trade hotels, transport & communications have witnessed the highest growth of level 10.9% in 2004, followed by financial services (With a overall growth rate of (6.4) % and community, social & personal services (5.9)% of all the three sectors, services have been the highest contributor to total GDP growth rate.

While in most parts of the developed world, the services sector's share of employment rose faster than its share of output in India there has been a relatively slow growth of jobs in the service sector. This is primarily because of the rise in labour productivity in services in sectors such as information technology that is dependent on skilled labour. Growth in tourism and tourism related services such as hotels, holds a large potential for employment generation.

IT enabled services, such as Business Process Outsourcing have been growing rapidly in the recent past and will continue to rise. However, the skill requirements for such services are of a specialized nature and the emergence of

somewhat inexplicable protectionist tendencies in some developed countries is a disturbing trend. However, it is important that India sees BPO in a larger perspective, than the Internet, as India's share is just \$ 3.5 billion in December 2004 compared to the global market of US \$ 178 billion. Also India outsourcing companies need to work more closely with their customers. In the complex BPOs, customers would like to have hybrid processes to control value. Indian companies need the right mix of domain expertise and process expertise, further, mere knowledge of English is not sufficient; management skills are also needed. Education for the offshoring industry needs to be given impetus too.

# 6.4 VAT

Value-Added Tax, one of the most radical reforms to be proposed for the Indian economy, could finally become a reality after four years of political and economic debate. So far 21 States have given their nod for the April 1 2005 deadline for switching over to VAT. The decision to introduce VAT was publicly discussed first at a conference of state chief ministers and finance ministers in November 1999. At that time, the deadline of April 2002 was agreed upon to bring in VAT but it couldn't be implemented due to political instability and a lack of initiatives. Now, despite a backlash from the trading community and some political circles, there appears to be a realistic scope for VAT to be introduced. VAT is value added a sales tax collected by the government (of the state in which the final consumer is located) - which is the government of destination state on consumer expenditure. Over 120 countries worldwide have introduced VAT over the past three decades and India is amongst the last few to introduce it. India already has a system of sales tax collection wherein the tax is collected at one point (first/last) from the transactions involving the sale of goods. VAT would, however, be collected in stages (installments) from one stage to another. The mechanism of VAT is such that, for goods that are imported and consumed in a particular state, the first seller pays the first point tax, and the next seller pays tax only on the valueaddition done - leading to a total tax burden exactly equal to the last point tax.

VAT is necessary, as it will close avenues for traders and businessmen to evade paying taxes. They will also be compelled to keep proper records of their sales and purchases. Many sections hold the view that the trading community has been amongst the biggest offenders when it comes to evading taxes. Under the VAT system, no exemptions will be given and a tax will be levied at each stage of manufacture of a product. At each stage of value-addition, the tax levied on the inputs can be claimed back from the tax authorities. At a macro level, there are two issues, which make the introduction of VAT critical for India. First, Industry watchers say that the VAT system, if enforced properly, forms part of the fiscal consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for the government. Second, any globally accepted tax administrative system will only help India integrate better in the World Trade Organization regime.

Hearing from caption of industry would give us a comprehensive picture of Indian economy as they are the people who are directly involved in evolution of current state of Indian economy.

#### An Indian renaissance

# India's top CEOS discuss the rewards of restructuring, both for the country and for companies

Mukesh Ambani

There is new found confidence in India. Indian information technology prowess has already become a legend. Other areas of technology, such as biotechnology and nanotechnology, are taking roots in India. We are beginning to see resurgence in science. Research-led companies of global reach are turning to our country to create science facilities here. India is emerging as a global manufacturing hub.

India has already made a mark in business process outsourcing. The width, depth and geographical reach of such services are expanding. Indian businesses are aspiring to be world-class players. Several industries, like steel, automobiles, pharmaceuticals, textiles and media, are beginning to imprint their footprints overseas.

An Indian renaissance is, therefore, no longer a dream. But in a world of globalization and intense competition, India has to go beyond the feel-good factor and the sense of newfound confidence to attain global leadership. This will call for concerted efforts by Indian business leadership to scout for global opportunities, seed nodes for innovation and build brand India. Business leadership will have to be obsessed with a passion for fostering global initiatives and attaining global leadership.

At the strategic level, Indian business will have to go beyond business process outsourcing to attaining global leadership in services; go beyond outsourced manufacturing to creating global brands; and go beyond contract research to creating new vistas of knowledge.

This cannot come about unless India invests heavily in science and technology education. This is because technology is driving economic growth and development in the New World and research-led higher education in science and technology is the crucible for ideation and innovation.

Indian institutions must also be geared to nurture innovation as it leads to greater productivity, higher economic growth and better standards of living. This can come about with sizeable public funding for research, surpluses from traditional businesses of large corporations channeled to research-led initiatives, protection for intellectual capital, vibrant venture capital participation, a competitive market place and a demanding environment for academic researchers.

Global leadership for India also means that India must access markets for goods, services and professional resources in other parts of the world. The developed world is gripped by the paranoia of protectionism. Non-trade barriers are emerging in the form of quantitative restrictions and phytosanitary requirements.

Subsidy for farmers in US and Europe is already a volatile issue. In this milieu, the Indian political and economic leadership must skillfully promote the interests of Indian trade in global conclaves. This would call for several bilateral and multilateral trade agreements to be put in place. Side by side, there is an urgent need to foster an efficient infrastructure within the country to support global trade. Efforts made by the government in roads need to be extended to ports, electricity, civil aviation and telecommunications. India must also have many more free trade zones.

India today has an once-in-a-lifetime opportunity to forge a new destiny of global leadership and transform the lives of over a billion of her people. With an eye on education, innovation, competition and market access and a vision that goes beyond business process outsourcing, contract manufacturing and contract research to building brands, technology and owning the global customer, India can make the grade.

#### The feel-good factor will stay

Kumar Mangalam Birla

India is back in currency. As the nation stands on the cusp of explosive growth, I believe the feel good factor is here to stay. The year 2003 has been remarkable on practically all fronts, signaling a tremendous resurgence in the economy. We have had a good monsoon. The faith and confidence of foreign investors in our country's economic prospects have been amply demonstrated with their putting in a record \$7 billion during this year.

Today, foreign exchange reserves in excess of \$100 billion are at an all-time high and secure us against any adverse external shock. In turn, this has prompted rating agencies to revise their outlook on India. Quarterly profits of corporations are soaring, helped by low interest rates, increasing demand for their products and improved productivity.

Overseas jobs are moving to India as the outsourcing wave gains momentum. Fifty per cent of Fortune 500 companies have taken this route. Interestingly, 100 of the Fortune 500 companies have set up R&D centres in India, and General Electric's R&D centre here is its second largest with over a 1000 PhDs.

As India outperformed the global economy in 2003 by a considerable margin, the whole world became alive to our country's potential. Stock markets are booming and currently represent wealth close to 55 per cent of our GDP.

The underlying trends in the economic fundamentals point to a performance that will be sustained well into the future. India's cost advantage and availability of a pool of skilled labour are proving to be sources of competitive strength. Our brain power has reshaped corporate America and continues to march on. One-third of NASA scientists are Indians and there are over 5,000 Indo-American professors in American colleges. At Harvard itself, I believe, 10 per cent of the faculty comprises Indian intellectuals.

In today's world, globalization is not an option but an imperative. Indeed the only option is how to harness the forces of globalization to one's advantage. Companies will locate where the costs are the lowest, and will service those markets where the returns are the highest. Therefore, it should come as no surprise that global auto companies

are increasingly sourcing their components,

and even designs from India. Many other sectors are following this trajectory. And this will further fuel our growth.

Earlier, India's traditional strength in services could not be exported, as services were seen as a non-tradable sector. Today, the scenario is different. Our techno takeoff has been and continues to be spectacular. Additionally, with growth in the telecommunications infrastructure, the skills even of a radiologist, a secretary, a financial analyst or a computer programmer have all become exportable.

High quality customer services can now be delivered over a telephone link, one end of which could be in Bangalore or Hyderabad. And this is causing the great exodus of jobs from high cost countries to India. The relative youth of India's labour force is another vantage point. The need to harness these favourable demographics to its maximum potential is well recognized today. It will also be the mainstay of India's pension reforms.

Finally, we can all bet on India's prosperity. With an expected 7 per cent to 8 per cent GDP growth and inflation under control at 4 per cent to 5 per cent, the scene at the macro level is indeed encouraging. Oil prices seem stable too and there is hardly any likelihood of pressures from other quarters. One hope that the rain gods will continue to be benevolent and no untoward global incidence occurs, in which case, we can all keep smiling.

#### Focus on infrastructure

#### Anand Mahindra

Corporate India has built a culture of cost cutting which has trimmed the flab and set our basics right. Many of us have also achieved global milestones in terms of quality. But cost cutting is only a first step - what will now take us forward is cost leadership. Cost cutting is only a small part of this. Leveraging cost leadership and delivering global quality are the factors that will drive our future growth. I think Indian companies are well aware of this, and we are already beginning to see the emergence of Indian multinationals.

Over the next few years up to the year 2010, as a nation we would have to focus on infrastructure, which has a multiplier effect on the economy, on agriculture, where we need to set our house in order, and focus on human development and improving the quality of life. Within our own group, growth will come from a combination of market leadership, innovative strategies, a quest for globalization and a ruthless focus on financial returns.

There are numerous areas where we need to pull up our socks. Although there has been a marginal improvement on the fiscal front, greater efforts are needed to discipline the burgeoning fiscal deficit. The unprecedented deterioration in the rate of public sector saving is a matter of concern. We need a faster reform process, especially in the areas of agricultural and fiscal reform.

We must also address the larger problems of civil society. We still need to overcome problems relating to corruption, economic scandals and good governance. Above all we must create an all-encompassing vision of the India that we want. To do this, there has to be a mechanism for dialogue between all stakeholders, so that we all

work in our respective fields towards the same vision of a better, more affluent and more inclusive India.

The Confederation of Indian Industry has been maintaining that 8 per cent sustainable growth is eminently feasible. With a stable external sector, a growth-oriented financial regime and a rejuvenated corporate sector, the final growth rate of 7 per cent for 2003-2004 appears well within our reach. In fact, we should be ambitious for more.

# Creating a brand image.

#### A M Naik

After more than four years of recession, the Indian economy is recovering and is poised on the growth path. No doubt the WTO regulations have made inroads into the country's trade policies, but they have also been nudging India to integrate with global economies. This has led to a mix of opportunities and challenges for Indian corporations.

While the service sector is set to boom, manufacturing organizations have to rethink their business models to survive and grow. The controlled economy regime forced Indian industries to invest in uneconomic volumes as well as expand outside their core areas. This legacy has come to haunt industry in the changed scenario. Therefore, restructuring to build upon the economies of scale in core areas and a capable human resource pool will be the key challenges for the survival and growth of Indian manufacturing.

The development of a strong and vibrant capital goods sector is a must for the growth of Indian industry. Since 1992, this sector has been rightly thrown open to international competition through a substantial reduction in duties as well as removal of trade barriers. At the same time, the sector continues to wallow in high costs. To sustain the manufacturing sector's growth, the government needs to expedite second generation reforms on labour issues, remove infrastructure bottlenecks and leverage India's strengths to promote the export of manufactured goods.

While the business environment has opened Indian industry to competition, the current situation has also made us realize the need to become international players. To manage the demand fluctuations in the domestic economy, L&T proactively embarked on the path of becoming an Indian multinational as an EPC (engineering, procurement & construction) organization.

To cope with these challenges, L&T is restructuring itself by hiving off unrelated businesses, reducing its interest burden by proactive treasury management and adopting the latest HR practices. L&T plans to generate 40 per cent of its revenues from international sales by 2007-2008.

The development of a global management pool, management of international business risk and creation of a

sustainable India brand image will be the key challenges for Indian corporations in the years ahead.

#### **Looking to the future**

Harsh Goenka.

Only a few years back, many started writing epitaphs for the Indian manufacturing sector and most believed them. The old economy companies were the prime targets. They heard the wake up call. Most realized that with globalization and competition, they had to act and now. They began to attack costs both in manufacturing and in supply chain management.

With a majority of the sectors surpassing their own standards, the turnaround that companies were waiting for finally became a reality. They consolidated their positions in the global arena too, an indicator being the ever increasing export figures witnessed in the pharmaceuticals, auto and IT industries. The second post-reforms growth is clearly visible now. This is the first time in a decade that the stock market has witnessed a broad-based rally and stock markets now play an important role in India's economic growth.

The story at RPG has been fairly representative of this sequence of events. A large diversified group like RPG had its fair share of challenges – a large workforce, the high cost of debt, very small and very large businesses and many associated issues. The situation could have been worse, if not for a major restructuring exercise initiated in 1993.

The group was then reorganized along core lines of business, processes were changed and fresh talent was infused into management. Restructuring, at RPG and outside, however, is an ongoing exercise. We may feel we are now somewhere close to completion. But in a dynamic environment, it never is really finished.

The last four years were indeed amongst the most challenging for the group. The key constituents of the group like power, transmission and tyres were facing a lot of challenges. We looked at three or four major areas of cost – manpower, interest, supply chain and process efficiencies. One of the biggest problems in power, high transmission and distribution losses, were dramatically reduced.

Looking to the future of Indian industry, the silver lining is clearly visible and signs of growth are evident. The evidence will ultimately rest on how the political framework lives up to the demands of a growing economy.

The commitment to the reform process has to be aided by a unified approach amongst all political parties when it comes to specifics. Indian industry has gained immense confidence on a global platform and as a nation we have earned a great deal of respectability. If we make a breakthrough in the way we manage and administer our nation I am sure we will see India shining for many years.

#### **6.5 SUMMARY**

India is in process to become an economic superpower. Since independence India has thrived hard for improving the pace of development. Indian economy has achieved a GDP growth rate of

above 6% during the last 4-5years. Growth in Indian economy has steadily increased since 1979, averaging 5.7% per year in the 23 year growth record. All the three sector namely, Agriculture, Industries, and service sector has contributed towards this growth. VAT proposed itself as a one of the most radical reforms for Indian economy.

#### **6.6 Questions for Discussion**

- 1. What are the various issues and priorities for India in new millennium?
- 2. "India prepares herself for becoming an economic superpower," discuss the statement with strong facts.
- 3. Discuss in detail the growth of three sector of Indian economy.
- 4. What do you mean by VAT? Also discuss the pros and cons of VAT.

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**Subject: Business Environment** 

Lesson:07

#### **ENVIRONMENTAL POLLUTION**

**Objective** –This lesson is intended to impart knowledge about the various types of environmental pollution, its effects, sources, and methods to control, prevention of environmental pollution, and solid waste management. Environmental legislation is also discussed in brief.

#### **Structure**

- 7.1 Introduction
- 7.2 Air pollution, sources, effects and control
- 7.3 Noise pollution, sources, effects and control
- 7.4 Water pollution, sources, effects and control
- 7.5 Water(prevention and control of pollution)act, 1974
- 7.6 The air (prevention and control of pollution) act, 1981
- 7.7 The environment (protection) act, 1986
- 7.8 Drawbacks of pollution related acts
- 7.9 Public environmental awareness
- 7.10 Summary
- 7.11 Questions for discussion
- 7.12 References

# 7.1 INTRODUCTION

Environment' is derived from the French word *Environner* that means to encircle or surround. All the biological and non-biological things surrounding an organism are thus included in environment. Thus *environment is sum total of water, air and land, inter-relationships among themselves and also with the human beings, other living organisms and property. The above definition given in Environment (Protection) Act, 1986 clearly indicates that environment includes all the physical and biological surroundings and their interactions.* 

For normal and healthy living a conducive environment is required by all the living beings, including humans, livestock plants microorganisms and the wildlife. The favorable unpolluted environment has a specific composition. When addition of harmful substances changes this composition, the environment is called polluted environment and the substances polluting it are called pollutants. *Environmental pollution can, therefore, be defined as any undesirable change in the physical, chemical or biological characteristics of any component of the environment (air, water, soil), which can cause harmful effects on various forms of life or property.* 

Environmental pollution could be of various types:

# 7.2 AIR POLLUTION, SOURCES, EFFECTS AND CONTROL

It is an atmospheric condition in which certain substances (including the normal constituents in excess) are present in concentrations, which can cause undesirable effects on living being and the environment. These substances include gases, particulate matter, radioactive substances etc.

Gaseous pollutants include oxides of sulphur (mostly  $SO_2$ ,  $SO_3$ ) oxides of nitrogen (mostly NO and  $NO_2$  or  $NO_x$ ), carbon monoxide (CO), volatile organic compounds (mostly hydrocarbons) etc. Particulate pollutants include smoke, dust, soot, fumes, aerosols, liquid droplets, pollen grains etc. Radioactive pollutants include radon-222, iodine-13I, strontium 90, plutonium-239 etc.

# **Sources of Air Pollution**

The sources of air pollution are natural and man-made (anthropogenic).

# **Natural Sources**

The natural sources of air pollution are volcanic eruptions, forest fires, sea salts sprays, biological decay, photochemical oxidation of terpenes, marshes, extra terrestrial bodies pollen grains of flowers, spores etc. Radioactive minerals present in the earth crust are the sources of radioactivity in the atmosphere.

#### Man-made

Man made sources include thermal power plants, industrial units, vehicular emissions, fossil fuel burning, agricultural activities etc. Thermal power plants have become the major sources for generating electricity in India, as the nuclear power plants couldn't be installed as

planned. The main pollutants emitted are fly ash and  $S0_2$ . Metallurgical plants also consume coal and produce similar pollutants. Fertilizer plants, smelters, textile mills, tanneries, refineries, chemical industries, paper and pulp mills are other sources of air pollution.

Automobile exhaust is another major source of air pollution. Automobiles release gases such as carbon monoxide (about 77%), oxides of nitrogen (about 8%) and hydrocarbons (about 14%). Heavy-duty diesel vehicles spew more NO<sub>x</sub> and suspended particulate matter (SPM) than petrol vehicles, which produce more carbon monoxide and hydrocarbons.

#### **Indoor Air Pollution**

The most important indoor air pollutant is radon gas. Radon gas and its radioactive daughters are responsible for a large number of lung cancer deaths each year. Radon can be emitted from building materials like bricks, concrete, tiles etc., which are derived from soil containing radium. Radon is also present in groundwater and natural gas and is emitted indoors while using them.

Many houses in the under-developed and developing countries including India use fuels like coal, dung-cakes, wood and kerosene in their kitchens. Complete combustion of fuel produces carbon dioxide, which may not be toxic. However, incomplete combustion produces the toxic gas carbon monoxide. Coal contains varying amounts of sulphur, which on burning produces sulphur dioxide. Fossil fuel burning produces black soot. These pollutants i.e. CO, sulphur dioxide, soots and many others like formaldehyde, benzo- (a) pyrene (BAP) are toxic and harmful for health. BAP is also found in cigarette smoke and is considered to cause cancer. A housewife using wood as fuel for cooking inhales BAP equivalent to 20 packets of cigarette a day.

# Effects of air pollution

Air pollution has adverse effects on living organisms and materials.

# Effects on Human Health

Human respiratory system has a number of mechanisms for protection from air pollution. The hairs and sticky mucus in the lining of the nose can trap bigger particles. Smaller particles can reach tracheobronchial system and there get trapped in mucus. They are sent back to throat by beating of hair like cilia from where they can be removed by spitting or swallowing. Years of exposure to air pollutants (including cigarette smoke) adversely affect these natural defenses and can result in lung cancer, asthma, chronic bronchitis and emphysema (damage to air sacs leading to loss of lung elasticity and acute shortness of breath). Suspended particulate can cause damage to lung tissues and diseases like asthma, bronchitis and cancer especially when they bring with them cancer causing or toxic pollutants attached on their surface. Sulphur dioxide (S0<sub>2</sub>) causes constriction of respiratory passage and can cause bronchitis like conditions. In the presence of suspended particulate, S0<sub>2</sub> can form acid sulphate particles, which can go deep into the lungs and affect them severely.

Oxides of nitrogen especially NO<sub>2</sub> can irritate the lungs and cause conditions like chronic bronchitis and emphysema. Carbon monoxide (CO) reaches lungs and combines with hemoglobin of blood to form carboxyhaemoglobin. CO has affinity for hemoglobin 210 times more than oxygen. Hemoglobin is, therefore, unable to transport oxygen to various parts of the body. This causes suffocation. Long exposure to CO may cause dizziness, unconsciousness and even death. Many other air pollutants like benzene (from unleaded petrol), formaldehyde and particulate like polychlorinated biphenyls (PCBs) toxic metals and dioxins (from burning of polythene) can cause mutations, reproductive problems or even cancer.

#### **Effects on Plants**

Air pollutants affect plants by entering through stomata (leaf pores through which gases diffuse), destroy chlorophyll and affect photosynthesis. Pollutants also erode waxy coating of the leaves called cuticle. Cuticle prevents excessive water loss -and damage from diseases, pests, drought and frost. Damage to leaf structure causes *necrosis* (dead areas of leaf), *chlorosis* (loss or reduction of chlorophyll causing yellowing of leaf) or *epinasty* (downward Curling of

leaf) and *abscission* (dropping of leaves). Particulates deposited on leaves can form encrustations and plug the stomata. The damage can result in death of the plant.

#### Effects on aquatic life

Air pollutants mixing up with rain can cause high acidity (lower pH) in fresh water lakes. This affects-aquatic life especially fishes. Some of the freshwater lakes have experienced total fish death.

#### **Effects on materials**

Because of their corrosiveness, particulate can cause damage to exposed surfaces. Presence of SO<sub>2</sub>and moisture can accelerate corrosion of metallic surfaces. SO<sub>2</sub>can affect fabric, leather, paint, paper, marble and limestone. Ozone in the atmosphere can cause cracking of rubber. Oxides of nitrogen can also cause fading of cotton and rayon fibers.

#### **Control of Air Pollution**

Air pollution can be minimized by the following methods:

- Siting of industries after proper Environmental Impact Assessment studies.
- Using low sulphur coal in industries.
- Removing sulphur from coal (by washing or with the help of bacteria).
- Removing NO<sub>x</sub> during the combustion process.
- Removing particulate from stack exhaust gases by employing electrostatic precipitators, bag-house filters, cyclone separators, scrubbers etc.
- Vehicular pollution can be checked by regular tune-up of engines; replacement of more polluting old vehicles; installing catalytic converters; by engine modification to have fuel efficient (lean) mixtures to reduce CO and hydrocarbon emissions; and slow and cooler burning of fuels to reduce *NO<sub>x</sub>* emission (Honda Technology).
- Using mass transport system, bicycles etc.
- Shifting to less polluting fuels (hydrogen gas).
- Using non-conventional sources of energy.
- Using biological filters and bio-scrubbers.
- Planting more trees.

# 7.3 NOISE POLLUTION, SOURCES, EFFECTS AND CONTROL

We hear various types of sound everyday. Sound is mechanical energy from a vibrating source. A type of sound may be pleasant to someone and at the same time unpleasant to others. The unpleasant and unwanted sound is called noise. Sound can propagate through a medium like air, liquid or solid. Sound wave is a pressure perturbation in the medium through which sound travels. Sound pressure alternately causes compression and rarefaction. The number of compressions and rarefactions of the molecules of the medium (for example air) in a unit time is described as frequency. It is expressed in Hertz (Hz) and is equal to the number of cycles per second.

There is a wide range of sound pressures, which encounter human ear. Increase in sound pressure does not invoke linear response of human ear. A meaningful logarithmic scale has been devised. The noise measurements are expressed as Sound Pressure Level (SPL) which is logarithmic ratio of the sound pressure to a reference pressure. It is expressed as a dimensionless unit, decibel (dB). The international reference pressure of 2 x 10<sup>-5</sup> Pa is the average threshold of hearing for a healthy ear. Decibel scale is a measure of loudness. Noise can affect human ear because of its loudness and frequency (pitch).

The Central Pollution Control Board (CPCB) committee has recommended permissible noise levels for different locations as given in Table 7.1.

Table 7.1 Noise Standard Recommended By CPCB Committee

AREA CODE	CATEGORY OF AREA	NOISE LEVEL IN dB (A) LEQ	
		DAY	NIGHT
(A)	Industrial	75	70
<b>(B)</b>	Commercial	65	55
(C)	Residential	55	45

(D) Silence Zone 50 40

#### Sources of Noise Pollution

The main sources of noise are various modes of transportation (like air, road, rail-transportation), industrial operations, construction activities and celebrations (social/religious functions, elections etc) electric home appliances. High levels of noise have been recorded in some of the cities of the world. In Nanjing (China) noise level of 105 dB has been recorded, while in some other cities of the world these levels are: Rome 90 dB, New York 88 dB, Calcutta 85 dB, Mumbai 82 dB, Delhi 80 dB, Kathmandu 75 dB.

#### Effects of Noise

Noise causes the following effects.

Interferes with man's communication
 In a noisy area communication is severely affected.

# 2. Hearing damage

Noise can cause temporary or permanent hearing loss. It depends on intensity and duration of sound level. Auditory sensitivity is reduced with noise level of over 90 dB in the midhigh frequency for more than a few minutes.

### 3. Physiological and Psychological changes

Continuous exposure to noise affects the functioning of various systems of the body. It may result in hypertension, insomnia (sleeplessness), gastro-intestinal and digestive disorders, peptic ulcers, blood pressure changes, behavioral changes, emotional changes etc.

#### NOISE POLLUTION DURING DIWALI

Diwali is a festival of lights. Traditionally people of all ages enjoy firecrackers. Some accidents do occur every year claiming a few lives. Besides, noise generated by various firecrackers is beyond the permissible noise levels of 125 decibels as per the Environmental (Protection) (Second Amendment) Rules, 1999. There has been a great concern over the noise levels generated during Diwali. Some measurements by certain group of researchers have also been made at various places during Diwali. It is recommended that the manufacturers of fireworks

should mention the noise levels in decibels generated by individual items. The department of explosives of the Union Ministry of Commerce and Industry is entrusted with the task to ensure that the industry produces firecrackers conforming to permissible noise standards.

According to a recent test report on firecrackers produced by the National Physical Laboratory, New Delhi most of the firecrackers available in the market produce noise beyond the permissible levels of 125 decibels as per the Environment (Protection) (Second amendment) Rules, 1999. Some of them have been observed to produce noise near the threshold of pain.

The noise levels were measured under standard conditions i.e. in areas not having noise-reflecting surfaces within a 15-metre radius. Two gadgets, for measuring sound levels were installed at a height of 1.3 metres and at a distance of 4 metres from the source of sound. Besides mentioning the sound levels on each of the types of firecrackers or banning the production of such firecrackers which produce noise above permissible levels, it is important to educate people about the harmful effects of noise during such festivals like Diwali. It can be done by giving public notices in the leading newspapers and messages through other mass media like radio and television.

Honorable Supreme Court in a Writ Petition (civil) of 1998 concerning noise pollution had passed the following directions as an interim measure. The Union Government, The Union Territories as well as all the State Governments shall in particular comply with amended Rule 89 of the Environmental (Protection) Rules, 1986 framed under the Environmental (Protection) Act, 1986 which essentially reads as follows.

- (i) The manufacture, sale or use of fire-crackers generating noise level exceeding 125 dB (AI) or 145 dB (C) pk at 4 meters distance from the point of bursting shall be prohibited.
- (ii) For individual firecracker constituting the series (Joined firecrackers), the abovementioned limit be reduced by 5 log 10 (N) dB, where N = Number of crackers joined together.
- 2. The use of fire works or firecrackers shall not be permitted except between 6.00 p.m. and 10.00 p.m. No fire works or firecrackers shall be used between 10.00 p.m. and 6.00 a.m.

4. Firecrackers shall not be used at any time in silence zones, as defined by the Ministry of Environment and Forests.

Silence Zone has been defined as: "Silence Zone in an area comprising not less that 100 meters around hospitals, educational institutions, courts, religious places or any other area which is declared as such by the competent authority".

5. The State Education Resource Centres in all the States and Union Territories as well as the management/principals of schools in all the States and Union Territories shall take appropriate steps to educate students about the ill effects of air and noise pollution.

#### **Control of Noise Pollution**

#### Reduction in sources of noise

- Sources of noise pollution like heavy vehicles and old vehicles may not be allowed to ply in the populated areas.
- Noise making machines should be kept in containers with sound absorbing media. The noise
  path will be in interrupted and will not reach the workers.
- Proper oiling will reduce the noise from the machinery.

#### Use of sound absorbing silencers

- Silencers can reduce noise by absorbing sound. For this purpose various types of fibrous material could be used.
- Planting more trees having broad leaves.

### **Through Law**

Legislation can ensure that sound production is minimized at various social functions. Unnecessary horn blowing should be restricted especially in vehicle-congested areas.

#### 7.4 WATER POLLUTION, SOURCES, EFFECTS AND CONTRL

Water pollution can be defined as alteration in physical, chemical or biological characteristics of water making it unsuitable for designated use in its natural state.

#### Sources of water pollution

Water is an essential commodity for survival. We need water for drinking, cooking, bathing, washing, irrigation, and for industrial operations. Most of water for such uses comes from rivers, lakes or groundwater sources. Water has the property to dissolve many substances in it; therefore, it can easily get polluted. Point sources or non-point sources can cause pollution of water. Point sources are specific sites near water, which directly discharge effluents into them. Major point sources of water pollution are industries, power plants, underground coal mines, offshore oil wells etc. The discharge from non-point sources is not at any particular site; rather, these sources are scattered, which individually or collectively pollute water. Surface run-off from agricultural fields, overflowing small drains, rain water sweeping roads and fields, atmospheric deposition etc. are the non-point sources of water pollution.

# Ground water pollution

Ground water forms about 6.2% of the total water available on planet earth and is about 30 times more than surface water (streams, lakes and estuaries). Ground water seems to be less prone to pollution as the soil mantle through which water passes helps to retain various contaminants due to its cation exchange capacity. However, there are a number of potential sources of ground water pollution. Septic tanks, industry (textile, chemical, tanneries), deep well injection, mining etc. are mainly responsible for ground water pollution, which is irreversible. Ground water pollution with arsenic, fluoride and nitrate are posing serious health hazards.

# **Surface water pollution**

The major sources 'of surface water pollution are:

- 1. *Sewage*: Pouring the drains and sewers in fresh water bodies causes water pollution. The problem is severe in cities.
- 2. *Industrial effluents*: Industrial wastes containing toxic chemicals, acids, alkalis, metallic salts, phenols, cyanides, ammonia, radioactive substances, etc. are sources of water pollution. They also cause thermal (heat) pollution of water.
- 3. *Synthetic detergents*: Synthetic detergents used in washing and cleaning produce foam and pollute water.
- 4. *Agrochemical*: Agrochemical like fertilizers (containing nitrates and phosphates) and pesticides (insecticides, fungicides, herbicides etc.) washed by rainwater and surface run-off

pollute water.

- 5. Oil: Oil spillage into seawater during drilling and shipment pollute it.
- 6. *Waste heat*: Waste heats from industrial discharge increases the temperature of water bodies and affects distribution and survival of sensitive species.

#### Effects of Water Pollution

Following are some important effects of various types of water pollutants:

#### Oxygen demanding wastes

Microorganisms present in water decompose organic matter, which reaches water bodies. For this degradation oxygen dissolved in water is consumed. Dissolved oxygen (DO) is the amount of oxygen dissolved in a given quantity of water at a particular temperature and atmospheric pressure. Amount of dissolved oxygen depends on aeration, photosynthetic activity in water, respiration of animals and plants and ambient temperature. The saturation value of DO varies from 8-15 mg/L. For active fish species (trout and Salmon) 5-8 mg/L of DO is required whereas less desirable species like carp can survive at 3.0 mg/L of DO. Lower DO may be harmful to animals especially fish population. Oxygen depletion (deoxygenating) helps in release of phosphates from bottom sediments and causes eutrophication.

# **Nitrogen and Phosphorus Compounds (Nutrients)**

Addition of compounds containing nitrogen and phosphorus helps in the growth of algae and other plants which when die and decay consume oxygen of water. Under anaerobic conditions foul smelling gases are produced. Excess growth or decomposition of plant material will change the concentration of CO<sub>2</sub>, which will further change pH of water. Changes in pH, oxygen and temperature will change many physico-chemical characteristics of water.

# **Pathogens**

Many wastewater especially sewage contain many pathogenic (disease causing) and non-pathogenic microorganisms and many viruses. Water borne diseases like cholera, dysentery, typhoid, jaundice etc. are spread by water contaminated with sewage.

# **Toxic Compounds**

Pollutants such as heavy metals, pesticides, cyanides and many other organic and inorganic compounds are harmful to aquatic organisms. Some of these substances like pesticides, methyl mercury etc. move into the bodies of organisms from the medium in which these organisms live. Substances like DDT are not water-soluble and have affinity for body lipids. These substances tend to accumulate in the organism's body. This process is called *bioaccumulation*. The concentration of these toxic substances builds up at successive levels of food chain. This process is called *biomagnifications*.

Toxic substances polluting the water ultimately affect human health. Some heavy metals like lead, mercury and cadmium cause various types of diseases. Mercury dumped into water is transformed into water soluble methyl mercury by bacterial action. Methyl mercury accumulates in fish. In 1953, people in Japan suffered from numbness of body parts, vision and hearing problems and abnormal mental behaviour. This disease called *Minamata* disease occurred due to consumption of methyl mercury contaminated fish caught from *Minamata* bay in Japan. The disease claimed 50 lives and permanently *paralysed* over 700 persons. Pollution by another heavy metal cadmium had caused the disease called *ltai-itai* in the people of Japan. The disease was caused by cadmium contaminated rice. The rice fields were irrigated with effluents of zinc smelters and drainage water from mines. In this disease bones, liver, kidney, lungs, pancreas and thyroid are affected.

Arsenic pollution of ground water in Bangladesh and West Bengal is causing various types of abnormalities. Nitrate when present in excess in drinking water causes *blue baby syndrome* or *methaemoglobinemia*. The disease develops when a part of hemoglobin is converted into nonfunctional oxidized form. Nitrate in stomach partly gets changed into nitrites, which can produce cancer-causing products in the stomach. Excess of fluoride in drinking water causes defects in teeth and bones called *fluorosis*. Pesticides in drinking water ultimately reach humans and are known to cause various health problems. DDT, aldrin, dieldrin etc. have therefore, been banned. Recently, in Andhra Pradesh, people suffered from various abnormalities due to consumption of endosulphan contaminated cashew nuts.

#### Control of Water Pollution

It is easy to reduce water pollution from point sources by legislation. However, due to absence of defined strategies it becomes difficult to prevent water pollution from non-point sources. The following points may help in reducing water pollution from non-point sources.

- (i) Judicious use of agrochemical likes pesticides and fertilizers, which will reduce their surface run-off and leaching. Avoid use of these on sloped lands.
- (ii) Use of nitrogen fixing plants to supplement the use of fertilizers.
- (iii) Adopting integrated pest management to reduce reliance on pesticides.
- (iv) Prevent run-off of manure. Divert such run-off to basin for settlement. The nutrient rich water can be used as fertilizer in the fields.
- (v) Separate drainage of sewage and rainwater should be provided to prevent overflow of sewage with rainwater.
- (vi) Planting trees would reduce pollution by sediments and will also prevent soil erosion.

For controlling water pollution from point sources, treatment of wastewater is essential before being discharged.

- Wastewater should be properly treated by primary and secondary treatments to reduce the BOD, COD levels up to the permissible levels for discharge.
- Advanced treatment for removal of nitrates and phosphates will prevent eutrophication.
   Before the discharge of wastewater, it should be disinfected to kill the disease-causing organisms like bacteria.
- Proper chlorination should be done to prevent the formation of chlorinated hydrocarbons or ozone or ultraviolet radiation should do disinfection.

# 7.5 WATER (PREVENTION AND CONTROL OF POLLUTION) ACT, 1974

It provides for maintaining and restoring the wholesomeness of water by preventing and controlling its pollution. Pollution is defined as *such* contamination of water, or such alteration of the physical, chemical or biological properties of water, or such discharge as is likely to cause a nuisance or render the water harmful or injurious to public health and safety or harmful for any other use or to aquatic plants and other organisms or animal life.

The definition of water pollution has thus encompassed the entire probable agents in water that may cause any harm or have a potential to harm any kind of life in any way.

The salient features and provisions of the Act are summed up as follows:

- (i) It provides for maintenance and restoration of quality of all types of surface and ground water.
- (ii) It provides for the establishment of Central and State Boards for pollution control.
- (iii) It confers them with powers and functions to control pollution.
- (iv) The Act has provisions for funds, budgets, accounts and audit of the Central and State Pollution Control Boards.
- (v) The Act makes 'provisions for various penalties for the defaulters and procedure for the same.

The main regulatory bodies are the Pollution Control Boards, which have been, conferred the following duties and powers:

#### **Central Pollution Control Board (CPCB)**

- It advises the central govt. in matters related to prevention and control of water pollution.
- Coordinates the activities of State Pollution Control Boards and provides them technical assistance and guidance.
- Organizes training programs for prevention and control of pollution.
- Organizes comprehensive programs on pollution related issues through mass media.
- Collects, compiles and publishes technical and statistical data related to pollution.
- Prepares manuals for treatment and disposal of sewage and trade effluents.
- Lays down standards for water quality parameters.
- Plans nation-wide programs for prevention, control or abatement of pollution.
- Establishes and recognizes laboratories for analysis of water, sewage or trade effluent sample.

The State Pollution Control Boards also have similar functions to be executed at state level and are governed by the directions of CPCB.

• The Board advises the state govt. with respect to the location of any industry that might pollute a stream or a well.

- It lays down standards for effluents and is empowered to take samples from any stream, well or trade effluent or sewage passing through an industry.
- The State Board is empowered to take legal samples of trade effluent in accordance with the procedure laid down in the Act. The sample taken in the presence of the occupier or his agent is divided into two parts, sealed, signed by both parties and sent for analysis to some recognized lab. If the samples do not conform to the prescribed water quality standards (crossing maximum permissible limits), then 'consent' is refused to the unit.
- Every industry has to obtain consent from the Board (granted for a fixed duration) by applying on a prescribed Performa providing all technical details, along with a prescribed fee following which analysis of the effluent is carried out.
- The Board suggests efficient methods for utilization, treatment and disposal of trade effluents.

The Act has made detailed provisions regarding the power of the Boards to obtain information, take trade samples, restrict new outlets, restrict expansion, enter and inspect the units and sanction or refuse consent to the industry after effluent analysis.

# 7.6 THE AIR (PREVENTION AND CONTROL OF POLLUTION) ACT, 1981

Salient features of the act are as follows:

- (i) The Act provides for prevention, control and abatement of air pollution.
- (ii) In the Act, air pollution has been defined as the presence of any solid, liquid or gaseous substance (including noise) in the atmosphere in such concentration as may be or tend to be harmful to human beings or any other living creatures or plants or property or environment.
- (iii) Noise pollution has been inserted as pollution in the Act in 1987.
- (iv) Pollution control boards at the centre or state level have the regulatory authority to implement the Air Act. Just parallel to the functions related to Water (prevention and Control of Pollution) Act, the boards perform similar functions related to improvement of air quality. The boards have to check whether or not the industry strictly follows the norms or standards lay down by the Board under section 17, regarding the discharge of emission of any air pollutant. Based upon analysis report consent is granted or refused to the industry.

- (v) Just like the Water Act, the Air Act has provisions for defining the constitution, powers and function of Pollution Control Boards, funds, accounts, audit, penalties and procedures.
- (VI) Section 20 of the Act has provision for ensuring emission standards from automobiles. Based upon it, the state govt. is empowered to issue instructions to the authority incharge of registration of motor vehicles (under Motor Vehicles Act, 1939) that is bound to comply with such instructions.
- (vii) As per Section 19, in consultation with the State Pollution Control Board, the state government may declare an area within the state as "air pollution control area" and can prohibit the use of any fuel other than approved fuel in the area causing air pollution. No person shall, without prior consent of State Board operate or establish any industrial unit in the "air pollution control area".

### 7.7 THE ENVIRONMENT (PROTECTION) ACT, 1986

The Act came into force on Nov. 19, 1986, the birth anniversary of our Late Prime Minister Indira Gandhi, who was a pioneer of environmental protection, issues in our country. The Act extends to whole of India. Some terms related to environment have been described as follows in the Act:

- *Environment* includes water, air and land and the inter-relationships that exist among and between them and human beings, all other living organisms and property.
- *Environmental pollution* means the presence of any solid, liquid or gaseous substance present in such concentration, as may be, or tend to be, injurious to environment.
- Hazardous Substance means any substance or preparation which by its physico-chemical properties or handling is liable to cause harm to human beings, other living organisms, property or environment.

The Act has given powers to the Central Government to take measures to protect and improve environment while the state governments coordinate the actions. The most important functions of Central Govt. under this Act include setting up of:

(a) The standards of quality of air, water or soil for various areas and purposes,

- (b) The maximum permissible limits of concentration of various environmental pollutants (including noise) for different areas.
  - (c) The procedures and safeguards for the handling of hazardous substances.
  - (d) The prohibition and restrictions on the handling of hazard our substances in different areas.
  - (e) The prohibition and restriction on the location of industries and to carry on process and operations in different areas.
  - (f) The procedures and safeguards for the prevention of accidents which may cause environmental pollution and providing for remedial measures for such accidents.

The power of entry and inspection, power to take sample etc. under this Act lies with the Central Government or any officer empowered by it.

For the purpose of protecting and improving the quality of the environment and preventing and abating pollution, standards have been specified under Schedule I-IV of Environment (Protection) Rules, 1986 for emission of gaseous pollutants and discharge of effluents/waste water from industries. Under the Environmental (protection) Rules, 1986 the State Pollution Control Boards have to follow the guidelines provided under Schedule VI, some of which are as follows:

- (a) They have to advise the Industries for treating the wastewater and gases with the available technology to achieve the prescribed standards.
- (b) The industries have to be encouraged for recycling and reusing the wastes.
- (c) They have to encourage the industries for recovery of biogas, energy and reusable materials.
- (d) While permitting the discharge of effluents and emissions into the environment, the State Boards have to take into account the assimilative capacity of the receiving water body.
- (e) The Central and State Boards have to emphasize on the implementation of clean technologies by the industries in order to increase fuel efficiency and reduce the

generation of environmental pollutants.

Under the Environment (Protection) Rules, 1986 an amendment was made in 1994 for Environmental Impact Assessment (EIA) of Various Development Projects. There are 29 types of projects listed under Schedule I of the rule, which require clearance from the Central Government before establishing.

#### 7.8 DRAWBACKS OF POLLUTION RELATED ACTS

- The power and authority has been given to central government with little delegation of power to state government. Excessive centralization very often hinders efficient execution of the provisions of the Acts in the states. Illegal mining is taking place in many forest areas. In Rajasthan alone, about 14000 cases of illegal mining have been reported. It becomes more difficult to check such activities at the central level.
- The provision of penalties in the Act is very insignificant as compared to the damage caused by the big industries due to pollution. The penalty is much less than the cost of the treatment/pollution control equipment. This always gives a loose rope to the industries.
- The Act has not included the "right to information" for the citizens. This greatly restricts the involvement or participation of the general public.
- The Environment (protection) Act, 1986 regarded as an umbrella Act, encompassing the earlier two acts often seems superfluous due to overlapping areas of jurisdiction. For instance Section 24 (2) of the new Act has made a provision that if the offender is punishable under the other Acts like Water Act or Air Act also, then he may be considered under their provisions. Interestingly, the penalty under the older two Acts is much lighter than the new Act. So the offender easily gets away with a lighter punishment.
- Under Section 19, a person cannot directly file a petition in the court on a question of environment and has to give a notice of minimum 60 days to the central government. In case the latter takes no action, then alone the person can file a petition, which certainly delays the remedial action.
- Litigation, particularly related to environment is very expensive, tedious and difficult since it
  involves expert testimony, technical knowledge of the issues and terminology, technical
  understanding of the unit process, lengthy prosecutions etc.

- The State Boards very often lack adequate funds and expertise to pursue their objectives.
- A tendency to seek to exercise gentle pressure on the polluter and out of the court settlements usually hinders the implementation of legal measures.
- For small units it is very expensive to install Effluent Treatment Plant (ETP) or Air pollution control devices and sometimes they have no other option but to close the unit. The Act should make some provision for providing subsidies for installing treatment plants or common effluent treatment plants for several small units.
- The pollution control laws are not backed by sound policy pronouncements or guiding principles.
- Political appointee usually occupies the position of chairman of the boards. Hence it is difficult to keep political interference at bay.
- The policy statement of the Ministry of Environment and Forests (1992) of involving public in decision-making and facilitating public monitoring of environmental issues has mostly remained on paper.

Environmental policies and laws need to be aimed at democratic decentralization of power, community-state partnership, administrative transparency and accountability and more stringent penalties to the offender. There is also a need for environmental law education and capacity building in environmental issues for managers.

#### 7.9 PUBLIC ENVIRONMENTAL AWARENESS

- Some of the main reasons responsible for widespread environmental ignorance can be summed up as follows:
- Our courses in Science, technology, economics etc. have so far failed to integrate the knowledge in environmental aspects as an essential component of the curriculum.
- Our planners, decision-makers, politicians and administrators have not been trained so as to consider the environmental aspects associated with their plans.
- In zeal to go ahead with some ambitious development projects, quite often there is purposeful concealment of information about environmental aspects.
- There is greater consideration of economic gains and issues related to eliminating poverty by

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providing employment that overshadows the basic environmental issues.

**Methods to Propagate Environmental Awareness** 

Environmental awareness needs to be created through formal and informal education to all sections of the society. Everyone needs to understand it because 'environment belongs to all' and 'every individual matters' when it comes to conservation and protection of environment. Various stages

and methods that can be useful for raising environmental awareness in different sections of the society are as follows:

Among students through education

Environmental education must be imparted to the students' right from the childhood stage. It is a

welcome step that now allover the country we are introducing environmental studies as a subject

at all stages including school and college level, following the directives of the Supreme Court.

Among the Masses through mass-media

Media can play an important role to educate the masses on environmental issues through

articles, environmental rallies, plantation campaigns, street plays, real eco-disaster stories and

success stories of conservation efforts. TV serials like Virasat, Race to save the Planet, Heads

and Tails, Terra-view, Captain planet and the like have been effective in propagating the seeds

of environmental awareness amongst the viewers of all age groups. Among the planners,

decision-makers and leaders

Since this elite section of the society plays the most important role in shaping the future of the

society, it is very important to give them the necessary orientation and training through specially

organized workshops and training programmes.

Publication of environment - related resource material in the form of pamphlets or booklets

published by Ministry of Environment & Forests could also help in keeping this section abreast

of the latest developments in the field.

**Role of Non-Government Organizations (NGO's)** 

Voluntary organizations can help by advising the government about some local environmental

issues and at the same time interacting at the grass-root levels. They can act as an effective and

viable link between the two. They can act both as an 'action group' or a 'pressure group'. They

can be very effective in organizing public movements for the protection of environment through

creation of awareness.

The "Chipko :Movement" for conservation of trees by Dasholi Gram Swarajya MandaI in

Gopeshwar or the "Narmada Bachao Andolan" organized by Kalpavriksh, are some of the instances where NGO's have played a landmark role in the society for conservation of environment. The Bombay Natural History Society (BNHS), the World Wide Fund for Nature - India (WWF, India) Kerala Sastra Sahitya Parishad, Centre for Science and Environment (CSE) and many others are playing a significant role in creating environmental awareness through research as well as extension work.

#### 7.10 SUMMARY

There are various environmental pollution, have harmful effects on human beings as well as on animal, plants and each and every units of this world. To control these, various control measures must be implemented effectively. The effective implementation of environmental legislation could play an important role to reduce the harmful impact up to significant extent. Various voluntary organizations have contributed in this regard.

# 7.11 QUESTIONS FOR DISCUSSION

- 1. What do you mean by environmental pollution? What are the major sources of air pollution? What are the various measures to control it?
- 2. What are the natural and man made pollutants that cause air pollution?
- 3. Briefly describe the sources, effects, and control of air pollution.
- 4. Give an account of noise generating during Diwali.
- 5. Discuss adverse effects and control of water pollution.
- 6. Wright short note on:
  - 1. Minamata disease
  - 2. Biomagnification
  - 3. Itai-itai disease
  - 4. Blue baby syndrome
- 7. How do you define pollution as per water (prevention and control of pollution)act, 1974? What are the salient features of the act?
- 8. Who has the authority to declare an area as "air pollution control area" in a state under the air

(prevention and control of pollution) act, 1981? What was noise inserted in this act?

- 9. Briefly explain the environmental pollution act, 1986?
- 10. What are the drawbacks to successful implementation of environmental legislation?
- 11. What are the different methods to propagate environmental awareness in the society?

# 7.13 REFERENCES

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**Subject**: Business Environment

Lesson: 08

# **GROWTH OF INDUSTRIES IN INDIA**

# **OBJECTIVE**

This lesson imparts information about industrial growth in India. This is being discussed in the light of new industrial policy and five year plans.

# **STRUCTURE**

- 8.1 Introduction
- 8.2 The pattern of industrialization.
- 8.3 Industrial pattern on eve of planning.
- 8.4 Industrial pattern and five year plans.
- 8.5 Present position.
- 8.6 Positive features.
- 8.7 New Industrial policy.
- **8.8** Current Industrial Performance
- 8.9 Summary

#### 8.1 INTRODUCTION

The industrial sector which possesses a relatively high marginal propensity to save and invest contributes significantly to a self sustaining economy. Besides, the process of industrialization is associated with the development of technical knowledge, attitudes and skills of industrial work, with experience of industrial management and with other attributes of modern society which in turn, are beneficial to the growth of productivity in agriculture, trade, Service and other related sectors of the economy. As a consequence of these factors, any successful transfer of labour from agriculture to industry contributes to economic development. Industrialization is thus inseparable from substantial, sustained economic development because it is both a consequence of higher incomes and means of higher productivity. With the rise in income level people tend to spend more on manufactured goods than on food. The differential income elasticity of demand confers an advantage on the manufacturing countries in the form of providing expanding market, higher productivity makes it an attractive occupation to diminishing returns in agriculture. Industrialization acts as an instrument for creating capacity to absorbed excess labour, and for catering to the diversification of the market required at higher stages of economic development.

#### 8.2 THE PATTERN OF INDUSTRIALIZATION

While there is now almost universal agreement on the importance of industrialization, there is still much debate regarding the proper pattern of industrial development. Historically industrial development has proceeded in three stages. In the first stage, industry is concerned with processing of primary products; "Milling grain, extracting oil, tanning leather, spinning vegetable fibres, preparing timber and smelting ores." The second stage comprises the transformation of materials making bread and confectionery, footwear, metal goods, manufacturing of machines and other capital equipments. In first stage the consumer goods industries are of over whelming importance, their net output being on the average five times as large as that of capital goods industries. This ratio is 2.5: 1 in the second stage and falls to 1:1 in the third stage and still lower in the fourth stage. Both these types of classifications emphasize the increasing role of the capital goods industries in the economy as industrial development takes place.

Though the general development of industry itself proceeds from consumer goods to the capital goods, there are many variations of this pattern, both in terms of time taken to

attain later stage and in terms of relative importance of each of the stages. Soviet pattern of industrialization involves a straight jump from the first to the third stage while British pattern is that of a gradual evolution. Similarly, underdeveloped countries may also evolve a different pattern of industrialization suitable to their economic conditions. It has been suggested that the pattern of industrialization in under-developed countries should be guided primarily by considerations arising from the relative scarcity of capital. Since labour is relatively plentiful and capital scarce, the development of labour-intensive consumer goods seems quite legitimate. However the basic premise of this approach is inappropriate. The problem is not how to economize the use of capital but how to increase its supply. Since most underdeveloped countries do not produce these goods at home, the only alternative to increasing their supplies is through imports. This depends upon the rate of growth in exports of primary commodities and manufactured goods.

Industrial development depends upon the rate of capital formation. Supply of capital goods can be augmented either through imports or through domestic production. Increase in the imports of capital goods depends upon the rate of growth of exports. Since the scope for the expansion of the exports of primary commodities is limited, export promoting manufacturing industries may be developed or alternatively, certain import substituting domestic industries may be developed, the effect of which will be to release foreign exchange for the imports of capital goods. In addition within the current volume of imports, capital goods may be substituted in place of consumer goods. Simultaneous development of all the three classes of industries will prove to be the most effective strategy of industrialization. The relative role of each is likely to vary with the particular economic circumstances of individual countries as well as with their current phase of industrialization.

### 8.3 INDUSTRIAL PATTERN ON THE EVE OF PLANNING

Indian industries not only supplied all local wants but also enabled India to export its finished products. Indian exports consisted chiefly of manufactures like cotton and silk fabrics, calicoes, artistic ware, silk and woolen cloth. The impact of the British connection and industrial revolution led to the decay of Indian handicrafts. Instead, machine-made goods started pouring into India. The void created by decay of Indian handicrafts was not filled by the rise of modern industry in India because of the British policy of encouraging the import of manufactures and export of raw materials from India.

The main features of the industrial pattern in Indian on the eve of planning (1950) were as under:

# (1) Lop sided pattern of industry

The peculiarity of the industrial pattern of India was the high concentration of employment either in small factories and household enterprises. i.e. the lowest size group or that there was a high concentration of employment in large factories, i.e. the highest size group. The medium size factories did not develop in India. The existence of this lopsided industrial pattern was due to the colonial nature of our economy. The foreign firms and those owned by big business and industrial magnates were of a very large size coming at the top of the pyramid, and at the bottom were a very large number of indigenous small size firms. The lopsidedness of the industrial pattern was reflected in the absence of the middle entrepreneurs running medium sized firms.

# (2) Low capital Intensity

Another feature of the Indian industrial pattern was the prevalence of low capital intensity. It was the result of two factors – first, the general level of wages in India was low, and second the small size of the home market in view of the low per capita income and the limited use of mass production (or high capital intensity) techniques resulted in low capital per worker employed.

# (3) Composition of Manufacturing output

There was a structural imbalance in the industrial pattern. In case of consumer goods, domestic supply was more than the demand. The index of domestic supply of consumer goods was 112 as compared to domestic demand equal to 100. But in case of producer goods the domestic supplies fell short of domestic demand. The index number of domestic supplies in

relations to demand was 80. This increased our dependence on other countries in the capital goods sector. The conclusions were obvious. There was a great need for increasing the output of firm and intermediate producer goods so as to correct the imbalance between their demand and supply. Industrial development "is not solely a process of expanding output to meet the rising demand created by growing capita incomes, it is also process in which existing demand for manufactures is met increasingly for domestic production instead of from foreign sources.

In short, the industrial pattern in Indian on the eve of planning was marked by low capital intensity, limited development of medium sized factory enterprises and imbalance between consumer goods and capital goods industries. It would be of interest to examine the extent to which the Five Plan Year have made an attempt to improve the industrial pattern, correct it lopsidedness develop the capital goods sector.

#### 8.4 INDUSTRIAL PATTERN AND THE FIVE YEAR PLANS

#### **Industries and the First Five Year Plan (1951-56)**

During the First Plan itself, no big effort was contemplated to industrialize the economy; Rather the emphasis was to build service like power and irrigation so that the process of industrialization is facilitated. A total investment of about Rs. 800 crores was planned for industry, out of which investment in the public sector was to be of the order of Rs. 94 crores only.

#### **Industries and the Second Plan (1956-61)**

The Second Five Year Plan programme for industrialization was based on the Industrial Policy resolution of 1956 which envisaged a big expansion of a public sector. A base of heavy industry was sought to be treated.

The industrial pattern sought to be developed during the Second Plan was conceived in term of the following priorities:

- (i) Increased production of iron and steel and of heavy engineering and machine building industries.
- (ii) Expansion of capacity in respect of other development commodities and producer goods such as aluminum, cement, chemical pulp, dyestuffs and phosphatic fertilizers and of essential drugs.
- (iii) Modernization and re-equipment of important national industries which have already come into existence such as jute and cotton textiles and sugar.

- (iv) Fuller utilization of existing installed capacity in industries where there are gaps between capacity and production; and
- (v) Expansion of capacity of consumer goods keeping in view the requirements of common production programmes and the productions targets for the decentralized sector of industry.

During the Second Plan a major task in industry was the building up of three steel plants in the public sector; Rourkela Steel Plant in Orissa, Bhilai Steel Plant in Madhya Pradesh and Durgapur Steel Plant in West Bengal. The other programmes of industrial development included the manufacture of electrical equipment, expansion of Hindustan Machine Tools, expansion of Sindri Fertilizer factory and the establishment of a fertilizer plant at Nangal, further expansion of Hindustan Shipyard and Cittaranjan Locomotive factory.

The Second Plan witnessed a major diversification of the industrial spectrum. It strengthened further the programmes of development in respect of oil exploration and coal and made a beginning with the development of atomic energy.

#### **Industries and the Third Plan (1961-66)**

The Third Plan saw the beginning of long term perspective, planning as an instrument to achieve the objective of an integrated growth of industry balanced with agriculture. With the base created in the first two plans, the Third Plan called for the maximum rate of investment to (a) strengthen industry, power and transport and (b) hasten the process of industrial and technological changes.

The key role in industrial development programme was for the public sector. The aim was to make the economy self sustaining in producers goods industries such as steel, machine building, etc., so that the quantum of external assistance needed could be curtailed to a very low level. An overall target of 70 per cent increase in industrial production was envisaged in the plan.

#### **Industries and the Forth Plan (1969-74)**

The Fourth Plan intended to complete industrial project undertaken in the Third Plan. It also aimed to enlarge capacities in export promotion and import substitution industries.

During the Fourth Plan, a total investment of Rs. 3050 crores was to be made in the public sector. Besides this, investment in small and village industries in the public sector was planned to be of the order of Rs. 190 crores. However, the actual outlay on organization was of

the order of Rs. 2700 crores in the public sector. Thus, the financial investment was short of the targets set out in the Fourth Plan. Nearly three fourths of the total investment was in the core sector. Viz. iron and steel, non ferrous metals, fertilizers, petroleum and petro demand coal and iron ore.

#### **Industries in the Fifth Plan (1974-78)**

Programmes of industrial development in the Fifth Plan were formulated keeping in view the objective of self-reliance and growth with social justice. The proposed emphasis was on the following:

- (i) Rapid growth of core sector industries by giving high priority to steel, non-ferrous metals, fertilizers, mineral oils, coal and machine building.
- (ii) Development of industries which promised a rapid diversification and growth of exports.
- (iii) Enlarging the production of industries supplying mass consumption goods, viz, cloth, edible oils and vanaspati, sugar, drugs, bicycles.
- (iv) Restraint on the production of Non essential goods, except for exports.
- (v) Development of small industries by reserving 124 items exclusively for them and by initiating intensive programme for the development of ancillary industries as feeder industries to large scale units.

#### **Industries in the Sixth Plan (1980-85)**

The sixth Plan (1980-85) intended to work within the overall developmental strategy particularly with regard to the objectives of structural diversification, modernization and self-reliance. The other elements of policy included the following.

- a) To meet foreign exchanges requirements, export of engineering goods and industrial products, as also of projects exports would be stepped up.
- b) A judicious blend of permitting import of cotemporary technology and promoting the development of indigenous know-how through domestic research and development.
- c) New strategies for development of backward regions would be devised. The thrust would be to implement a new model of development, which would prevent concentration of industry in existing metropolitan area.

#### **Industries in the Seventh Plan (1985-90)**

The main elements of the Seventh Plan Industrial strategy were:

- (i) Rapid removal of infrastructure constraints by placing greater emphasis on additional availability of power through more efficient use of existing capacity as well as the establishment of new power stations including super thermal and nuclear plants.
- (ii) Encouragement of modernization and technological upgradation in industries like textiles and sugar where a large number of units were set up in the early part of the  $20^{th}$  century.
- (iii) Specific targets of productivity for major industries like steel, fertilizers, non-ferrous metals petrochemicals, paper and cement were to be set for the plan.
- (iv) Export production was to be made an integral part of production in the domestic economy. A special effort was to be made in selected industries in which the country has comparative advantage and has reached a degree of industrial maturity.
- (v) Encouragement of emerging industries such as tele-communications, computers, micro-electronics, ceramic composites and bio-technology. Industries were to be encouraged to adopt technologies like fibre optics, lasers, robotics etc. for enhancing productivity and quality.
- (vi) Location of industries near the small district towns which were not industrialized so far would be promoted with a view to removing regional disparities and encouraging dispersal of industries.
- (vii) About 30 per cent of industries large and medium had already installed pollution control system. The Seventh Plan intended to enlarge the coverage of this programme as also to strengthen it.

A review of the progress of the Seventh Plant reveals that the annual growth rate of the industrial sector including mining, manufacturing and electricity generation during the Seventh Plan period was 8.5% which though marginally lower than targeted 8.7% was much higher than the 3.5% achieved during the Sixth Plan.

# **Industries in the Eighth Plan (1992-97)**

The Eight Plan was formulated under a new environment when a number of reforms in industrial, fiscal, trade and foreign investment policies were introduced in the economy-commonly called as economic liberalization. In this background, there was emphasis

on qualitative targets and planning had become more "indicative". Eighth Plan believed that the desired growth of different sectors could be achieved primarily through modifications in industrial, trade, fiscal policies and changes in duties and taxes rather than through quantitative restrictions in imports/exports or licensing mechanisms.

# Industries in Ninth Plan (1997-2002)

Ninth Plan was launched on the 50<sup>th</sup> Year of independence of our country. According to the approach paper of the plan, it will be for a period from 1<sup>st</sup> April, 1998, to 31<sup>st</sup> March, 2002. Total investment proposed is Rs. 22,05,000 crore. Of it Rs. 859200 crore will be in public sector and Rs. 1345800 crore in private sector. The plan aims at achieving 6.5 percent growth rate per annum.

Main objectives of the Ninth Plan were:

- 1. Priority to Agriculture and Rural Development: With a view to generating employment and eradicating of poverty, the plan aims at according priority to agriculture and rural development.
- **2. Growth and stability in prices:** The Plan has as its objective to maintain price stability as also to accelerate the growth rate of the economy.
- **3. Food and Nutritional Security:** To ensure food and nutritional security for all especially the weaker sections of the society.
- **4. Minimum Basic Services:** To provide minimum basic services like, safe drinking water, primary health care facility, primary education for all during the specified time period and housing facilities.
- **5. Reduction in Growth Rate of population:** Ninth Plan aims at reducing the growth rate of population.
- **6. Environmental Reforms:** To ensure environmental protection in the development process with the cooperation of the people.

#### **Industries in tenth plan (2002-2007)**

Main objectives of the Tenth plan are:

#### 1. Rate of Growth of National Income:

The objective of the Tenth Plan is to double about 8 per cent for the period 2002-07.

# 2. Growth Rate of Per Capita Income:

The objective of the Tenth Plan is to double the growth rate of per capita income in the next ten years.

# 3. Improvement in quality of life:

The Tenth Plan aims to ensure significant progress towards improvement in the quality of life of all people. This include not only an adequate level of consumption of food and other types of consumer goods but also access to basic social services especially education, health, availability of dirking water and basic sanitation.

# 4. Reduction in Poverty:

The objective is reduction of poverty ration by 5 percentage points by 2007 and by 15 percentage points by 2012. It implies that poverty ratio will be reduced from 26 per cent by 2007.

# 5. Provision of Employment:

The Tenth plan aims at providing gainful and high quality employment to the additional labour force over the Tenth Plan period. It is proposed to provide an additional 5 crore jobs to the people.

#### **6.** Provision of Universal Education:

The objectives of Tenth Plan is to make provision for universal access to primary education by 2007, i.e., all children to be in school by 2003 and all children to complete 5 years of schooling by 2007.

#### 7. Reduction in Gender Gaps:

The Tenth Plan aims at reduction of gender gaps in literacy and wage rates by at least 50 per cent by 2007.

# 8. Reduction in Growth Rate of Population:

The Tenth Plan aims at reducing growth rate of population to 75 per cent within the plan period.

# 9. Increase in Literacy Rate:

The Tenth Plan aims at increasing the literacy rate to 75 per cent within the plan period.

# **10.** Reduction of Infant Mortality Rate:

The objective of the Tenth Plan is to reduce Infant morality Rate (IMR) to 45 per 1000 live births by 2007 and to 28 by 2012.

# 11. Reduction in Maternal Mortality Ratio:

The Tenth plan aims at reducing material mortality ratio (MMR) to 2 per 1000 live births by 2007and to 1 by 2012.

# 12. Environmental protection:

To ensure environmental protection certain measures will be taken. These include: (i) The area under forest tree cover is to be increased to 25 per cent by 2007 and 33 per cent by 2012. (ii) The major polluted rivers will be cleaned by 2007.

# 13. Provision of Drinking Water:

All villages have to have sustained access to drinking water within the plan period.

# 14. Growth, Equity and Sustainability:

The main objective of Tenth Plan is to achieve sustainable growth with equity and social justice.

# 15. Balanced Development in All States:

To ensure balanced development for all states the Tenth Plan should include a state-wise break-down of the broad developmental targets.

# **Strategy for Industrial Development and Growth**

The industrial sector will have to grow at over 10 per cent to achieve the target growth –rate of 8 per cent growth for GDP during the Tenth Plan period. Industry will however, have to face stronger international competition in view of the removal of quantitative restrictions on imports since April 2001.Moreover, divestment in the public enterprises will results in steady increase in the role of private enterprise. The Tenth Plan must therefore, focus on creating an industrial policy environment conducive for efficient and competitive operations.

Reduction of projective tariff barriers will be gradually used to enhance the competitive ability of the industrial enterprise. Moreover, the policy of liberalization must be made more pervasive and some of the cumbersome regulatory mechanism that continues to persist must be dismantled. Thirdly, tenth Plan must also ensure that polices encouraging the employment-intensive small scale sector are pursued. However, there is a need to review and rewind some of the reservations of products for the small scale sector. Fourthly, the private enterprise must also willingly and steadily gear itself to an environment of competition. Seeking policy measure for elimination of competition will negate the advantages of the liberalization policy framework.

#### 8.5 PRESENT POSITION

Indian industry, though not much advanced, is no longer a backward one. The industrial scenario is quite an impressive one. And its place in the economy is fairly important.

# **Industries and composition**

The number of industries is very large, with a massive number of producing units engaged in the production of a large variety of products. These industries may be divided into two groups, namely, large industries and small industries. The groups of large industries, which largely forms the basis of the country's index in industrial production, includes the following three industries: (i) mining and quarrying, often referred to as mining; (ii) manufacturing; and (iii) electricity, gas and water supply.

The different types of industries taken together make an impressive showing. Of the three industries sector referred to above, the most important is the manufacturing sector. It carries a weight of as much as 79.36 per cent in the index of industrial production (base 1993-94). The other two groups are way behind this sector, with the weight of 10.47 per cent for mining and 10.17 per cent for electricity.

The structural composition based on the end use of output reveals the considerable strength of the industrial scene. When regrouped, the industries producing basic goods (like minerals, fertilizers, cement, iron and steel, non-ferrous basic metals, electricity etc.) stand at the top in respect of their production. An indication of their importance is the large weight at 35.5 per cent assigned to them in the index of industrial production. This is much higher than the weight of 28.4 per cent assigned to consumer goods industries. If we add to the basic industries, the capital goods industries (machinery, machine-tools, rail road equipment etc.) with the weight at 9.3 per cent in the index of production, one gets the impression and right that the country's industrial structure is a strong one. The industries producing intermediate goods with the weight at 26.5 per cent stand next to the consumer goods industries.

#### Placing in the economy

The status of industries in the economy is important. The contributions of these industries to the gross domestic product are about 25 per cent, with manufacturing alone (i.e. excluding mining and electricity) contributing over 15 per cent. In the export sector, these industries have a high standing, with manufactured goods alone contributing more than 75 per cent of exports. In some other spheres too, the industries are of considerable importance. For

example, as a results of a diversified industrial structure, the country's dependence on imports for some crucial items has been much reduced. Again, the industrial personnel, consisting of scientists, technocrats, highly skilled labor, well trained managers etc. is very large indeed so that India ranks third in the world in this respect.

# **Present uptrend**

While the growth rate has moved on a higher path, one needs to understand that the very low rates in the two years of the nineties (1991-93) and in 2001-02, are in no way a retrogression from the uptrend. This fall in the growth rate has been caused by the governments recent polices to stabilize economy (i.e. reducing/eliminating the large fiscal and balance of payments deficits and curbing the high inflationary rise in prices) and to restructure it to make it more competitive and efficient. These policies have involved compression in imports, adversely affecting import-dependent industries, reduction in Government's expenditure reducing aggregate demand for the industrial products; high interest rates causing an increase in the industrial costs; devaluation of the rupee making import inputs expensive etc.

#### 8.6 POSITIVE FEATURES

# Impressive growth

The growth rate of industrial output has been satisfactory. The industrial production has grown at the rate of 6 per cent since 1951. As a result, its contribution to the gross domestic product has moved up sharply from 6 per cent to 25 per cent at present. The achieved growth rate is far higher than that of agricultural growth at 2.7 per cent since 1951. It is also much above the growth in national income at 4 per cent. The industrial growth rate has also far exceeded the population growth at around 2 per cent. Compared to the pre-independence trend, it is remarkable.

# Strengthened industrial base

Besides the satisfactory industrial performance in the overall quantitative terms, there has also been a large progress in strengthening the base for further industrial growth. This is evident from the large strides made in the field of basics and capital goods industries. The establishment and fast expansion of such industries as steel, cement, engineering, petroleum, etc. strengthen the supplying capacity of the economy. The strength of India's industrial development

may also be gauged from the fact that India is one of the six countries in the world that can build thermal and hydroelectric stations on their own.

#### Modernization

The profile of industries has undergone a radical change from one of old and traditional to one of new and modern. This is evident from the many change that have characterized industrial development. One, there is a considerable diversification in the industrial setup. Two, there are considerable advances made in the field of technological and managerial skills. This has enabled the country not only to operate highly complex and sophisticated industrial enterprise, but also for their planning, design and construction. Significant progress has also been made in industrial research as also in the absorptive capacity in respect of using, adapting and developing of modern industrial technology.

#### **Self reliance**

India has made great strides towards the goal of self reliance. In quite a number of commodities the country has become self sufficient, and in others the foreign dependence has become very much less as compared to the position in 1951. For example, in iron and steel the dependence is almost nil, and in important items as machinery and fertilizers it has been considerably reduced.

#### Positive investment scenario

With several healthy development listed above, and the new industrial policy in operation since 1991, there is much that holds for the future of industrial growth. This is evident from the large investments actualized and planned for in the 1990's and thereafter. The sharp increase in the loans sanctioned and loan disbursed by various Financial Institutions are indicative of this development. Similarly big increases in the number of new issues, and the amount raised from the capital market, domestically and overseas, are other bright features of investment scene. Again the investment intentions, largely indicated by the number of Industrial Entrepreneurs Memorandum (IEM) have also gone up considerably. The approvals to the foreign investors' intentions during this period too involved big amounts, with most of these investments at over 80 per cent for priority sectors such as power generations, oil refining electrical equipment, chemical and export related sectors.

### 8.7 INDUSTRIAL POLICY

Objectives of the Industrial Policy of the Government are -

- To maintain a sustained growth in productivity;
- To enhance gainful employment;
- To achieve optimal utilization of human resources;
- To attain international competitiveness and
- To transform India into a major partner and player in the global arena.

# Policy focus is on -

- Deregulating Indian industry;
- Allowing the industry freedom and flexibility.

Providing a policy regime that facilitates and fosters growth of Indian industry. Following are some important policy measures announced by the Ministry of Finance, Department of Industrial policy to pursue the above objectives.

# 1. Liberalization of Industrial Licensing Policy

At present, only six industries are under compulsory licensing mainly on account of environmental, safety and strategic considerations. Similarly, there are only three industries reserved for the public sector.

# 2. Introduction of Industrial Entrepreneurs' Memorandum(IEM)

Industries not requiring compulsory licensing is to file an Industrial Entrepreneurs' Memorandum (IEM) to the Secretariat for Industrial Assistance (SIA). No industrial approval is required for such exempted industries. Amendments are also allowed to IEM proposals filed after 1.7.1998.

# 3. Liberalization of the Location Policy

A significantly amended locational policy in tune with the liberalized licensing policy is in place. No industrial approval is required from the Government for locations not falling within 25 kms of the periphery of cities having a population of more than one million except for those industries where industrial licensing is compulsory. Non-polluting industries such as electronics, computer software and printing can be located within 25 kms of the periphery of cities with more than one million population. Permission to other industries is granted in such locations only if they are located in an industrial area so designated prior to 25.7.91. Zoning and land use regulations as well as environmental legislations have to be followed.

# 4. Policy for Small Scale

A differential investment limit has been adopted since 9th October 2001 for 41 reserved items where the investment limit upto rupees five crore is prescribed for qualifying as a small scale unit. The investment limit for tiny units is Rs. 25 lakhs. 749 items are reserved for manufacture in the small scale sector. All undertakings other than the small scale industrial undertakings engaged in the manufacture of items reserved for manufacture in the small scale sector are required to obtain an industrial license and undertake an export obligation of 50% of the annual production. This condition of licensing is, however, not applicable to those undertakings operating under 100% Export Oriented Undertakings Scheme, the Export Processing Zone (EPZ) or the Special Economic Zone Schemes (SEZs).

#### 5. Non-Resident Indians Scheme

The general policy and facilities for Foreign Direct Investment as available to foreign investors/company are fully applicable to NRIs as well. In addition, Government has extended some concessions specially for NRIs and overseas corporate bodies having more than 60% stake by the NRIs. These inter-alia includes (i) NRI/OCB investment in the real estate and housing sectors upto 100% and (ii) NRI/OCB investment in domestic airlines sector upto 100%. NRI/OCBs are also allowed to invest upto 100% equity on non-repatriation basis in all activities except for a small negative list. Apart from this, NRI/OCBs are also allowed to invest on repatriation/non-repatriation under the portfolio investment scheme.

# **6.** Electronic Hardware Technology Park

As have been given to the Development Commissioners of Export Processing Zones in the case of Export Oriented Units. All other application for setting up projects under these schemes, are considered by the Inter-Ministerial Standing Committee (IMSC) Chaired by Secretary (Information Technology). The IMSC is serviced by the SIA.

# 7. Policy for Foreign Direct Investment (FDI)

The Department has put in place a liberal and transparent foreign investment regime where most activities are opened to foreign investment on automatic route without any limit on the extent of foreign ownership. Some of the recent initiatives taken to further liberalize the FDI regime, inter alia, include opening up of sectors such as Insurance (upto 49%); development of integrated townships (upto 100%); defense industry (upto 26%); tea plantation (up 100% subject to divestment of 26% within five years to FDI); Encenhancement of FDI limits in private sector banking, allowing FDI up to 100% under the automatic route for most manufacturing activities in SEZs; opening up B2B e-commerce; Internet Service Providers (ISPs) without Gateways; electronic mail and voice mail to 100% foreign investment subject to 26% divestment condition; etc.

The Department has also strengthened investment facilitation measures through Foreign Investment Implementation Authority (FIIA).

#### 8.8 CURRENT INDUSTRIAL PERFORMANCE

The industrial sector has shown a sustained increase during the fiscal year 2003-04. the overall growth in industrial production, as measured by the index of industrial production (IIP) has increased from 2.7% in 2001-02 to 5.7% in 2002-03. further, it grew by 6/.9% during April- March, 2003-04.

# **Investment Climate**

Many positive developments in the Indian Economy have further improved the investment climate of the country. The overall growth in GDP as per CSO in real terms is 8.2%. in 2003-04. During April-March 2003-04, growth rate in industrial output was 6.9% against 5.7% in corresponding period in previous year. Further surge in foreign exchange reserves, which not only strengthens India's external sector, is also a source of confidence to prospective foreign investors. The soft interest rate is helping the industry to improve its competitiveness. Investment Foreign Institutional Investors (FIIs) has shown a significant increase on account of economic recovery. According to data published in the RBI Bulletin of May 2004, there was an inflow of

FII investment in Dollar terms of US \$9947 million during 2003-04 against US \$562 million in the corresponding period last year.

#### **SUMMARY**

Industrialization contributes a lot to economic development. This can help us to improve the required industry. Industrialization on the eve of planning laid some emphasis on correcting the lop sided pattern of Indian industry, low capital intensity, composition of manufacturing output. The main features and objectives of new industrial policy has also discussed.

#### **Questions:**

- 1. What do you mean by industrialization?
- 2. Discuss some main objectives of first five Five year plans?
- 3. Discuss in detail the present position of industries in India.
- 4. What are the positive features of industrialization?
- 5. Discuss the objective of new industrial policy?

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Subject : Business Environment

# LESSON-9 MERGERS AND ACQUISITIONS

**OBJECTIVE:** The present lesson discusses different aspects of mergers and acquisitions in India.

#### **STRUCTURE**

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9.1	Introduction
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- 9.2 Forms of Expansion
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- 9.6 Scheme of Merger
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- 9.9 Valuation of Firm
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- 9.11 Capital Structure after Merger and Consolidations
- 9.12 Financial Problems of Merger and Consolidation
- 9.13 Mergers in India
- 9.14 Summary
- 9.15 Self Assessment Questions

## 9.1 introduction

Growth is always essential for the existence of a business concern. A concern is bound to die if it does not try to expand its activities. There may be a number of reasons which are responsible for the expansion of business concerns. Predominant reasons for expansion are economic but there may be some other reasons too. The reasons for expansion are:

- 1. Existence. The existence of the concern depends upon its ability to expand. In a competitive world only the fittest survives. The firm needs to control its costs and improve its efficiency so that it may be achieved if the activities of the firm are expanded. So, expansion is essential for the existence of the firm otherwise it may result into failure and may be out of business.
- 2. Advantages of Large Scale. A large scale business enjoys a number of economies in production, finance, marketing and management. All these economies enable a firm to keep its costs under control and have an upper hand over its competitors. A large scale concern can also withstand the cyclical changes in the demands of their products.
- **3. Use for Higher Profits.** Every businessman aspires to earn more and more profits. The volume of profits can be increased by the expansion of business activities. Undoubtedly, profit is

the main motive behind all types of expansions. The incurring of higher costs at the time of expansion may not be associated with higher profits. If a new concern is purchased at a higher price without considering economic aspects, it will not be wise expansion plan. One should be very careful while planning expansion scheme and economic factors should be the motivating forces to enable a concern to increase its profits.

- **4. Monopolistic Ambitions.** One of the important factors behind business expansion is the monopolistic ambitions of business leaders. They try to control more and more concerns in the same line so that they may be able to dictate their terms. So expansions also result out of monopolistic ambitions.
- **5. Better Management.** A bigger business concern can afford to use the service of experts. Various managerial functions can be efficiently managed by those persons who are qualified for such jobs. On the other hand, a smaller concern is generally managed by the owners themselves and they may not be experts in all departments of the business.
- **6. Natural Urge.** The expansion is also a way of life. As everybody wants to go higher and higher in his private life and this is applicable to a business concern too. Every business man wants to expand its activities in a natural way. It not only gives him more profits but also gives him satisfaction.

# 9.2 Forms of Expansion

The expansion of a concern may be in the form of enlargement of its activities or acquisition of an ownership and control of other concerns. Thus, expansion may be; (i) internal expansion, and (ii) external expansion.

## Internal Expansion

Internal expansion results from the gradual increase in the activities of the concern. The concern may expand its present production capacity by adding more machines or by replacing old machines with new machines with higher productive capacity. The internal expansion can also be undertaken by taking up the production of more units or by entering new fields on the production and marketing sides. Internal expansion may be financed by the issue of more share capital, generating funds from profits or by issuing long-term securities. The net result of internal expansion is the increase in business activities and broadening the present capital structure.

# **External Expansion or Business Combination**

External expansion refers to 'business combination' where two or more concerns combine and expand their business activities. The ownership and control of the combining concerns may be undertaken by a single agency.

Business combination is a method of economic organization by which a common control, of greater or lesser completeness, is exercised over a number of firms which either is operating in competition or independently. This control may either be temporary or permanent, for all or only for some purposes. This control over the combining firm can be exercised by a number of methods which in turn give rise to various forms of combinations. In the words of Haney, "To combine is to become one of the parts of a whole, and combination is merely a union of persons to make a whole or group for the persuasion of some common purpose." From this definition it is clear that combination may be of varying degrees and is always for the achievements of common objectives. Combination is the coming together of persons or organizations and the main

motivation behind such assembly is to secure maximization of profits by eliminating competition.

In the process of combination, two or more units engaged in similar business or in different related process or stages of the same business join with a view to carry on their activities or shape their policies on common or co-ordinated basis for mutual benefit or maximum profits. The combination may be among competing units or units engaged in different processes. After combination, the constituent firms pursue some common objectives or goals.

## 9.3 Forms of Combination

There is some disagreement on the precise meaning of various terms relating to the forms of business combinations, viz; merger, amalgamation, absorption, consolidation, acquisition, takeover, etc. Sometimes, these terms are used interchangeably, in broad sense even when there are legal distinctions between the kinds of combinations.

# (a) Merger or Amalgamation

A merger is a combination of two or more companies into one company. It may be in the form of one or more companies being merged into an existing company or a new company may be formed to merge two or more existing companies. The Income Tax Act, 1961 of India uses the term 'amalgamation' for merger.

According to Section 2 (1A) of the Income Tax Act, 1961, the term amalgamation means the merger of one or more companies with another company or merger of two or more companies to form one company in such a manner that :

- (i) All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.
- (ii) All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation.
- (iii) Shareholders holding not less than nine-tenths in value of the shares in the amalgamating company or companies other than shares already held therein immediately before the amalgamation by or by a nominee for, the amalgamated company by virtue of the amalgamation.

According to the Companies Act, 1956, the term amalgamation includes 'absorption'. In S.S Somayajula v. Hop Prudhommee and Co. Ltd., the learned judge refers to amalgamation as "a state of things under which either two companies are joined so as to form a third entity or one is absorbed into or blended with another." Thus, merger or amalgamation may take any of the two forms:

(i) Merger or amalgamation through absorption.

- (ii) Merger or amalgamation through consolidation.
- (i) Absorption. A combination of two or more companies into an existing company is known as 'absorption'. In a merger through absorption all companies except one go into liquidation and lose their separate identities. Suppose, there are two companies, A Ltd. and B Ltd., Company B Ltd. is merged into A Ltd. leaving its assets and liabilities to the acquiring company A Ltd; and company B Ltd. is liquidated. It is a case of absorption. An example of this type of merger in India is the absorption of Reliance Polyproplene Ltd. (RPPL) by Reliance Industries Ltd. As a result of the absorption, the RPPL was liquidated and its shareholders were offered 20 shares of RIL for every 100 shares of RPPL held by them.
- (ii) Consolidation. A consolidation is a combination of two or more companies into a new company. In this form of merger, all the existing companies, which combine, go into liquidation and form a new company with a different entity. The entity of consolidating corporations is lost and their assets and liabilities are taken over by the new corporation or company. The assets of old concerns are sold to the new concern and their management and control also passes into the hands of the new concern. Suppose, there are two companies called A Ltd. and B Ltd.; and they merge together to form a new company called AB Ltd. or C Ltd; it is a case of consolidation. The term 'consolidation' is also, sometimes used as 'amalgamation'. However, a merger through absorption may be distinguished from a merger through consolidation. One concern acquires the business of another concern without forming a new company in the case of absorption whereas a new concern is formed by the union of two or more concerns in case of consolidation. Consolidation, generally takes places between two equal-size concerns and the size of concerns considerably differs in case of a merger through absorption. Generally a small concern is merged with a big concern. Though both the terms are used interchangeably. The methods and problems of financing mergers through absorption and consolidations are also similar.

# (b) Acquisition and Take-Over

An essential feature of merger through absorption as well as consolidation is the combination of the companies. The acquiring company takes over the ownership of one or more other companies and combines their operations. However, an acquisition does not involve combination of companies. It is simply an act of acquiring control over management of other companies. The control over management of another company can be acquired through either a 'friendly take-over' or through 'forced' or 'unwilling acquisition'. When a company takes-over the control of another company through mutual agreement, it is called acquisition or friendly take-over. On the other hand, if the control is acquired through unwilling acquisition, i.e., when the take-over is opposed by the 'target' company it is known as hostile take-over.

# (c) Holding Companies

The other form of partial consolidation is a holding company which generally arises out of lust for power. A holding company is a form of business organization which is created for the purpose of combining industrial units by owning a controlling amount of their share capital. Legally, a holding company is one which holds directly or through a nominee, a majority of the voting shares in the subsidiary company or possesses the power to nominate the majority of the directors. A holding company may have a number of subsidiary companies or subsidiary company may be a holding company of another company or companies. The subsidiary of a subsidiary company is also a subsidiary company of the holding company, although a subsidiary

company has a separate legal entity but for all practical purposes subsidiaries are under the effective control of a holding company.

# 9.4 Economics/Reasons of Mergers

A number of mergers, take-overs and consolidation have taken place in our country in the recent times. Barely two months after Procter and Gamble India Ltd. and Godrej Soaps announced their strategic alliance, the Rs. 2087 crore Hindustan Lever Ltd. announced that it will take over the loss-making Tata Oil Mills (TOMCO) ending the latter's 76 year existence with a merger. The Rs.3700 crore RPG Enterprises has sold the typewriter maker, Remington Rand, to a Calcutta based business man. Chabarias have taken over a number of companies. But, then, what are the motives or reasons for such mergers and acquisitions? One of the major reason cited, for such mergers, is the liberalization of the Indian economy. Liberalization is forcing companies to enter new businesses, exit from others, and consolidate in some simultaneously. The following are the other important reasons for mergers or amalgamations:

1. Economics of Scale. An amalgamated company will have more resources at its command than the individual companies. This will help in increasing the scale of operations and the economies of large scale will be availed. These economies will occur because of more intensive utilization of production facilities, distribution network, research and development facilities, etc. These economies will be available in horizontal mergers (companies dealing in same line of products) where scope of more intensive use of resources is greater.

The economies will occur only up to a certain point of operations known as optimal point. It is a point where average costs are minimum. When production increases from this point, the cost per unit will go up.

- **2. Operating Economies.** A number of operating economies will be available with the merger of two or more companies. Duplicating facilities in accounting, purchasing, marketing, etc. will be eliminated. Operating inefficiencies of small concerns will be controlled by the superior management emerging from the amalgamation. The amalgamated companies will be in a better position to operate than the amalgamating companies individually.
- **3. Synergy.** Synergy refers to the greater combined value of merged firms than the sum of the values of individual units. It is something like one plus one more than two. It results from benefits other than those related to economies of scale. Operating economies are one of the various synergy benefits of merger or consolidation. The other instances which may result into synergy benefits include, strong R&D facilities of one firm merged with better organized production facilities of another unit, enhanced managerial capabilities, the substantial financial resources of one being combined with profitable investment opportunities of the other, etc.
- **4. Growth.** A company may not grow rapidly through internal expansion. Merger or amalgamation enables satisfactory and balanced growth of a company. It can cross many stages of growth at one time through amalgamation. Growth through merger or amalgamation is also cheaper and less risky. A number of costs and risks of expansion and taking on new product lines are avoided by the acquisition of a going concern. By acquiring other companies a desired level of growth can be maintained by an enterprise.
- **5. Diversification.** Two or more companies operating in different lines can diversify their activities through amalgamation. Since different companies are already dealing in their respective lines there will be less risk in diversification. When a company tries to enter new lines of activities then it may face a number of problems in production, marketing etc. When some concerns are already operating in different lines, they must have crossed many obstacles and

difficulties. Amalgamation will bring together the experiences of different persons in varied activities. So amalgamation will be the best way of diversification.

- **6. Utilization of Tax Shields.** When a company with accumulated losses merges with a profit making company it is able to utilize tax shields. A company having losses will not be able to set off losses against future profit, because it is not a profit earning unit. On the other hand if it merges with a concern earning profits then the accumulated losses of one unit will be set off against the future profits of the other unit. In this way the merger or amalgamation will enable the concern to avail tax benefits.
- 7. Increase in Value. One of the main reasons of merger or amalgamation is the increase in value of the merged company. The value of the merged company is greater than the sum of the independent values of the merged companies. For example, if X Ltd. and Y Ltd. merge and form Z Ltd., the value of Z Ltd. is expected to be greater than the sum of the independent values of X Ltd. and Y Ltd.
- **8. Eliminations of Competition.** The merger or amalgamation of two or more companies will eliminate competition among them. The companies will be able to save their advertising expenses thus enabling them to reduce their prices. The consumers will also benefit in the form of cheap or goods being made available to them.
- **9. Better Financial Planning**. The merged companies will be able to plan their resources in a better way. The collective finances of merged companies will be more and their utilization may be better than in the separate concerns. It may happen that one of the merging companies has short gestation period while the other has longer gestation period. The profits of the company with short gestation period will be utilized to finance the other company. When the company with longer gestation period starts earning profits then it will improve financial position as a whole.
- 10. Economic Necessity. Economic necessity may force the merger of some units. If there are two sick units, government may force their merger to improve their financial position and overall working. A sick unit may be required to merge with a healthy unit to ensure better utilization of resources, improve returns and better management. Rehabilitation of sick units is a social necessity because their closure may result in unemployment etc.

# 9.5 Types of Mergers

Notwithstanding terminological forms, mergers can be broadly classified into three major types :

1. Horizontal Merger. When two or more concerns dealing in same product or service join together, it is known as a horizontal merger. The idea behind this type of merger is to avoid competition between the units. For example, two manufacturers of same type of cloth, two book sellers, and two transport companies operating on the same route-the merger in all these cases will be horizontal merger.

Besides avoiding competition, there are economies of scale, marketing economies, elimination of duplication of facilities, etc.

2. Vertical Merger. A vertical merger represents a merger of firms engaged at different stages of production or distribution of the same product or service. In this case two or more companies dealing in the same product but at different stages may join to carry out the whole process itself. A petroleum producing company may set up its own petrol pumps for its selling. A railway company may join with coal mining company for carrying coal to different industrial centers. Similarly, a textile unit may merge with a transport company for carrying its products to

different places. All these are the examples of vertical merger. The idea behind this type of merger is to take up two different stages of work to ensure speedy production or quick service.

3. Conglomerate Merger. When two concerns dealing in totally different activities join hands it will be a case of conglomerate merger. The merging concerns are neither horizontally nor vertically related to each other. For example, a manufacturing company may merge with an insurance company, a textile company may merge with a vegetable oil mill. There may be some common features in merging companies, such as distribution channels, technology, etc. This type of merger is undertaken to diversify the activities.

# 9.6 Scheme of Merger

The scheme of merger is prepared in consultation with its merchant banker(s)/financial advisors by the company acquiring the business. The important elements of the scheme constitute:

- (1) The authorized, issued and subscribed/paid-up capital of the transfer and transferee company.
- (2) Size of Board of Directors and participation of Transferee Company's director's on the board.
- (3) Terms and conditions of the scheme of amalgamation/merger and effective date of amalgamation.
- (4) Fixing of a cut-off date from which all assets both movable and immovable of amalgamating company shall be transferred to the amalgamated company. This date is known as transfer date.
- (5) Deciding the name and accounting year.
- (6) Object clause of memorandum of association of the transferor and transferee companies so as to determine whether the power of amalgamation exits or not. The object clause of Transferee Company should permit for carrying on the business of the transferor company.
- (7) The scheme must provide protection to the existing employees.
- (8) Obtaining of approval of shareholders, creditors, financial institutions/banks under section 391 and 394 of the Companies Act, 1956 in order to obtain the approval from High Court.
- (9) Expenses of amalgamation.
- (10) Dividend position and future prospects.

# 9.7 Basis of merger

The scheme of merger/amalgamation should be prepared taking into account the following basis :

- (i) Valuer's report on the assets of both the transfer companies.
- (ii) Reports of chartered accountants engaged for analyzing the financial statement of the transferor companies.
- (iii) Exchange ratio i.e. at which the shareholders of the amalgamating company would be offered shares in the amalgamated company.
- (iv) Reports of the auditors.
- (v) Audited accounts of both the companies prepared up to transfer date.

  In nut shell, the scheme should be just and equitable to the shareholders, protect the interest of the creditors/financial institutions/banks and be fair to the employees and general public.

# 9.8 Legal and procedural aspects of merger

The procedure of amalgamation or merger is long-drawn and involves some important legal dimensions. Following steps are taken in this procedure:

- 1. Analysis of proposal by the companies. Whenever a proposal for amalgamation or merger comes up then managements of concerned companies look into the pros and cons of the scheme. The likely benefits such as economies of scale, operational economies, improvements in efficiency, reduction in costs, benefits of diversification, etc. are clearly evaluated. The likely reactions of shareholders, creditors and others are also assessed. The taxation implications are also studied. After going through the whole analysis work, it is seen whether the scheme will be beneficial or not. It is pursued further only if it will benefit the interested parties otherwise the scheme is shelved.
- **2. Determining Exchange Ratios.** The amalgamation or merger schemes involve exchange of shares. The shareholders of amalgamated companies are given shares of the amalgamated company. It is very important that a rational ratio of exchange of shares should be decided. Normally a number of factors like book value per share, market value per share, potential earnings, value of assets to be taken over are considered for determining exchange ratios.
- **3. Approval of Board of Directors.** After discussing the amalgamation scheme thoroughly and negotiating the exchange ratios, it is put before the respective Board of Directors for approval.
- **4. Approval of Shareholders.** After the approval of this scheme by the respective Boards of Directors, it must be put before the shareholders. According to section 391 of Indian Companies Act, the amalgamation scheme should be approved at a meeting of the members or class of the members, as the case may be, of the respective companies representing three-fourth in value and majority in number, whether present in person or by proxies. In case the scheme involves exchange of shares, it is necessary that is approved by not less than 90 per cent of the

shareholders (in value) of the transferor company to deal effectively with the dissenting shareholders.

- **5. Consideration of Interests of the Creditors.** The views of creditors should also be taken into consideration. According to section 391, amalgamation scheme should be approved by majority of creditors in numbers and three-fourth in value.
- **6. Approval of the Court.** After getting the scheme approved, an application is filed in the court for its sanction. The court will consider the viewpoint of all parties appearing, if any, before it, before giving its consent. It will see that the interest of all concerned parties is protected in the amalgamation scheme. The court may accept, modify or reject an amalgamation scheme and pass orders accordingly. However, it is up to the shareholders whether to accept the modified scheme or not.

It may be noted that no scheme of amalgamation can go through unless the Registrar of Companies sends a report to Court to the effect that the affairs of the company have not been conducted as to be prejudicial to the interests of its members or to the public interest.

7. Approval of Reserve Bank of India. In terms of Section 19(1)(d) of the FEMA, permission of the RBI is required for the issue of any security to a person resident outside India. Accordingly, in a merger, the transferee company has to obtain permission before issuing shares in exchange of shares held in the transferor company. Further, Section 29 restricts the acquisition of the whole or any part of any undertaking in India in which non-residents' interest is more than the specified percentage.

## 9.9 Valuation of Firm

The question of valuing the business to be acquired and consolidated poses a problem at the very outset. All parties try to convince about their viewpoints and want to tilt the values in their favour. The valuation issue should be settled impartially because it will affect the whole financial management after merger and consolidation. Not only the bargaining of the parties but practical aspects like earning capacity, present values of assets and future expectations from the concern should be given due weightage while valuing the concerns. The issue of valuation is not only important at the time of merger or consolidation but it will also influence the pricing of new issues of securities, in purchase, sale or pledge of existing securities, in recapitalisation, and in reorganization and liquidation.

Some of the important methods for valuing property of companies are discussed as follows :

1. Capitalised Earnings. The capitalized earnings method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns from such investments. The capitalized earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalization.

The estimation of earnings will involve the study of past earnings. The past earnings over a long period will give an exact idea about the earning position of the business. The past earnings of one or two years may be influenced by abnormal causes such as price fluctuations, etc.; so a true and fair opinion will not be made available and nothing should be concealed. If the earnings are showing a stability then the earnings will be easily calculated; if, on the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time.

After estimating the average earnings, the earnings should be capitalized to arrive at an investment value. A decision about the rate of earnings at which the profits are to bed capitalized is very difficult. It is a sort of arbitrary figure. One should be guided by economic factors only while calculating capitalistion rate. If the earnings per share are Rs.5 and the capitalization rate is 10%, then the value of the share will be Rs.50.

- 2. **Assets Approach.** Assets approach is the commonly used method of valuation. The assets may be taken at book value, reproduction value and liquidation value. In book value method, the values of assets are taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share. If preference stock is also outstanding then preference stock should be deducted before dividing the assets values by the number of equity shares. This approach is also known as net worth value. There is a difference of opinion about the assets to be included and assets such as goodwill, patent rights, deferred expenses should be excluded. Another view is that goodwill and patents should be included while fictitious assets such as deferred expenses should only be excluded. The fixed assets are taken at book value less depreciation up to present balance sheet period. A company following a rigorous depreciation policy may be at a disadvantage than the company providing lower depreciation. Public utilities may use the reproduction value of assets while valuing the property. Liquidation values of assets are used on the assumption that if the concern is liquidated at present then what values will be fetched by the assets. The concern is taken as a going concern and as such current book values of assets are used in most of the case.
- 3. Market Value Approach. This approach is based on the actual market price of securities settled between the buyer and the seller. The market value will be the realistic value because buyers will be ready to pay in lieu of a purchase. The price of a security in the free market will be its most appropriate value. Market price is affected by the factors like demand and supply and position of money market. The price of a security in the free market will be its most appropriate value. Market value is a device which can be readily applied at any time.

A number of practical problems are faced while applying market value approach. The market value will be available for securities of big companies only. The number of shares offered in the market is generally small and it will not be advisable to apply the same value to the whole lot of shares of the company. Another objection against this method is that there are many upward and downward trends in values of securities in the stock exchanges and it becomes a problem to decide about the price to be taken for valuation. Despite practical limitations, market value approach may be used under many conditions.

**4. Earning Per Share.** Another method of determining the values of the firms under merger or consolidation is the earnings per share(EPS). According to this approach, the value of a prospective merger or acquisition is a function of the impact of merger/acquisition on the earnings per share. Such impact could either be positive resulting into the increases in EPS or may be negative resulting into dilution of EPS. As the market price per share is a function

(product) of EPS and Price-Earning Ratio, the future EPS will have an impact on the market value of the firm. The following example explains the effect of merger/acquisition on EPS. **Illustration 1.** A Ltd. wants to take over B Ltd. and the financial details of both the companies are as below:

	A Ltd.	B Ltd.
	(Rs.)	(Rs.)
Equity share capital of Rs. 10 each	2,00,000	1,00,0000
Preference share capital	40,000	
Share premium		4,000
Profit and loss account	76,000	8,000
10% Debentures	30,000	10,000
Total liabilities	3,46,000	1,22,000
Fixed assets	2,44,000	70,000
Current assets	1,02,000	52,000
Total assets	3,46,000	1,22,000
Profit after tax and preference dividend	48,000	30,000
Market price per share	24	27

You are required to determine the share exchange ratio to be offered to the shareholders of B Ltd., based on (i) net assets value, (ii) EPS, and (iii) market price. Which should be preferred from the point of view of A LTD.?

## Solution:

# (i) Calculation of share exchange ratio based on net assets value

		A Ltd.		B Ltd.
		(Rs.)		(Rs.)
Total assets		3,46,000		1,22,000
Less: 10% Debentures	30,000		10,000	
Preference share capital	40,000	70,000		10,000
Net worth (Net assets value)[a]		2,76,000		1,12,000
Number of equity shares[b]		20,000		10,000
Net work (assets) per share[a÷b]		Rs.13.80		Rs.11.20
Share Exchange Ratio =				
Net worth per share of target firm				
Net worth per share of acquiring firm				
11.20				
= = 0.81				
13.80				
Thus, number of shares to be issued by				
A Ltd. = $10,000 \times 0.81 = 8,100$ .				

### (ii) Calculation of share exchange ratio based on earnings per share (EPS)

	A Ltd.	B Ltd.
	(Rs.)	(Rs.)
Profit after tax and preference dividend	Rs.48,000	Rs.30,000
Number of equity shares	20,000	10,000
Earnings per share (EPS)	Rs.2.40	Rs.3.00
Share Exchange Ratio =		
EPS of target firm		
EPS of acquiring firm		
3.00		
= = 1.25		
2.40		
Thus, number of shares to be issued by		
A Ltd. = 10,000 x 1.25 = 12,500.		

## (iii) Calculation of share exchange ratio based on market price

Market Price per Share		A Ltd.		B Ltd.
		Rs. 24		Rs. 27
Share Exchange Ratio =				
Net worth per share of target firm				
Net worth per share of acquiring firm				
27				
=	= 1.125			
24				
Thus, number of shares to be issued by A Ltd. = $10,000 \times 1.125 = 11,250$				
Comments: A Ltd. should prefer the share exchange ratio based on net assets value as it has to issue				
minimum number of shares i.e., 8,100 in that case.				

# 9.10 Forms of Financing A Merger

A merger can be financed through various modes of payment, viz, cash, exchange of shares, debt or a combination of cash, shares and debt. Deferred payment plans, leveraged buyouts and tender offers are also being used as financial techniques in financing of mergers in the recent times. The choice of the means of financing primarily depends upon the financial position and liquidity of the acquiring firm, its impact on capital structure and EPS, availability of debt and market conditions.

1. Cash Offer. After the value of the firm to be acquired has been determined, the most straight forward method of making the payment could be by way of offer for cash payment. The major advantage of cash offer is that it will not cause any dilution in the ownership as well as earnings per share of the company. However, the shareholders of the acquired company will be

liable to pay tax on any gains made by them. Another important consideration could be the adverse effect on liquidity position of the company. Thus, only a company having very sound liquidity position may offer cash for financing a merger.

- 2. Equity Share Financing or Exchange of Shares. It is one of the most commonly used methods of financing mergers. Under this method, shareholders of the acquired company are given shares of the acquiring company. It results into sharing of benefits and earnings of merger between the shareholders of the acquired companies and the acquiring company. The determination of a rational exchange ratio is the most important factor in this form of financing a merger. The actual net benefits to the shareholders of the two companies depend upon the exchange ratio and the price-earning ratio of the companies. Usually, it is an ideal method of financing a merger in case the price-earning ratio of the acquiring company is comparatively high as compared to that of the acquired company. Further, when the shareholders of the acquired company receive shares in exchange in the acquiring company, they are not liable to any immediate tax liability.
- **3. Debt and Preference Share Financing.** A company may also finance a merger through issue of fixed interest bearing convertible debentures and convertible preference shares bearing a fixed rate of dividend. The shareholders of the acquired company sometimes prefer such a mode of payment because of security of income along with an option of conversion into equity within a stated period. The acquiring company is also benefited on account of lesser or no dilution of earnings per share as well as voting/controlling power of its existing shareholders.
- 4. Deferred Payment or Earn Out Plan. Deferred payment also known as earn-out plan is a method of making payment to the target firm which is being acquired in such a manner that only a part of the payment is made initially either in cash or securities. In addition to the initial payment, the acquiring company undertakes to make additional payment in future years if it is able to increase the earnings after the merger or acquisition. It is known as earn-out plan because the future payments are linked with the firm's future earnings. This method enables the acquiring company to negotiate successfully with the target company and also helps in increasing the earning per share because of lesser number of shares being issued in the initial years. However, to make it successful, the acquiring company should be prepared to co-operate towards the growth and success of the target firm.
- 5. Leveraged Buy Out. A merger of a company which is substantially financed through debt is known as leveraged buy-out. Debt, usually, forms more than 70 per cent of the purchase price. The shares of such a firm are concentrated in the hands of a few investors and are not generally, traded in the stock exchange. It is known as leveraged buy out because of the leverage provided by debt source of financing over equity. However, a leveraged buy-out may be possible only in case of a financially sound acquiring company which is viewed by the tenders as risk free.
- **6. Tender Offer.** Under this method, the purchaser, who is interested in acquisition of some company, approaches the shareholders of the target firm directly and offers them a price (which is usually more than the market price) to encourage them sell their shares to him. It is a method that results into hostile or forced take-over. The management of the target firm may also tender a counter offer at still a higher price to avoid the take over. It may also educate the shareholders by informing them that the acquisition offer is not in the interest of the shareholders in the long-run.

# 9.11 Capital Structure After Merger and Consolidations

The acquiring company in case of merger and the new company in case of consolidation take over assets and liabilities of the merging companies and new shares are issued in lieu of the old. The capital structure is bound to be affected by new changes. The capital structure should be properly balanced so as to avoid complications at a later stage.

A significant shift may be in the debt-equity balance. The acquiring company will be requiring cash for making the payments. If it does not have sufficient cash then it will have to give new securities for purposes of an exchange. In all cases the balance of debt and equity will change. The possibility is that equity may be increased more than the debt.

The mergers and consolidations result into the combining of profits of concerned companies. The increase in profitability will reduce risks and uncertainties. It will affect the earnings per share. The investors will be favourably inclined towards the securities of the company. The expectancy of dividend declarations in the future will also have a positive effect. If merging companies had different pay-out policies, then shareholders of one company will experience a change in dividend rate. The overall effect on earnings will be favourable because the increased size of business will experience a number of economies in costs and marketing which will increase profits of the company.

The capital structure should be adjusted according to the present needs and requirements. The concern should assess the effects of merger and consolidation on earning pattern, rate of growth, risks and uncertainties. The capital can be increased by issuing new preference and equity shares. The capital can be increased by issuing bonus shares too. On the other hand, if long-term debt is to be increased then it can be done by the issue of debentures, conversion of redeemable preference shares into debentures and renewal of bonded in debtness.

# 9.12 Financial Problems of Merger and Consolidation

After merger and consolidation the companies face a number of financial problems. The liquidity of the companies has to be established afresh. The merging and consolidating companies pursue their own financial policies when they are working independently. A number of adjustments are required to be made in financial planning and policies so that consolidated efforts may enable to improve short-term and long-term finances of the companies. Some of the financial problems of merging and consolidating companies are discussed as follows:

- 1. Cash Management. The liquidity problem is the usual problem faced by acquiring companies. Before merger and consolidation, the companies had their own methods of payments, cash behaviour patterns and arrangements with financial institutions. The cash pattern will have to be adjusted according to the present needs of the business.
- **2. Credit Policy.** The credit policies of the companies are unified so that same terms and conditions may be applied to the customers. If the market areas of the companies are different, then same old policies may be followed. The problem will arise only when operating areas of the companies are the same and same credit policy will have to be pursued.
- **3. Financing Planning.** The companies may be following different financial plans before merger and consolidation. The methods of budgeting and financial controls may also be different. After merger and consolidation, a unified financial planning is followed. The divergent financial controls will be unified to suit the needs of the acquiring concerns.
- **4. Depreciation Policy.** The companies may be following different depreciation policies. The methods of depreciation, the rates of depreciation, and the amounts to be taken to revenue

accounts will be different. After merger and consolidation the first thing to be decided will be about the depreciable and non-depreciable assets. The second will be about the rates of depreciation. Different assets will be in different stages of use and appropriate amounts of depreciation should be decided.

# 9.13 Mergers in India

In developed economies, corporate mergers and amalgamations are a regular feature where hundreds of mergers take place everyday. In India too, mergers have become a corporate game today. In 1988, there were only 15 mergers whereas in 1998 there were over 500 mergers. Corporate takeovers in India, were started by Swaraj Paul when he tried to take over Escorts. Since then many takeovers have taken place in our country such as Ashok Leyand by the Hindujas; Shaw Wallace, Dunlop, and Falcon Tyres by the Chabbria Group; Ceat Typres by the Goenkas and Consolidated Coffee by Tata Tea. The Institute of Chartered Accountants of India has issued Accounting Standard 14 on Accounting for Amalgamations. The Government has also favoured mergers and amalgamations when these are in the interest of general public. The Government has issued SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 to provide greater transparency in the acquisition of shares and takeover of companies. The major provisions of AS-14 acquisition and the SEBI regulations are given below:

# **As-14 (Accounting for Amalgamations)**

The Accounting Standard 14, which came into force with effect from April 1, 1995 provides two methods of accounting for amalgamations namely (i) the pooling of interest method and (ii) the purchase method. The pooling of interest method is applicable to amalgamations in the nature of merger. The purchase method is used in a accounting for amalgamations in the nature of purchase. Under the purchase method, the transferee company is required to account for the amalgamation either by incorporating the assets and liabilities at their existing values or by allocating the consideration to individual items of assets and liabilities on the basis of their fair value at the date of amalgamation.

The Standard prescribes that if, at the time of amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform accounting policy must be adopted following the amalgamation. The Standard also provides for treatment of 'reserves' on amalgamation. In the case of an amalgamation in the nature of a merger, the reserves appear in financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the case of an amalgamation in the nature of purchase, the identity of reserves, other than reserves created under a statute, is not preserved. Similar treatment is provided in the Standard for treatment of the balance in Profit and Loss Account of the transferor company.

The Standard also prescribes certain disclosures to be made in the first financial statements prepared following the amalgamation. The important disclosures to be made are :

- (i) Name and general nature of business of the amalgamation companies.
- (ii) Effective date of amalgamation for accounting purposes.
- (iii) Particulars of the scheme sanctioned.

- (iv) Description and number of shares issued together with exchange ratio.
- (v) The amount of difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

# Sebi (Substantial Acquisitions of Shares and Takeover Regulations, 1997

To safeguard the interests of shareholders and investors, the Government has brought a code to regulate the takeover bids through SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 1997. The main objective of these regulations is to provide greater transparency through a system of disclosures of information. Regulations 1 to 5 are the preview dealing with short title and commencement, definitions, applicability, the takeover panel and powers of the Board. Regulations 6 to 29 deal with disclosures of shareholding and control in a listed company whereas regulations 30 to 37 relate to 'bail out takeovers'. Regulations 38 to 47 provide for investigation and action by the board. Regulations 6 to 22 as amended by the SEBI (Substantial Acquisitions of Shares and Takeovers) Amendment Regulations, 1998 are reproduced below:

**Regulation 6 : Transitional Provision.** (1) Any person, who holds more than five per cent shares or voting rights in any company, shall within two months of notification of these Regulations disclose his aggregate shareholding in that company, to the company.

- (2) Every company whose shares are held by the persons referred to be sub-regulation (1) shall, within three months from the date of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the aggregate number of shares held by each person.
- (3) A promoter or any person having control over a company shall within two months of notification of these Regulations disclose the number and percentage of shares or voting rights held by him and by person(s) acting in concert with him in that company, to the company.
- (4) Every company, whose shares are listed on a stock exchange, shall within three months of notification of these Regulations, disclose to all stock exchange on which the shares of the company are listed, the names and addresses of promoters and or person(s) having control over the company, and number and percentage of shares or voting rights held by each such person.

# 7. Acquisition of 5% and more shares or voting rights of a company

- (1) Any acquirer who acquires shares or voting rights which (taken together with shares or voting rights, if any, held by him) would entitle him to more than five per cent shares or voting rights in a company, in any manner whatsoever shall disclose the aggregate of his shareholding or voting right in that company to the company.
- (2) The disclosure mentioned in sub-regulation (1) shall be made within four working days of
  - (a) The receipt of intimation of allotment of shares : or
  - (b) The acquisition of shares or voting rights, as the case may be.
- (3) Every company, whose shares are acquired in a manner referred to in sub regulation (1), shall disclose to all the stock exchanges on which the shares of the said company are listed the

aggregate number of shares held by each of such persons referred above within seven days of receipt of information under sub-regulation (1).

#### 8. Continual disclosures.

- (1) Every person, including a person mentioned in Regulation 6 who holds more than 15 (fifteen) per cent shares or voting tights in any company, shall, within 21 days from the financial year ending March 31, make yearly disclosures to the company, in respect of his holding as on 31<sup>st</sup> March.
- (2) A promoter or every person having control over a company shall, within 21 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him, in that company to the company.
- (3) Every company whose shares are listed on a stock exchange, shall within 30 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock exchange on which the shares of the company are listed, the changes if any, in respect of the holdings of the persons referred to under sub-regulation (1) and also holdings of promoters or person(s) having control over the company as on 31<sup>st</sup> March.
  - (4) Every company whose shares are listed on a stock exchange shall maintain a register in the specified format to record the information received under sub-regulation
  - (3) of Regulation 6. Sub-regulation (1) or Regulation 7 and sub-regulation (2) of Regulation 8.

#### 9. Power to call for information.

The stock exchanges and the company shall furnish to the Board information with regard to the disclosures made under Regulation 6,7 and 8 as and when required by the Board. Substantial Acquisition of shares or voting rights in and acquisition of control over a listed company

- 10. Acquisition of 15% or more of the shares or voting rights of any company. No acquirer shall acquire shares or voting rights which (taken together with shares or voting right if any held by him or by person acting in concert with him) entitle such acquirer to exercise 15% or more of the voting right in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the Regulations.
- 11. Consolidation of holdings. (1) No acquirer who, together with persons acting in concert with him, has acquired, in accordance with the provisions of law 15% or more but less than 75% of the shares or voting rights in a company, shall acquire, either by himself or through or with person acting in concert with him additional shares or voting rights entitling him to exercise more than 5% of the voting rights, in any period of 12 months, unless such acquirer makes a public announcement to acquire shares in accordance with Regulations.
- (2) No acquire who, together with persons acting in concert with him has acquired in accordance with the provisions of law, 75% of the shares or voting rights in an company shall acquire either by himself or through persons acting in concert with him any additional shares or

voting rights, unless such acquirer makes a public announcement to acquire shares in accordance with the regulations.

**Explanation :** For the purposes of Regulations 10 and Regulations 11 acquisition shall mean and include :

- (a) Direct acquisition in a listed company to which the Regulations apply:
- (b) Indirect acquisition by virtue of acquisition of holding companies, there listed or unlisted, whether in India or abroad.
- **12. Acquisitions of control over a company**: Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person make a public announcement to acquire shares and acquires such shares in accordance with the Regulations.

Provided that nothing contained herein shall apply to any change in control which takes place in pursuance to a resolution passed by the shareholders in general meeting.

Explanation:

(i) For the purposes of this Regulations, where there are two or more persons in control shall not be deemed to be a change in control of management nor shall any change in the nature and quantum of control amongst them constitute change in control of management:

Provided however that if the transfer of joint control to sole control is through sale at less than the market value of the shares, a shareholders meeting of the target company shall be convened to determine mode of disposal of the shares of the outgoing shareholder by a letter of offer or by block – transfer to the existing shareholders in control in accordance with the decision passed by a special resolution. Market value in such cases shall be determined in accordance with Regulation 20;

- (ii) Where any person or persons are given joint control, such control shall not be deemed to be change in control so long as the control given is equal to or less than the control exercised by person(s) presently having control over the company.
- **13. Appointment of a Merchant Banker.** Before making any public announcement of offer referred to in Regulation 10 or Regulation 11 or Regulation 12 the acquirer shall appoint a merchant banker in Category 1 holding a certificate of registration granted by the Board, who is not associate of or group of the acquirer or the target company.

### 14. Timing of the Public Announcement of Offer

- (1) The public announcement referred to the Regulation 10 or Regulation 11 shall be made by the merchant banker not later than four working days of entering into an agreement for acquisition of shares or voting rights or deciding to acquire shares or voting rights exceeding the respective percentage specified therein.
- (2) In case of an acquirer acquiring securities, including Global Depository Receipts or American Depository Receipts which, when taken together with the voting rights, if any already held by him or persons acting in concert with him, would entitle him to voting rights, exceeding the percentage specified in Regulation 10 or Regulation 11 the public announcement referred to in sub regulation (1) shall be made not later than four working days before he acquired voting rights on such securities upon conversion or exercise of option as the case may be.
- (3) The public announcement referred to in regulation 12 shall be made by the merchant banker not later than four working days after any such change or changes are decided to be made as would result in the acquisition of control over the target company by the acquirer.
- **15. Public Announcement of Offer.** (1) The public announcement to be made under Regulation 10 or 11 or 12 shall be made in all editions of one English national daily with wide

circulation, one Hindi national daily with wide circulation and a regional language daily with wide circulation at the place of the stock exchange where the shares of the target company are most frequently traded.

- (2) A Copy of the public announcement to be made under Regulation 10, 11 or 12 shall be submitted to the Board through the merchant banker at least two working days before its issuance.
- (3) Simultaneous with the submission of the public announcement to the Board, the public announcement shall also be sent to all the stock exchanges on which the shares of the company are listed for being notified on the notice board, and to the target company at its registered office for being placed before the board of directors of the company.
- (4) The offer under these Regulations shall be deemed to have been made on the date on which the public announcement has appeared in any of the newspapers referred to in subregulation (1).
- **16. Contents of the Public Announcement of Offer.** The Public announcement referred to in Regulation 10 or 11 or 12 shall contain the following particulars, namely:-
  - (i) The paid up share capital of the target company, the number of fully paid up and partly paid up shares.
  - (ii) The total number and percentage of shares proposed to be acquired from the public, subject to a minimum as specified in sub-regulation (1) of Regulation 21;
  - (iii) The minimum offer price for each fully paid up or partly paid up share;
  - (iv) Mode of payment of consideration;
  - (v) the identity of the acquirer(s) and in case the acquirer is a company or companies, the identity of the promoters and, or the persons having control over such company(s) and the group, if any, to which the company(s) belong;
  - (vi) the existing holding, if any of the acquirer in the shares of the target company including holding of persons acting in concert with him;
  - (vii) salient features of the agreement, if any, such as the date, the name of the seller, the price at which the shares are being acquired, the manner of payment of the consideration and the number and percentage of shares in respect of which the acquirer has entered into the agreement to acquire the shares or the consideration, monetary or otherwise, for the acquisition of control over the target company, as the case may be;
  - (viii) the highest and the average price paid by the acquirer or persons acting in concert with him for acquisition, if any, of shares of the target company made by him during the twelve month period prior to the date of public announcement;
  - object and purpose of the acquisition of the shares and future plans, if any, of the acquirer for the target company, including disclosures whether the acquirer proposes to dispose of or otherwise encumber any assets of the target company in the succeeding two years, except in the ordinary course of business of the target company:
    - Provided that where the future plans are set out, the public announcement shall also set out how the acquirers proposes to implement such future plans.
  - (x) the 'specified date' as mentioned in Regulation 19;
  - (xi) the date by which individual letters of offer would be posted to each of the shareholders;

- (xii) the date of opening and closure of the offer and the manner in which and the date by which the acceptance or rejection of the offer would be communicated to the shareholders;
- (xiii) the date by which the payment of consideration would be made for the shares in respect of which the offer has been accepted;
- (xiv) disclosure to the effect that firm arrangement for financial resources required to implement the offer is already in place, including details regarding the sources of the funds whether domestic i.e., from banks, financial institutions, or otherwise or foreign i.e. from Non-resident Indians or otherwise;
- (xv) provision for acceptance of the offer by person(s) who owns the shares by is not the registered holders of such shares;
- (xvi) statutory approvals, is any, required to be obtained for the purpose of acquiring the shares under the Companies Act, 1956 (1 of 1956), the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969), the Foreign Exchange Regulation Act, 1973 (46 of 1973), and /or any other applicable laws;
- (xvii) approvals of banks or financial institutions required, if any;
- (xviii) whether the offer is subject to a minimum level of acceptances from the shareholders; and
- (xix) such other information as is essential for the shareholders to make an informed decision in regard to the offer.
- 17. Brochures, advertising material, etc. The public announcement of the offer or any other advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares shall not contain any misleading information.
- **18. Submission of letter of offer to the Board.** (1) Within fourteen days from the date of public announcement made under Regulation 10, 11 or 12 as the case may be, the acquirer shall, through its merchant banker, file with the Board, the draft of the letter of offer, containing disclosures as specified by the Board.
- (2) The letter of offer shall be dispatched to the shareholders not earlier than 21 days from its submission to the Board under sub-regulation (1):

Provided that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any, in the letter of offer (without being under any obligation to do so), the merchant banker and the acquirer shall carry out such changes before the letter of offer is dispatched to the shareholders.

- (3) The acquirer shall, along with the draft letter of offer to in sub-regulation (1), pay a fee of Rs. 50,000 to the Board either by a banker's cheque or demand draft in favour of the Securities and Exchange Board of India, payable at Mumbai.
- **19. Specified date.** The public announcement shall specify a date, which shall be the 'specified date' for the purpose of determining the names of the shareholders to whom the letter of offer should be sent :

Provided that such specified date shall not be later than the thirteenth day from the date of the public announcement.

- **20. Minimum offer price.** (1) The offer to acquire the shares under Regulation 10, 11 or 12 shall be made at a minimum offer price which shall be payable—
  - (a) in cash: or
  - (b) by exchange and, or transfer of share of acquirer company, if the person seeking to acquire the shares is a listed body corporate; or

- (c) by exchange and/or transfer of secured instruments with a minimum of 'A' grade rating form a credit rating agency;
- (d) a combination of clause (a), (b) or (c);

Provided that where payment had been made in cash to any class of shareholders for acquiring their shares under any agreement or pursuant to any acquisition in the open market or in any other manner during the preceding 12 months from the date of public announcement, the offer document shall provide that the shareholders have the option to accept payment either in cash or by exchange of shares or other secured instruments referred to above.

- (2) For the purpose of sub-regulation (1), the minimum offer price shall be the highest of—
  - (a) the negotiated price under the agreement referred to in sub-regulations (1) of Regulation 14;
  - (b) highest price paid by the acquirer or persons acting in concert with him for any acquisitions, including by way of allotment in a public or rights issue, if any, during the 26 week period prior to the date of public announcement;
    - (c) the price paid by the acquirer under a preferential allotment made to him or to persons acting in concert with him, at any time during the twelve month period up to the date of closure of the offer.
  - (d) the average of the weekly high and low of the closing prices of the shares of the target company as quoted on the stock exchange where the shares of the company are most frequently traded during the 26 weeks preceding the date of public announcement.
- (3) Where the shares of target company are infrequently traded, the offer price shall be determined by the issuer and the merchant banker taking into account the following factors:
  - (a) the negotiated price under the agreement referred to in sub-regulation (1) of Regulation 14;
    - (b) highest price paid by the acquirer or persons acting in concert with him for acquisitions including by way of allotment in a public or rights issue, if any, during the 26 week period prior to the date of public announcement;
  - (c) the price paid by the acquirer under a preferential allotment made to him or to persons acting in concert with him, at any time during the twelve month period up to the date of closure of the offer;
  - (d) other parameters including return on net worth, book value of the shares of the target company, earning per share, price earning multiple vis-à-vis the industry average.

**Explanation**—(i) For the purpose of this clause, shares will be deemed to be infrequently traded if on the exchange, the annualized trading turnover in that share during the preceding 6 calendar months prior to the month in which the public announcement is made is less than two per cent (by number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the said six months period may be taken.

(ii) In case of shares which have been listed within six months preceding the public announcement, the trading turnover may be annualized with reference to the actual number of days for which the share has been listed.

(4) Notwithstanding the provisions of sub-regulations (1), (2) and (3) above, where the acquirer has acquired shares in the open market or through negotiation or otherwise, after the date of public announcement at a price higher than the minimum offer price stated in the letter of offer, then the highest price paid for such acquisition shall be payable for all acceptances received under the offer.

(Provided that no such acquisition shall be made by the acquirer during the last sever working day prior to the closure of the offer.)

- (5) In case where the shares or secured instruments of the acquirer company are offered in lieu of cash payment, the value of such shares or secured instruments, shall be determined in the same manner as mentioned in sub-regulations (2) and (3) above to the extent applicable, as duly certified by an independent category 1 Merchant Banker (other than the managers to the offer) or an independent Chartered Accountant of 10 years standing.
- (6) The letter of offer shall contain justification on the basis on which the price has been determined.
- **Explanation.** -(1) The highest price under clause (b) or the average price under clause (d) of sub-regulation (2) may be adjusted for quotation, if any, cum-right or cum-bonus basis during the said period.
- (2) Where the public announcement of offer is pursuant to acquisition by way of firm allotment in a public issue or preferential allotment, the average price under clause (d) of subregulation (2) shall be calculated with reference to the 26 week period preceding the date of the board resolution which authorized the firm, preferential allotment.
- (3) Where the shareholders have been provided with an option to accept payment either in cash or by way of exchange of security, then, subject to the provisions of Regulation 20, the pricing for the cash offer could be different from that of a share exchange offer or offer for exchange with secured instruments, provided that the disclosures in the offer documents contain suitable justifications for such differential pricing.
- (4) Where the offer is subject to a minimum level of acceptance, the acquirer may subject to the provision of Regulation 20, indicate a lower price for the minimum acceptance of 20% should the offer not receive full acceptance.
- **21. Minimum number of shares to be acquired.** (1) The public offer shall be made to the shareholders of the target company to acquire from them an aggregate minimum of 20% of the voting capital of the company;

Provided that where the open offer is made in pursuance to sub-regulation (2) of Regulation 11, the public offer shall be for such percentage of the voting capital of the company as may be decided by the acquirer.

- (2) Where the offer is conditional upon minimum level of acceptances from the shareholders as provided for in clause (xviii) if Regulation 16 the provisions of sub regulation (1) of this regulation shall not be applicable, if the acquirer has deposited in escrow account in cash a sum of 50% of the consideration payable under the public offer.
- (3) If the public offer results in the public shareholding being reduced to 10% or less of the voting capital of the company, or if the public offer is in respect of a company which has public shareholding of less than 10% of the voting capital of the company, the acquirer shall either
  - (a) with in a period of 3 month from the date of closure of the public offer, make an offer or buy out the outstanding shares remaining with the shareholders at the same offer price, which may result in desisting of the target company; or

- (b) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public, which shall open within a period of 6 months from the date of closure of the public offer, such number of shares so as to satisfy the listing requirement.
- (4) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (3).
- (5) For the purpose of computing the percentage referred to sub-regulations (1), (2) and (3) the voting rights as at the expiration of 30 days after the closure of the public offer, shall be reckoned.
- (6) Where the number of shares offered for sale by the shareholders are more than the shares agreed to be acquired by the person making the offer, such person shall, accept the offers received from the shareholders on a proportional basis, in consolation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable manner and does not result in non marketable lots:

Provided that acquisition of shares from a shareholder shall not be less than the minimum marketable lot or the entire holding if it is less than the marketable lot.

- **22. General obligations of the acquirer.** (1) The public announcement of offer to acquire the shares of target company shall be made only when the acquirer is able to implement the offer.
- (2) Within 14 days of the public announcement of the offer, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address, for being placed before the board of directors and to all the stock exchanges where the shares of the company are listed.
- (3) The acquirer shall ensure that the letter of offer is sent to all the shareholders (including non-resident Indians) of the target company, whose names appear on the register of members of the company as on the specified date mentioned in the public announcement, so as to reach them within 45 days from the date of public announcement:

Provide that where the public announcement is made pursuant to an agreement to acquire share or control over the target company, the letter of offer shall be sent to shareholder other than the parties to the agreement.

**Explanation.**-(i) A copy of the letter of offer shall also be sent to the Custodians of Global Depository Receipts or American Receipts to enable such persons to participate in the open offer, if they are entitled to do so.

- (ii) A copy of the letter of offer also is sent to warrant holders or convertible debenture holders, where the period of exercise of option or conversion falls within the offer period.
- (4) The date of opening of the offer shall be not later than the sixtieth day form the date of public announcement.
- (5) The offer to acquire shares form the shareholders shall remain open for a period of 30 days.
- (6) In case the acquirer is a company, the public announcement of offer, broacher, circular, letter of offer or any other advertisement or publicity material issued to shareholders in connection with the offer must state that the director accept the responsibility for the information contained in such documents.

Provided that if any of the director desires to exempt himself from responsibility for the information in such document, such director shall issue a statement to that effect, together with reasons thereof for such statement.

(7) During the offer period, the acquire or persons acting in concert with him shall not be entitled to be appointed on the board of Director of the target company.

- (8) Where an offer is made conditional upon minimum response to the minimum level of acceptances, acquirer or any person acting in concert with him –
- (i) shall, irrespective of whether or not the offer received response to the minimum level of acceptances, acquire shares from the public to the extent of the minimum percentage specified in sub regulation (1) of Regulation 21.

Provided that the provisions of this clause shall not be applicable in case the acquirer has deposited in the escrow account, in cash 50% of the consideration payable under the public offer;

- (ii) shall not acquire, during the offer period, any shares in the target company, except by way of fresh issue of shares of the target company, as provided for under regulation 3;
- (9) If any of the persons representing or having interest in the acquirer is already a director on the board of the target company or is an "insider" within the meaning of SEBI (Insider Trading) Regulations,1992. he shall recluse himself and not participate in any matter(s) concerning or 'relating' to the offer including any preparatory steps leading to the offer.
- (10) On or before the date of issue of public announcement of offer, the acquirer shall create an escrow account as provided under Regulation 28.
- (11) The acquirer shall ensure that firm financial arrangement has been made for fulfilling the obligations under the public offer and suitable disclosures in this regard shall be made in the public announcement of offer.
- (12) The acquirer shall, within a period of 30 days from the date of the closure of the offer complete all procedures relating to the offer including payment of consideration to be shareholders who have accepted the offer and for the purpose open a special account as provided under Regulations 29:

Provided that where the acquirer is unable to make the payment to the shareholders who have accepted the offer before the said period of 30 days due to non-receipt of requisite statutory approvals, the Board may, if satisfied that non-receipt of requisite statutory approvals was not due to any willful default or neglect of the acquirer or failure of the acquirer to diligently pursue the applicants for such approvals, grant extension for the purpose, subject to the acquirer agreeing to pay interest to the shareholders of delay beyond 30 days, as may be specified by the Board from time to time.

- (13) Where the acquirer fails to obtain the requisite statutory approvals in time on account of willful default or neglect or inaction or non-action on his part, the amount being in the escrow account shall be liable to be forfeited and dealt with in the manner provided in clause (e) of sub-regulation (12) of Regulations 28, apart from the acquirer being liable for penalty as provided in the Regulations.
- (14) In the event of withdrawal of offer in terms of the Regulations, the acquirer shall not make any offer for acquisition of shares of the target company for a period of six months from the date of public announcement of withdrawal of offer.
- (15) In the event of non-fulfillment of obligations under Chapter III or Chapter IV of the Regulations, the acquirer shall not make any offer for acquisition of shares of any failed company for a period of twelve months from the date of closure of offer.
- (16) If the acquirer, in pursuance to an agreement, acquire shares which along with his existing holding, if any, increases his shareholding beyond (15%) then such agreement for sale of shares shall contain a clause to the effect that in case of non compliance of any provisions of this regulation, the agreement for such sale not be acted upon by the seller or the acquirer.
- (17) Where the acquire or persons acting in concert with him has acquired any shares (in terms of sub regulation 4 of regulation 20), he shall disclose the number, percentage, the price

and the mode of acquisition of such shares to the stock exchange on which the shares of the target company are listed and to the merchant bankers, within 24 hours of such acquisition.

(18) Where the acquirer has not in the public announcement and, or the letter of offer stated his intention to dispose of or otherwise encumber any assets of the target company except in the ordinary course of business of the target company, the acquire, where he has acquired control over the target company, shall be debarred form disposing of or otherwise encumbering the assets of the target company for a period 2 years from the date of closure of the public offer.

# 9.14 Summary

One size does not fit all. Many companies find that the best route forward is expanding ownership through mergers and acquisitions. At least in theory mergers create synergies and economies of scale, expanding operations and cutting costs. A merger is the combination of two or more firms through direct acquisition of assets by one of other or other. Merger can be horizontal, vertical or conglomerate. A merger results into an economic advantage when the combined firms are worth more together than as separate entities. Merger should be undertaken when the acquiring company's gain exceeds the cost. Merger and acquisition activities are regulated under various laws in India.

## 9.15 Self Assessment Questions

- 1. Discuss merger and consolidation of business concerns. Why are merger and consolidation necessary?
- 2. Explain various methods of valuation at the time of merger.
- 3. Describe the financial problems faced by the concerns after merger and consolidation
- 4. Highlight the legal and procedural aspects of merger.

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## LESSON-10 FOREIGN INVESTMENT IN INDIA

**OBJECTIVE:** The present lesson discusses aims at introducing the meaning, need and

importance of foreign investment in India.

#### **STRUCTURE**

- 10.1 Introduction
- 10.2 Forms of Foreign Capital
- 10.3 Government Policy towards Foreign Capital
- 10.4 Foreign Direct Investment
- 10.5 Competitive Advantage of India for Foreign Investors
- 10.6 Foreign Investment Inflows
- 10.7 An Assessment of Policies towards Foreign Collaboration
- 10.8 Major Recommendation of the Steering Committee, 2001
- 10.9 Major Initiatives to Attract FDI during 2002-03
- 10.10 Euro Issues
- 10.11 External Commercial Borrowings
- 10.12 Investments by FIIs
- 10.13 NRI Investments in India
- 10.14 NRI Deposits
- 10.15 Investment Risks in India
- 10.16 Potential for Investment in India
- 10.17 Summary
- 10.18 Self Assessment Questions

## 10.1 Introduction

If a underdeveloped or developing country is interested in rapid economic development, it will have to import machinery, technical know how, spare parts and even raw materials. One method of paying for the imports is to step up exports. This is possible, if the Government is prepared to curtail consumption drastically and export more, simultaneously curtailing import of consumption goods. Russia, China, and others had adopted this method after the establishment of communist governments in these counties. As this involves a lot of sacrifice, it can be adopted only by a Government which is committed to such a policy. The second alternative of getting

foreign technology and equipment is to depend upon foreign assistance in some form or the other. Most countries of the world which embarked on the road to economic development had to depend on foreign capital to some extent. The degree of dependence, however, varied with the extent to which domestic resources could be mobilized, the state of the domestic economy in respect of technical progress, the attitude of the respective governments, etc. But the fact cannot be denied that foreign capital contributed in many ways to the process of economic growth and industrialization. The need for foreign capital for a developing country like India can arise on account of the following reasons:-

- (a) Domestic capital is inadequate for purposes of economic growth and it is necessary to invite foreign capital.
- (b) For want of experience, domestic capital and entrepreneurship may not flow into certain lines of production. Foreign capital can show the way for domestic capital.
- (c) There may be potential savings in a developing economy like India but this may come forward only at a higher level of economic activity. It is therefore, necessary that foreign capital should help in speeding up economic activity in the initial phase of development.
- (d) It may be difficult to mobilize domestic savings for the financing of projects that are badly needed for economic development. In the early stages of development, the capital market is itself underdeveloped. During the period in which the capital market is in the process of development, foreign capital is essential for the development of capital market itself.
- (e) Foreign capital brings with it other scarce productive factors, such as technical know how, business experience and knowledge which are equally essential for economic development. It also create an overall environment for investment into various business activities and boosts the demand thereof.

# 10.2 Forms of Foreign Capital

The different forms of foreign investment are:

- (a) Direct Foreign Investment. Foreign capital can enter India in the form of direct investments. In the past, companies had been formed in advanced countries with the specific purpose of operating in India. Sometimes companies of advanced countries start their subsidiary offices or branches and affiliates in India. Alternately, foreigners may subscribe to stocks and debentures of concerns in India. (This is known as portfolio investment.)
- (b) Foreign Collaboration. In recent years there has been joint participation of foreign and domestic capital. India has been encouraging this form of import of foreign capital. There are three types of foreign collaborations—joint participation between private parties, between foreign firms and Indian Government and between foreign governments and Indian Government.

- (c) Inter-Government Loans. Since the Second World War, there has been a growing tendency towards direct inter-government loans and grants. Marshall Aid was a massive system of American aid given to the war-devasted European countries to reconstruct their economies. Other advanced countries too provide grants and loans to Governments of less developed countries.
- (d) Loans from International Institutions. Since 1946, the World Bank and its affiliates have been important suppliers of capital to India. International Monetary Fund (MF), Aid India Consortium, Asian Development Bank (ADB) and the World Bank have been the major sources of external assistance to India in recent years.
- (e) External Commercial Borrowing (ECB). India has also been tapping export credit agencies like the US Exim Bank, the Japanese Exim Bank, ECGC of the UK etc. to obtain a major portion of the commercial borrowing from the capital market.

# 3. Government Policy towards Foreign Capital

With the advent of freedom, the pressure for economic development in India necessitated a realistic approach towards foreign capital. The late Prime Minister Nehru made a statement in April 1949 giving three important assurance to foreign investors:

- (a) India would not make any discrimination between foreign and local undertakings;
- (b) Foreign exchange position permitting, reasonable facilities would be given to foreign investors for remittances of profits and repatriation of capital; and
- (c) In case of nationalization of the undertaking, fair and equitable compensation would be paid to foreign investors.

The Industrial Policy Resolution of 1948 and 1956 as well Mr. Nehru's statement on foreign capital were the basis of the Government's policy on foreign capital till 1991 when the New Industrial Policy was announced.

The Indian Government recognized foreign capital as important supplement to domestic saving for the development of the country and for securing scientific, technical and industrial know-how. Although as a matter of policy the major ownership and effective control of undertaking was to be in Indian hands. The Government permitted, in a few cases, foreign capital to have majority control of an enterprise. The Government extended a number of tax concessions favouring foreign enterprises and streamlined industrial licensing procedures to avoid delays in approvals of foreign collaborations.

The Government of India decided in 1972 to permit wholly owned subsidiaries of foreign companies provided they undertake to export 100 per cent of their output. However, in case the new venture is to export less than 100 per cent of its output, the extent of permissible foreign capital participation would be subject to negotiation with the Government.

Since the new policy of the Government marked a reversal of its earlier policy of reducing the share of foreign equity holdings in subsidiaries of foreign companies operating in

India, it gave rise to suspicion and anxiety. During February 1972, the Government developed a precise formula setting out the limits of participation by Indians in foreign subsidiary companies if they undertook plans of output-expansion. Thus companies with foreign holdings exceeding 75 per cent would have to raise 40 per cent of the estimated cost of expansion by issue of additional equity to Indians. The corresponding proportion for companies with 60-70 per cent foreign ownership would be 33.3 per cent and for those with 51-60 per cent foreign ownership would be 25 per cent.

Thus, the Government had to choose between pursuing a policy of Indianisation of foreign subsidiary companies to boost up exports through the agency of foreign firms. The latter course, which was chosen, was beset with grave dangers of proliferation of the influence of foreign concerns. While, liberalizing the conditions for foreign private investment the Government should in no case permit such subsidiary companies which are neither willing to make a firm commitment about export promotion nor are wiling to accept the scheme of gradual Indianisation. The principles of participation should be laid down in unambiguous terms.

## The Janata Party and Foreign Collaborations

In its statement on Economic Policy (November, 1977) the Janata Party laid the following guidelines regarding foreign collaborations:

"The Janata Party will not go in for foreign collaboration in areas where adequate Indian skills and capital are available....whenever the need for foreign collaborations is felt in areas of high priority emphasis should be on purchasing outright technical know-how, technological skills and machinery."

"The provisions of FERA must be rigorously enforced in the sector of consumer goods industries. The foreign firms should be asked to carry forward the process of Indianisation. Their production capacities also should be frozen at the existing levels."

During two years of Janata rule, two major decisions regarding multinationals were taken and much advertised. Firstly, the Coca-Cola Company was asked to wind up its operations. Secondly, the government asked International Business Machines (IBM) to dilute its equity to 40 per cent so as to conform to FERA guidelines. Since the IBM did not agree, it was also asked to fold up its operations.

Despite these two decisions, multinationals continued to operate in non-priority areas like tobacco, toiletries, beverages, etc. For instance, Hindustan Lever was permitted 51 per cent of foreign equity on the grounds of introduction of sophisticated technology in India. But the plea was unwarranted because the products of Hindustan Lever include vanaspati, shampoo, toothpaste, soap, detergent etc. India can certainly produce these products and induction of sophisticated technology is a lame excuse. Even against the guidelines of FERA, several foreign companies viz., Alkali Chemicals, Indian Explosives, Dunlop, Good Year, Asbestos Cement, Hindustan Pilkington were permitted to retain foreign equity at 51 per cent or more.

# 10.4 Foreign Direct Investment (FDI)

Foreign direct investment is one of the most important sources of foreign investment in developing counties like India. It is seen as a means to supplement domestic investment for achieving a higher level of growth and development. FDI is permitted under the following forms of investments.

- 1. Through financial collaborations/capital/equity participation.
- 2. Through joint ventures and technical collaborations.

- 3. Through capital markets (Euro Issues).
- 4. Through private placements or preferential allotment.

Capital participation/financial collaboration refers to the foreign partner's stake in the capital of the receiving country's companies while technical collaboration refers to such facilities provided by foreign partners as licensing, trade marks and patents (against which he gets lump sum fee or royalty payments for specified period); technical services etc.

From investors' point of view, the FDI inflows can be classified into the following three groups:

- (a) Market seeking. The investors are attracted by the size of the local market, which depends on the income of the country and its growth rate.
- **Lower cost.** Investors are more cost-conscious. They are influenced by infrastructure facilities and labour costs.
- (c) Location and other factors. Technological status of a country, brand name, goodwill enjoyed by the local firms, favourable location, openness of the economy, policies of the Government and intellectual property protection granted by the Government are some of the factors that attract investors to undertake investments.

Industrial Policy (1991) announced by the Congress Government accepted the fact that foreign investment is essential for modernization, technology upgradation and industrial development of India. The policy, therefore overbent to cajole foreign capital to come to India. The main points of the policy were:

- (i) Approval would be given for direct foreign investment up to 51 per cent foreign equity in high priority industries. Clearance would be available if foreign equity covers the foreign exchange requirement for imported capital goods.
- (ii) The payment of dividends would be monitored through the Reserve Bank of India so as to ensure that outflows on account of dividend payments are balanced by export earnings over a period of time.
- (iii) To provide access to international markets, majority foreign equity holding up to 51% equity would be allowed for trading companies primarily engaged in export activities.
- (iv) Automatic permission would be given for foreign technology agreements in high priority industries up to a lump sum payment of Rs. 1 crore, 5% royalty for domestic sales and 8% for exports, subject to a total payment of 5% of sales over a 10 year period from date of agreement or 7 years from commencement of production.

The Government of India liberalized its policy towards foreign investment in 1991 to permit automatic approval for foreign investment up to 51 per cent equity in 34 industries. The Foreign Investment Promotion Board (FIPB) was also set up to process applications in cases not covered by automatic approval.

During 1992-93 several additional measures were taken by the Government of India to encourage flow of foreign investment in India particularly in favour for direct foreign investment, portfolio investment, NRI investment and investment in Global Depository Receipts (GDR). These measures are given below:

- (i) The dividend balancing condition earlier applicable to foreign investment up to 51 per cent equity is no longer applied except for consumer goods industries.
- (ii) Existing companies with foreign equity can raise it to 51 per cent subject to certain prescribed guidelines. Foreign direct investment has also been allowed in exploration, production and refining of oil and marketing of gas. Captive coal mines can also be owned and run by private investors in power.
- (iii) NRIs and Overseas Corporate Bodies (OCBs) predominantly owned by them are also permitted to invest up to 100 per cent equity in high priority industries with repartriability of capital and income. NRI investment up to 100 per cent of equity is also allowed in export-houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels, etc., Foreign citizens of Indian origin are now permitted to acquire house property without the permission of the RBI.
- (iv) Disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank. It has been allowed at market rates on Stock Exchanges from September 15, 1992 with permission to repatriate the proceeds of such disinvestment.
- (v) India has signed Multilateral Investment Guarantee Agency Protocol for the protection of foreign investors on April 13, 1992.
- (vi) Provisions of the Foreign Exchange Regulation Act (FERA) have been liberalized through an Ordinance dated January 9, 1993 as a result of which companies with more than 40 per cent of foreign equity are also now treated at par with fully Indian owned companies. Later on FERA was replaced with FEMA.
- (vii) Foreign companies have been allowed to use their trade marks on domestic sales from May 14, 1992.
  - (viii) The Government has allowed reputed Foreign Institutional Investors (FIIs) including pension funds, mutual funds, asset management companies, investment trusts etc. to invest in the Indian Capital Market subject to the condition that they register with the Securities and Exchange Board of India (SEBI) and obtain RBI approval. Scanty rainfall and outbreak of drought like conditions also affected FII perceptions regarding prospective returns from Indian markets. Down grading, by some international credit

rating agencies, of Indian companies was also a contributory factor. FIIs inflows improved in the last quarter of 2001-02, because it was a time when the global economy was relatively more up beat, and global equity market sentiments more positive.

## Factors that Attracts FDIs in India

The following factors can be held responsible for the flow of foreign direct investments in India:

- 1. India has a well developed network of banking and financial institutions and an organized capital market open to foreign institutional investors that attracts them to undertake investments.
- 2. India has vast potential of young entrepreneurs in the private sector. Indian skills and competence is used as a base for carrying out production activities and export to neighbour countries.
- 3. For the last few years there has been political stability in the country.
- 4. India enjoys good reputation among other countries as to honouring of its commitments about repayment obligations, remittance of dividends etc.
- 5. India has vast pool of unskilled labour available at cheap rates as compared to other countries, and vast natural resources that attract foreign investors.

## Factors that Discourage FDIs

Factors that discourage foreign investors to undertake investments in India include:

- (i) High rates of taxation.
- (ii) Lack of infrastructure facilities.
- (iii) Favouritism in the selection of investment.
- (iv) Complicated legal framework of rules, regulations procedures for foreign direct investment into India.
- (v) Lack of transparency.

# 10.5 Competitive Advantages of India for foreign investors

India and the Indians have undergone a paradigm shift. From a shortage economy of food and foreign exchange, India has now become a surplus one. From an agro based economy it has emerged as a service oriented one. After having been an aid recipient, India is now joining the aid givers club. Although India was late and slow in modernization of industry in general in the past, it is now a front runner in this emerging era of information, internet revolution and knowledge based New Economy. Indian companies are no longer afraid of MNCs. They have become competitive and some of them have started becoming MNCs themselves. Indian name is no more "too long... how do you pronounce it?" but it is a recognized asset among venture capitalists of Silicon Valley. Fatalism and contentment of the Indian mindset has given way to optimism and ambition. Introvert and defensive approach have been replaced by outward-looking and confident attitude. The Indian value system which looked down upon wealth as a sin and believed in simple living and high thinking has started recognizing money and success as acceptable and necessary goals. Graduates no longer queue up for safe government jobs. They

prefer and enjoy the challenges and risks of becoming entrepreneurs and competition of the global market place.

While India is being globalize, there is also a quiet Indianisation of the Globe. There are about 20 million people of Indian origin outside India. Some of them have become Presidents and Prime-Ministers and many have become CEOs of top MNCs particularly in USA. One third of Microsoft employees, one quarter of IBM and one sixth of scientists of Intel are Indians. Four out of 10 Silicon Valley start-ups are run by Indians. The richest immigrant group in USA are Indians.

# Indian has arrived as an emerging economic power.

Here are the highlights of the new India:

- Large and growing market of 1 billion people of which 300 million are middle class consumers.
- India offers a vibrant market of youth and vigour with 54% of population below 25 years of age.
- One of the largest economies of the world and the fourth largest in terms of purchase power parity.
- Stable economy with strong fundamentals. Average growth of 5.6% past 20 years without any boom-bust cycles.
- Largest democracy with stable, mature and exemplary democratic governance.
- Strong and transparent legal and accounting system.
- Primacy of rule of law and independent judiciary.
- Numerous watchful and proactive NGOs.
- Free, vocal, alert and quality media. 5600 dailies with a combined circulation of 60 million, nearly 15000 weeklies and 20000 periodicals in 21 languages.
- Strong tradition of domestic entrepreneurship combined with the emergence of a strong force of young entrepreneurs in IT.
- Well organized educational system, with internationally recognized excellence in some areas of higher education. 250 universities and over 10000 higher educational institutions producing a million graduates including 100000 engineers per year.

- Easy communication through English, the main business language of India.
- Second largest reservoir of knowledge resource-engineers, scientists, managers and skilled personnel and the largest pool of IT manpower in the world.
- Well developed R&D infrastructure with 1500 research facilities. About 100 MNCs have set up research centers in India.
- India is in the forefront of knowledge based industries, business and service such
  as IT, biotechnology, bioinformatics and pharmaceuticals and is well positioned
  to take advantage of the opportunities arising in the New Economy.
- Internet is not just another technology for India. It has triggered a socio-cultural revolution empowering the masses and firing the imagination and ambition of youth.
- India has joined the select club of countries with advanced technologies in some areas such as space research, atomic energy, supercomputing and oceanography.
   One among the six countries which have capabilities of satellite launching, production and use of these technologies for development.
- Other than USA and Japan, the only other country which has built super computer indigenously is India.
- India has emerged as a global player in Information Technology with software exports of 8 billion US Dollars and as a leading center for Business Process Outsourcing. Of the Fortune 500, half of them outsource their software from India. 40 Indian IT companies certified at "SEI-CMM Level 5" out of global total of 80 plus companies.
- Diversified and large industrial base which is becoming globally competitive.
- Indian Pharma industry emerging as global player with exports of 2 billion US
  Dollar per year. Ranbaxy, the largest Indian pharma company, gets 70 per cent of
  its dollar revenue from overseas. It exports to 70 counties, has ground operations
  in 25 markets and manufacturing in seven countries including China. India has the

largest number of annual bulk drug filings (77) with USFDA. India is home to the largest number of pharma plants approved by USFDA outside USA.

- India is the second largest cement producer with 110 million tons per year.
- Hero Honda of India is the largest motorcycle producer in the world with 1.7 million units in 2002.
- One of the largest food producers and the largest producer of milk in the world. Second largest exporter of rice and the fifth largest exporter of wheat.
- Sixth largest power generator in the world with large scope and need for further capacity.
- Sound banking system with a network of 70000 branches, among the largest in the world. Bank deposit is roughly half of GDP-among the highest in the world.
- Vibrant capital market comprising 24 stock exchanges with over 9000 listed companies. Bombay stock exchange is the second largest after NYSE. Stock market trading and settlement system are of world class. Indian stock market considered as having the greatest long-term potential in Asia.
- Legal protection for intellectual property rights.
- Conductive foreign investment environment that provides freedom of entry and exit, investment, location, choice of technology, imports and exports and current account convertibility.
- India has been recognized as a destination for business and investment opportunities with an assured potential for attractive returns.

# Performance of the Indian Economy

• India is, today, one of the six fastest growing economies of the world. A unique feature of the transition of the Indian economy has been high growth with stability. The Indian economy has proved its strength and resilience when there have been crises in other parts of the world including in Asia in recent years

- India has recorded one of the highest growth rates in the GDP in 1990s. The target of the 10<sup>th</sup> Five Year Plan (2002-07) is 8%. The GDP at current prices is US \$ 502 billion. While the agricultural and industrial sectors have continued to grow, the services sector has grown at a significantly higher pace, and is currently contributing to nearly half of the total GDP.
- The economy is now on the verge of a sustained increase in domestic demand due to rising per capita GDP. The domestic demand is expected to double over the ten year period from 1998 to 2007. The number of households with "high income" is expected to increase by 60% in the next four years to 44 million households.
- The foreign exchange reserves have reached a record level of US \$ 90 billion as on 8 October, 2003. This comfortable situation has facilitated further relaxation of foreign exchange restrictions and a gradual move towards greater capital account convertibility.
- Given the large foreign exchange reserves, the Government has made premature repayment of US \$ 3 billion of 'high-cost' loans to World Bank and Asian Development Bank.
- The Government has decided to (i) discontinue receiving aid from other countries except the following five: Japan, UK, Germany, USA, EU, and the Russian Federation and (ii) to make pre-payment of all bilateral debt owned to all the countries except the five mentioned above.
- The Government has written off debts of 30 million US dollars due from seven heavily indebted countries as part of the "India Development Initiative".
- The external debt to GDP ratio has improved significantly from 38.7% in 1992 to 20% in 2003. This is one of the lowest among developing economies. The external debt is around US \$ 105 billion.
- The interest rates continue to be reduced and is around 6%. This is the lowest in the last thirty years and this is stimulating consumption and investment.

- After reaching an all-time low of Rs. 49.06 per US dollar in May, 2002, the rupee has strengthened against the dollar reaching a rate of US \$ 1 = Rs. 45 in October, 2003, and even lower there after.
- The inflation rate has been contained to 3.4% in 2002-03.
- Exports increased to US \$ 51.7 billion and imports reached US \$ 59.3 billion in 2002-03. The trade deficit has declined from US \$ 14.4 billion in 2001-02 to US \$ 7.68 billion in 2002-03. On the other hand, the current account has recorded a surplus in the last two years.
- Food grain production reached 182.57 million tones in 2002-03. The buffer stock of food grains has reached a record volume of 30 million tones as against the target of 24 million tones. This has helped India enter the food grains export market in a significant way. Agri exports account for 15% of the total exports.
- The IT industry has been growing in India, despite the worldwide slump. The potential for exports has been estimated to be US \$ 50 billion by 2008.
- Indian companies have started investing abroad to position themselves for tapping
  the opportunities arising from globalization. In 2002-03 Indian investment abroad
  was US dollars 1 billion. Other developing countries have started realizing the
  economic and technological strength of India and seriously considering India as a
  source of cost effective imports and appropriate technology.

## 10.6 Foreign Investment Inflows

Policies in the post-reforms period have emphasized upon greater encouragement and mobilization of non-debt creative private capital inflows for reducing reliance on debt flows as the chief source of external resources. Progressive liberal policies adopted in this regard have led to increasing inflows of foreign investment in the country both in terms of direct investment as well as portfolio investment.

## 1. Foreign Investment Approvals and Actual Inflows

After the announcement of New industrial Policy (1991), there has been an acceleration in the flow of foreign capital in India. As per data provided by the Government of India, during 1991-92 to 2002-03, total foreign investment flows were of the order of \$54.5 billion, out of which about \$30.3 billion (55.5 per cent) were in the form of Foreign Direct Investment and the remaining \$24.3 billion (44.5 per cent) were in the form of portfolio investment. This clearly shows that the preference of foreign firms was more in favour of direct investment. Moreover, out of the total direct foreign investment of the order of \$30.3 billion, nearly 4.8 per cent (\$2.62 billion) was contributed by Non-resident Indians. Thus, the net contribution of foreign firms in direct investment was 51 per cent of total foreign investment flows.

As a response to the policies of liberalization, the foreign investors were very keen to undertake portfolio investment, including GDR (Global Depository Receipts) and investment by Foreign Institutional Investors, Euro equities and others rose sharply from \$244 million in 1992-93 to \$3,824 million in 1994-95 and declined to \$1,828 million in 1997-98. Portfolio in investment became negative in 1998-99 but again improved to \$2.76 billion in 2000-01, but again declined to nearly \$1 billion in 2002-03.

Table-I: Foreign Investment Flows by Categories

US \$ million

	Direct Investment			Po	Portfolio Investment			
	Foreigners	NRI's	Sub-total	FIIs	Others	Sub-total	Total	
	(1)	(2)	(3=1+2)	(4)	(5)	(6=4+5)	(7=3+6)	
1991-92	66	63	129	4	0	4	133	
1992-93	264	51	315	1	243	244	559	
1993-94	369	217	586	1665	1902	3567	4153	
1994-95	872	442	1314	1503	2321	3824	5138	
1995-96	1429	715	2144	2009	739	2748	4892	
1996-97	2182	639	2821	1926	138	3312	6133	
1997-98	3316	241	3557	979	849	1828	5385	
1998-99	2400	62	2462	-390	329	-61	2401	
1999-00	2071	84	2155	2135	591	3026	5181	

2000-01	3962	67	4029	1847	913	2760	6789
2001-02	6096	35	6131	1505	516	2021	8152
2002-03	4660	-	4660	377	602	979	5639
Total	27687	2616	30303	13561	10691	24252	54555
(1991-92 to 2002-03)	(50.7)	(4.8)	(55.5)	(24.9)	19.6)	(44.5)	(100.0)

#### Note:

- 1. Foreigners include investment flows by RBI automatic route and SIA/FIPB route.
- 2. Others include Euro-equities (GDR amounts raised by Indian Corporates) and Offshore funds and others.
- 3. Figures in brackets are percentages of total investment.

Data given table 2 shows that total FDI proposals approved since 1991 till 2002 amounted to Rs. 2,84,812 crores against just Rs. 1,274 crores approved during the whole of the previous decade (1981-90). There is no doubt that it takes sometime for all these proposals to fructify into actual inflows. Unfortunately, the actual flows as a proportion of approvals were low till 1997, but the situation has shown distinct improvement thereafter. Actual flow during 2002 peaked to Rs. 21,286 crores—a creditable achievement.

Table-2: Direct Foreign Investment: Approvals and Inflows

Year	Amount approved (Rs. Crores) (1)	Actual Inflow (Rs. cores) (2)	2 as % of 1
1991	534	351	65.7
1992	3888	675	17.1
1993	8859	1787	20.2
1994	14187	3289	23.2
1995	32072	6820	21.3
1996	36147	10389	28.7
1997	54891	16425	29.9
1998	30814	13340	43.3
1999	28367	16868	59.5
2000	37039	19342	52.2
2001	26875	19265	71.7
2002	11140	21286	191.1

Total	284812	129838	45.6
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Note: Approvals and inflows include NRI investments as well.

Industry-wise approval of FDI reveal that for the entire period August 1991 to March 2002, basic goods industries accounted for about 39 per cent of FDI. Out of this, the major share was appropriated by power (15.6%) and oil refineries (10.8%). Mining and metallurgy (ferrous and non-ferrous) accounted for 5.6% and chemicals only 4.6%. The next group in order of importance was that of services accounting for 37% of FDI. The share of telecommunications was about 20% and that of computer software was 6.4%. Financial services contributed barely 4.2%. Capital goods and intermediate goods accounted only 11% of FDI approvals. Although it is commonly believed that consumer durables are attracting large share of FDI, but the data reveal that they only accounted for 3.4% of FDI approvals. Consumer non-durables shared about 10% FDI (Refer Table 3).

Table-3: Share of Different Industries in Foreign Collaboration Approvals

(August 1991 to March 2002)

	No. of Approvals	Approved FDI Investment (Rs. crores)	Percent of Total
A. Basic Goods	2,459	1,07,576	38.8
(i) Power	353	43,359	15.6
(ii) Oil Refinery	373	30,008	10.8
(iii) Chemicals	1,713	12,734	4.6
(iv) Mining, Metallurgy and other metals	689	15,403	5.6
(v) Other Fertilizers, cement etc.	331	6,072	2.2
B. Capital Goods	6,538	25,117	9.0
(i) Transportation Industry	1,172	9,456	3.4
(ii) Electrical Equipment	1,661	5,963	1.2
(iii) Electronics	485	3,228	1.2
(iv) Others	3,220	6,470	2.3
C. Intermediate Goods	811	4,993	1.8
D. Consumer Non-durables	4,363	27,623	10.1
E. Consumer Durables	159	9,357	3.4
F. Services	6,172	1,02,928	37.1
(i) Telecommunications	801	55,281	19.9
(ii) Computer Software	2,353	17,616	6.4
(iii) Financial Services	414	11,760	4.2
(iv) Other Services	2,604	18,271	6.6
Total	21,502	2,77,597	(100.0)

Analysis of FDI approvals underlines the fact that nearly 75 per cent was accounted for by basic goods industries, capital good and telecommunication and computer software services which are high on our priority list. Since segregated data about actual flows industry wise is not available, it is not possible to comment whether the intentions are being realized in practice, or are distorted in the process of implementation.

It is really strange that industrial machinery accounted for only 1.1 per cent of total approved investment. Explaining this situation, ISID study mentions: "With steep reduction in the customs duties for capital goods sector, foreign investors might be finding it more advantageous to export to India than to manufacture within the country. It has also been observed that this sector has not been receiving much attention even in technical collaborations."

However, the data do not reveal the full story. Economic Survey (1996-97) estimated the share of consumer goods sector to be 15.3 per cent and that of capital goods and machinery 13.1 per cent and infrastructure 49.1 per cent in FDI approvals during August 1991 to October 1996. It gives an impression that relatively the share of the consumer goods sector is small, but in reality it is not so. This is due to the fact that although food processing accounted for just 6.5 per cent of total approved investment (Rs. 7,500 crores), Coca Cola alone received approvals worth Rs. 2,700 crores and Pepsi Rs. 1,000 crores. But these two soft drink giants since liberalization are dominating the market. Since a number of consumer goods companies are setting up holding companies and subsidiaries, and the investment in them is not included in approved investment, the figures of approved investment understate the potential of these companies to influence market structures. For instance, Hindustan Lever has recently taken over a number of Indian firms (Brooke Bond, Lipton), Tata Oil Mills and several other firms and created a subsidiary Unilever. Since investment in subsidiaries is not reflected in approved investment, these figures do not reflect the full potential of these firms to dominate the Indian market structure.

The spectoral pattern of FDI inflows to India shows that despite a slowdown in the overall level of FDI, flows into the engineering sector have remained stable, largely in consonance with buoyancy in export growth in that sector. Empirical studies in the Indian context suggest a lagged feedback effect from export growth to FDI. On the other hand, FDI inflows into the software sector continued to exhibit a downward trend despite the robust export performance of the software sector. This suggests that FDI is complementary rather than substitutive in sectors where domestic entrepreneurship and production have acquired an international competitiveness. FDI inflows into the services sector declined to US \$ 431 million from a peak of US \$ 1,128 million in 2001-02, in spite of high growth in services domestically and sustained exports of professional and commercial services (Table-4)

Table-4: Country-wise and Industry with Inflows\*

(US \$ million)

Country/Industry	2003-04	2002-03	2001-02				
1	2	3	4				
Total FDI	1,462	1,658	2,988				
Country-wise Inflows							
Mauritius	381	534	1,863				
US	297	268	364				
UK	157	224	45				
Germany	69	103	74				
Netherlands	197	94	68				
Japan	67	66	143				
France	34	53	88				
Singapore	15	39	54				

Switzerland	5	35	6
South Korea	22	15	3
Others	218	227	280
Indus	try-wise Inflows		
Chemical and allied products	46	53	67
Computers	151	297	368
Engineering	274	262	231
Electronics and electrical equipments	103	95	659
Finance	4	54	22
Food and dairy products	63	35	49
Pharmaceuticals	79	44	69
Services	431	509	1,128
Others	311	309	395

<sup>\* :</sup> Data in this table exclude FDI inflows under the NRI direct investment route through the Reserve Bank and inflows due to acquisition of shares under Section 5 of the FEMA, 1999.

## FDI Inflows in Select-Asian Countries

FDI inflows are indicators of the foreign investor community's long term stakes in the host economy. A time series profile of FDI inflows into select Asian host economies is given in Table-5.

Table-5: FDI Inflows in Select Asian Economies

(in US \$ million)

	1996	1997	1998	1999	2000	2001
World	386140	478082	694457	1088263	1491934	735146
Developed economies	219908	267947	484239	837761	1227476	503144
Developing economies	152685	191022	187611	225140	237894	204801
Asia	93331	105828	96109	102779	133707	102066
South, East and South-East Asia	87843	96338	86252	99990	131123	94365
a. China	40180	44237	43751	40319	40772	46846
b. India	2525	3619	2633	2168	2319	3403
c. Indonesia	6194	4677	-356	-2745	-4550	-3277
d. Korea	2325	2844	5412	9333	9283	3198
e. Malaysia	7296	6324	2714	3895	3788	554
f. Philippines	1520	1249	1752	578	1241	1792
g. Singapore	8608	10746	6389	11803	5407	8609
h. Thailand	2271	3626	5143	3561	2813	3759

The Table-5 depicts that in 2001, developing economics of Asia accounted for around 14 per cent of total global FDI inflows. China has been the largest recipient of FDI inflows among developing economies of Asia with its share in total FDI of these economics increasing from 43% in 1996 to almost 46% in 2001. India, though little behind China in attracting FDI inflows, has been able to improve its share in total FDI inflows of developing economies of Asia from 2.7 per cent (US \$ 2525 million) in 1996 to 3.3 per cent (US \$ 3403 million) in 2001. A sharp increase in volume of FDI inflows in the Indian economy in 2001-02 thus indicates its growing attractiveness as an investment destination.

Developing Asian countries experienced a sharp decline in overall net private capital flows due to the effect of East Asian Crisis in 1997-98. Although decline is more attributable to reduced volumes of portfolio inflows, FDI inflows also have declined. The reduction of FDI inflows in the Indian economy after 1997-98 (Table 1) therefore are indicators of the overall declining trends of private capital flows in emerging market, including developing Asia. No doubt China is an exception to it.

## FDI Inflows and Exports

Foreign direct investment (FDI) is an important avenue through which investment takes place in India. The importance of FDI extends beyond the financial capital that flows into the country. In addition, FDI can be a tool for bringing knowledge, and integration into global production chains, which are the basis of a successful exports strategy.

Table-6 shows major receipts of FDI in the developing world. The major recipient of FDI inflows has been China. It received US \$ 46.8 billion in 2001. India rank 3<sup>rd</sup> in number being recipient of US \$ 3.4 billion of FDI inflows. The table also points out to the competition that India has to face to attract FDI.

Table-6 also points at the link between FDI and exports. Exports from developing countries are often associated with international firms who choose a country as a target for FDI and who carry out production with the objective of marketing of products in global markets.

Table-6: FDI Inflows and Exports in selected Asian developing countries in the year 2001 (billion US \$)

		FDI	Percent share to world total	Exports	Percent share to world total
1.	China	46.8	(6.4)	266.6	(4.4)
2.	Hong Kong	22.8	(3.1)	189.9	(3.1)
3.	India	3.4	(0.5)	43.3	(0.7)
4.	Indonesia	-3.3	(-0.4)	52.1	(0.9)
5.	Korea	3.2	(0.4)	150.4	(2.5)
6.	Malaysia	0.6	(0.1)	88.0	(1.4)
7.	Phillipines	1.8	(0.2)	32.7	(0.5)
8.	Singapore	8.6	(1.2)	121.8	(2.0)

9. Sri Lanka	0.2	(0.0)	4.8	(0.1)
10. Thailand	3.8	(0.5)	65.1	(1.1)
Developing economies	204.8	(27.9)	2255.1	(36.8)
World	735.1		6121.3	

## 10.7 An Assessment of Policies towards Foreign Collaborations

The main arguments put forth by the protagonists of liberalization to permit larger doses of foreign collaborations are: The days of East India Company are over. The inflow of foreign collaborations through Multinational Corporations (MNCs) or their subsidiaries does not imply subjugation. The share of India in direct foreign investment when compared with China, Brazil, Mexico etc. is very low.

Foreign Direct Investment flows have increased from US \$ 51.1 billion in 1992 to about \$ 204.8 billion by 2001 for all developing countries. Data given in table 7 reveal that India's share in Foreign Direct Investment increased from 0.5% in 1992 to 1.7% in 2001. As against it, China's share improved from 21.8% in 1992 to 34% in 1995 and then declined to 22.9% in 2001. In absolute terms, whereas China's share was US \$ 46.8 billion in 2001, India's share was barely US \$ 3.43 billion. Obviously, India has not been able to benefit much from Foreign Direct Investment despite the red carpet spread by it for the foreign investors.

Secondly, transfer technology can also be effected with more investment being made by technologically advanced MNCs. These gains are not disputed by the critics, but the fact of the matter is that there are aspects of foreign direct investment which seriously impinge on people's welfare and national sovereignty. It is these aspects which need serious consideration.

Table: Foreign Direct Investment by Host Region

(US \$ million)

Country	1992	1995	2001
China	11,156	35,849	46,846
India	233	2,144	3,403
Indonesia	1,777	4,346	-3,277
South Korea	727	1,357	3,198
Malaysia	5,183	5,816	594
Philippines	228	1,459	1,792
Thailand	2,114	2,000	3,759
All Developing Countries (including China)	51,108	1,11,884	2,04,801
India's Share (%)	0.5	1.9	1.77
China's Share(%)	21.8	34.0	22.9

Thirdly, 45 per cent of the Foreign Investment is in the nature of portfolio investment (financial investment) which only strengthens speculative trading in shares. The wisdom of permitting foreign companies to trade in the share market is punctuated by a question mark. This has led to an artificial boom in the share market and the BSE Sensitive Index touched a high mark of 4,282 on 18<sup>th</sup> June 1994. Earlier when the share market boom burst, the market came tumbling down and millions of small shareholders who entered the share market to have a quick buck, suffered very heavy losses, but the big sharks were able to manipulate the market to corner

big gains for them. The securities boom resulted in a scam involving over Rs. 5,000 crore. The critics are of the view that although we feel jubilant over the strengthening of the share market, but we do not realize the fact that we may be sitting on a volcano.

Even during 2001, the activities of MNCs resulted in wild fluctuations in BSE Sensitive Index which came tumbling down after budget 2001-2002 was presented to the Parliament. The Government had to intervene so that confidence in the market is revived. This only underlines the fact that MNCs are able to manipulate the stock market to suit their goals.

Fourthly, foreign direct investment is catering to the needs of the upper middle and affluent classes, thus concentrating on the 180 million consumers in the Indian economy. In this sense, they feel a new consumer culture of colas, jams, ice creams, processed foods and the acquisition of durable consumer goods. Consequently, there is an utter neglect of the wage goods sector.

During 1980-81 to 1992-93, the output of consumer durables increased at an annual average rate of 10 per cent, while that of wage goods was as low as 4.5 per cent. In other worlds, production instead of benefiting the masses, is only catering to the needs of the upper classes,. In this sense, the multinationals by entering into production of goods like potato chips, wafers, bakery products, food processing etc. are rapidly displacing labour working in the small scale sector since such units are faced with the stark prospects of closure being unable to complete with MNCs. Thus both from the point of view of the pattern of production and employment, the unrestricted entry of multinationals in soft areas has dangerous implications.

Fifthly, portfolio investment made in India is in the nature of hot money which may take to flight if the market signals indicate any adverse trends. Thus, it would be a mistake to treat portfolio investment as a stable factor in our growth.

Sixthly, a larger inflow of foreign direct investment, more so in the financial sector, will lead to building of reserves which in turn will expand domestic money supply. Consequently, inflationary trend of prices gets strengthened in the process. Moreover, the country is witnessing the growth of a vast non-banking financial and intermediate sector which may include foreign financial companies and mutual funds. If this sector grows at a very fast rate as is happening in India, it may render any efforts of monetary management by the Reserve Bank of India ineffective.

Seventhly, MNCs after their entry are rapidly increasing their shareholding in India companies and are thus swallowing Indian concerns. This has resulted in a number of takeovers by the MNCs and thus, the process of Indianisation of the corporate sector initiated by Jawaharlal Nehru has been totally reversed. This explains the reason why leading industrialists of the Bombay Club or the All India Manufacturers Organization (AIMO) have raised their voice against the "discriminatory" policies of the Government to woo foreign capital at the cost of indigenous capital.

Finally, it has recently come to light that multinationals such as Cadbury Schweppes, Gillette, Procter and Gamble, Danone, GEC, Unilever, Ciba-Geigy, Hewlett Packard, Timex, ABB, Unisys and Rhone-Poulenc have decided to expand their business in India by adopting the wholly-owned (100%) subsidiary route at the cost of their established and listed subsidiaries. Thus thousands of Indian minority shareholders in the listed affiliate subsidiaries (joint ventures) feel cheated by this move of the multinationals, Earlier, in the last couple of years, most of the MNCs augmented their holdings in listed affiliates by acquiring shares at heavy discounts over market prices through the mechanism of preferential allotment of shares, MNCs promised that they would bring fresh capital, introduce latest technologies and marketing skills and help Indian

affiliates become more competitive internationally and accelerate their growth. The move to keep Indian affiliates out of their activities on the one hand has hurt Indian interests, but a serious issue is that more attractive and profitable businesses have been transferred to wholly owned and newly created subsidiaries. Thus a conflict of interest has arisen between a wholly owned subsidiary and the 51 per cent owned affiliates. But since MNCs have acquired majority stake in the affiliates, the Indian minority investor has been rendered powerless to take any retaliatory action. Indian industrialists feel that the new move is a kind of day light robbery because the MNCs want to profit on established brand names. Moreover, this will accelerate the process of forex drain from India. But, the clandestine manner by which the multinationals enhanced their equity at throw away prices by seeking preferential allotment of shares, is a blatant abuse of the permissive clauses in industrial policy (1991). It is, therefore, of urgent necessity that the Government should take remedial steps through SEBI and RBI to plug this abuse. To sum up, while capital inflows by multinationals may be permitted, but this should not be allowed at the cost of Indian national interests. The Government should, therefore, not have an open door policy but should be more selective in its approach.

# 10.8 Major Recommendations of the Steering Committee, 2001

As pert of the ongoing process of liberalizing FDI policies, the Planning Commission had set up a Steering Committee on FDI in August 2001, for suggesting measures for enhancing FDI inflows in India. The major recommendations of the Committee are given below:

- (i) Enactment of a Foreign Investment Promotion Law incorporating and integrating relevant aspects for promoting FDI.
- (ii) Urge States to enact a special investment law relating to infrastructure for expediting investment in infrastructure and removing hurdles to production in infrastructure.
- (iii) Empower the Foreign Investment Promotion Board (FIPB) for granting initial Central level registrations and approvals wherever possible, for speeding up the implementation process.
- (iv) Empower Foreign Investment Implementation Authority (FIIA) for expediting administrative and policy approvals.
- (v) Disaggregating FDI targets for the Tenth Plan in terms of sectors, and relevant administrative ministries/departments, for increasing accountability.
- (vi) Reduction of sectoral FDI caps to the minimum and elimination of entry barriers. Caps can be taken off for all manufacturing and mining activities (except defense), eliminated in advertising, private banks, and real estate, and hiked in telecom, civil aviation, broadcasting, insurance and plantations (other than tea).
- (vii) Overhauling the existing FDI strategy by shifting from a broader macro-emphasis to a targeted sector specific approach.
- (viii) Information aspects of the FDI strategy require refinement in the light of India's strengths and weakness as an investment destination and should use information technology and modern marketing techniques.
- (ix) The Special Economic Zones (SEZs) should be developed as internationally competitive destinations for export oriented FDI, by simplifying laws, rules and procedures, and reducing bureaucratic rigmarole on the lines of China.
- (x) Domestic policy reforms in power, urban infrastructure, and real estate, and decontrol/de-licensing should be expedited for attracting more FDI.

## 10.9 Major Initiatives to Attract FDI During 2002-03

- (1) FDI up to 100% is permitted under the automatic route in the advertising sector. FDI under the automatic route up to 100% is available for film sector and will not be subject to conditions about debt equity ratio, minimum level of equity investment etc.
- (2) FDI up to 100% is allowed in tea sector, including tea plantations, permitted subject to compulsory disinvestments of 26% equity in favour of Indian partner within a period of 5 years and prior approval of the State government in case of any future land use change.
- (3) Re-issuance of ADR/GDR permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the domestic market.
- (4) FDI up to 100 percent permitted with prior approval of the government for development of integrated township, including housing, commercial premises, hotels, resorts and regional level urban infrastructure facilities such as roads and bridges and mass rapid transit system, subject to the guidelines issued on dated January 4, 2002.
  - (5) Automatic route of FDI up to 100% allowed in all manufacturing activities in

Special Economic Zones, except some of the activities such as:

- (i) Arms and ammunition
- (ii) Atomic energy
- (iii) Defense aircrafts and warships
- (iv) Distillation and brewing of alcoholic drinks and cigarettes and cigars
- (v) Mining of iron, manganese, chrome, gypsum sulphur, gold, diamonds, copper, zinc.
- (6) FDI in print media sector is allowed up to 26% of paid up equity capital of India

entities publishing periodicals and newspapers dealing with news and current affairs.

The above are some of the initiatives taken in 2002-03 in fostering FDI, which constitute a part of the ongoing effort from 1991 onwards at steadily opening access to India for FDI flows. A committee headed by N.K. Singh, Member, Planning Commission, has drafted a set of proposals for further augmenting these flows, which are currently under evaluation.

In a recent development that has taken place in March 2004, SEBI has allowed lead managers and book runners to the mega issue of ONGC to issue participatory notes (PNs) for attracting foreign investment. PNs are like contract notes which are issued by foreign institutional investors and merchant bankers to their overseas clients who are not eligible to invest in the Indian stock market directly. According to SEBI, the value of outstanding PNs were about Rs. 15,528 crore till October 2003. This is almost 20 percent of the total FII investment of Rs. 80,325 crore as on October 13,2003.

#### 10.10EURO ISSUES

Euro issue is a method of raising funds required by a company in foreign exchange. It provides greater flexibility to the issuers for raising finance and allow room for controlling their cost of capital. The term 'Euro issue' means an issue made abroad through instruments denominated in foreign currency and listed on an European stock exchange, the subscriptions for which may come from any part of the world. The idea behind Euro issues is that any one capital market can absorb only a limited amount of company's stock at any given time and cost. The

following are the two primary instruments through which finance is raised by Indian companies in international markets:

- (i) Foreign Currency Convertible Bonds (FCCBs); and
- (ii) Global Depository Receipts (GDRs) / American Deposit Receipts
- (i) Foreign Currency Convertible Bonds. FCCBs are bonds issued to and subscribed by a non-resident in foreign currency which are convertible into certain number of ordinary shares at a pre-fixed price. They are like convertible debentures, have a fixed interest rate and a definite maturity period. These bonds are listed on an European Stock Exchange. The issuer company has to pay interest on FCCBs in foreign currency till the conversion takes place and if the conversion option is not exercised by the investor, the redemption of bond is also to be made in foreign currency. Essar Gujrarat, Reliance Industries, ICICI,TISCO and Jindal Strips are some of the Indian companies which have successfully issued such bonds.
- Global Depository Receipts. GDR is an instrument, denominated in dollar or some other feely convertible foreign currency, which is traded in Stock Exchanges in Europe or the US or both. When a company issues equity outside its domestic market, and the equity is subsequently traded in the foreign market, it is usually in the form of a Global Depository Receipt. Though the system of GDRs, the shares of a foreign company are indirectly traded. The issuing company works with a bank to offer to its shares in a foreign country via the sale of GDRs. What happens under this system is that a bank holds the shares of a foreign firm and it further issues claims against the shares it holds. The bank issues GDRs as an evidence of ownership. Thus foreign company/ corporation instead of directly making the issue to the public in the foreign market deals through the bank called Overseas Depository Bank. The equity shares or bonds representing the GDRs are registered in the name of the overseas depository bank and the share/bond certificates are delivered to another intermediary called the 'Domestic Custodian Bank'. A holder of a GDR is given an option to convert it into equity shares or bonds. However, till conversion, the GDR does not carry any voting rights. The biggest advantage of issuing GDR is that the issuing companies are relieved from the burden of complying with various legal formalities imposed by the regulatory authorities of that country in which they are making issues through GDRs. It also gives them the benefit of reducing licence fees and exempt them from reporting various information regarding issue of securities required by the regulatory authorities. Further, the GDR issue does not involve any foreign exchange risk to the issuing Indian companies as the shares represented by GDR are expressed in rupees. The listing of GDRs on Overseas Stock Exchange provides liquidity and makes the company's securities more attractive.

**American Depository Receipts (ADRs)** are the US version of GDRs. American Depository Receipts have almost the same features as of GDRs with a special feature that ADRs are necessarily denominated in US dollars and pay dividend in US dollars.

In recent years, the Euro issues are increasingly becoming popular in India. Indian companies can raise large volume of funds in US dollars or any other foreign currency at much lower cost as compared to the domestic market. In order to facilitate the issues of foreign currency convertible bonds (FCCBs) and GDRs, the Ministry of Finance, Department of Economic Affairs, introduced the Issue of Foreign Currency Convertible Bonds and Ordinary

Shares (Through Deposit Receipt Mechanism) Scheme, 1993. Internal guidelines for Euro Issues have also been issued by the Government of India. The Government has been liberalizing the guidelines for issue of GDRs/ADRs in a phased manner. Unlisted companies are now permitted to float Euro issues under certain conditions. All end use restrictions on GDR/ADR issue proceeds have been removed, except the prevailing restrictions on investment in stock markets and real estate. The 90-day validity period for final approvals of GDR/ADR issues has been withdrawn and final approval will continue to be valid, thereby imparting greater flexibility to issuing companies regarding the timing of issues. Indian companies are now permitted to issue GDRs/ADRs in the case of bonus or rights issue of shares, or on genuine business reorganizations duly approved by the High Court. The initiative taken by the Government in 2001-02 include: (a) Indian companies have been permitted to list in foreign stock exchanges by sponsoring GDR/ADR issues with overseas depository against shares held by its shareholders subject to prescribed conditions; (b) All companies that have made an ADR/GDR issue earlier and listed abroad have been permitted the facility of overseas business acquisition through ADR/GDR stock swap under the automatic route subject to conditions that include adherence to FDI policy and the value limit for the transaction not to exceed US \$ 100 million or 10 times the export earnings during the proceeding financial year, and (c) Operational guidelines for facility for limited two way fungibility for Indian ADR/GDRs announced by the Finance Minister in the Union Budget 2001-2002 were finalized in consultation with the RBI and the SEBI.

As a consequence to the liberalization measures, the funds raised through issue of ADRs/GDRs amounted to US \$ 477 million in 2001-2002 as compared with US \$ 831 million in 2000-01. The Reliance Industries Limited was the first Indian Company to raise funds through GDR issue in May 1992. The total funds raised through ADRs/GDRs from 1992-93 to 2000-2001 amounted to US \$ 8405 million.

## 10.11 External Commercial Borrowings (ECB)

India has also been obtaining foreign capital in the form of external commercial borrowings from agencies like US EXIM Bank, Japanese EXIM Bank, ECCG of UK etc.

External Commercial Borrowings primarily include (a) commercial bank loans, (b) securitized

borrowings, (c) loans/securitized borrowings etc. with multilateral/bilateral guarantee and (d) self liquidating loans. The export credit includes : (i) buyer's credit, (ii) suppliers' credit, (iii) export credit component of bilateral credit, and (iv) export credit for defense purchases.

The policy for external commercial borrowings has been operated flexibly by the Government so as to facilitate better access to international financial markets, keep maturities long, costs low and encourage infrastructure and export sector financing.

Table-8 shows the aggregate approvals granted by the Ministry of Finance and the Reserve Bank of India for raising ECBs during the period 1998-99 to 2003-04. The amount of aggregate approvals include the intimations given under the automatic route facility of the RBI (up to US \$ 50 million) including refinancing of existing ECBs. The sectoral break up for ECB approvals pertains to the approvals granted by the Ministry of Finance for ECB proposals beyond US \$ 100 million. These ECBs are generally for higher maturities pertaining to infrastructure industry.

Aggregate ECB approvals are exhibiting a declining trend since 1998-99 (US \$ 5200 million) to (US \$ 4234.96 million) till 2003-04. As in the previous years, the power sector received the highest ECB approvals. The status of approvals given to the corporates under normal widows during the last six financial years (1998-99 to 2003-04) is given below:

Table-8: Approvals given for External Commercial Borrowings								
	During 1998-99 to 2003-04							
					(In US	\$ \$ million)		
Sector	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04		
Power	3998	2267	1065	270.11	375.00	700.00		
Telecom	75	0	0		341.00	1166.00		
Shipping	37	27	144					
Civil Aviation	0	0	0					
Petroleum & NG	40	218	150	750				
Railways	15	0	0					
Financial Institutions	150	125	70	150	225.00	1015.00		
Ports, Roads, etc.	0	80	0		829.00	0		
Others (including exporters)	885	129	60	750.00	156.76	0		
Approval given by RBI	0	552	802	243.00	1044.46	1108.47		

Amount raised under auto-route facility	0	0	546	489.00	1263.74	4186.03
Total	5200	3398	2837	2652.00	4234.96	8175.50
ECB approval under credit enhancement scheme	0	233	1098			

#### Economic serve P-123-124

External commercial borrowing outflows exceeded inflows during 2002-03, resulting in net negative inflows of US \$ 2.3 billion. At this level, net outflows exceeded the previous year's level of US \$ 1.6 billion. While outflows increased by almost US \$ 1 billion to US \$ 5.2 billion in 2002-03 from US \$ 4.3 billion in 2001-02, inflows increased only marginally to US \$ 2.8 billion from US \$ 2.7 billion in 2001-02. The proportionally larger increase in outflows resulted in a much larger volume of net negative inflows for external commercial borrowings during 2002-03.

During the year 2003-04, external commercial borrowings recorded net negative inflows for the first three-quarters, reflecting the trend observed during the previous two years. Net inflows during the first three quarters were estimated at US \$ 3.7 billion. This was far higher than the net inflow of US \$2.0 billion observed during the corresponding period of 2002-03. While outflows during April-December 2003 were estimated at US \$ 6.7 billion, far higher than US \$ 3.9 billion during the corresponding period of 2002-03, aggregate inflows at US \$ 3 billion during April-December 2003 were also higher than US \$ 1.8 billion recorded during April-December 2002. However, the increase in outflows has been more than double than that of inflows (April-December 2003 vis-à-vis April-December 2002) leading to a larger increase in net negative inflows.

The increasing volume of net negative inflows under external commercial borrowings during 2001-02 and 2002-03 is largely attributable to a gradually widening differential between disbursements on one hand and amortization payments on the other. The differential has been widening largely on account of lower disbursement, which underlie lower demand for ECBs during 2001-02 and 2002-03, presumably due to weak domestic investment demand. The trend for the current year indicates that the differential is showing signs of increasing further. However, an increase in the number of ECB approvals during 2003-04 may indicate a future reversal in the offing.

In order to further improve the access of Indian corporates to global capital markets, the existing ECB policy was comprehensively liberalized in January 2004. Presently ECBs are permitted for investment in all sectors except capital markets and real estate. The eligible list of ECB borrowers now includes all corporates, except banks, financial institutions and NBFCs. ECBs up to US \$ 20 million and minimum average maturity of three years are now eligible under the automatic route. ECBs above US \$ 20 million and up to US \$ 500 million are also permissible under the automatic route of the RBI for loans with minimum average maturity of five years. An empowered Committee set up by the RBI considers ECB proposals falling outside the purview of the automatic route limits and for maturity periods exceeding the permissible time period allowed under the automatic route.

## 10.12 Investments by Foreign Institutional Investors (FIIs)

SEBI (Foreign Institutional Investors) Regulations, 1995, define Foreign Institutional Investors as an institution established or incorporated outside India which proposes to make investment in India in securities. The regulations make it mandatory for FIIs to seek registration with SEBI before operating in Indian securities market. Before granting certificate of registration, the applicant's track record, professional competence, financial soundness experience, general reputation of fairness and integration is taken into consideration by SEBI.

## Eligibility Criteria

An FII eligible to apply has to be:

- (i) An institution established or incorporated outside India as a pension fund or mutual fund or investment trust.
- (ii) An asset management company or nominee company or bank or institutional portfolio manager, established or incorporated out side India and proposing to make investments in India on behalf of a broad based fund.
- (iii) A trustee or power of attorney holder established or incorporated outside India and proposing to make investments in India on behalf of broad based funds.

By an amendment in October, 1996, university funds, endowments foundations or charitable trusts or charitable societies were included. Proprietary funds which are regulated in their home countries were also included under the eligible list of FIIs later in February, 1997. A certificate for registration once issued is valid for 5 years and can be renewed there after.

#### **Investment Restrictions**

FIIs are permitted to invest only in the following securities:

- (i) Securities in the primary and secondary markets including share, debentures and warrants of companies whether listed or to be listed on a recognized stock exchange in India including OTC Exchange of India.
- (ii) Units of schemes floated by domestic mutual funds including UTI.
- (iii) Dated government securities w.e.f. February, 1997.
- (iv) Derivatives traded on a recognized stock exchange.
- (v) Commercial paper.

FIIs are now permitted to invest in unlisted companies. Transactions in government securities, commercial paper including treasury bills shall be carried as per Reserve Bank of India rules. All investments by FIIs are subject to Government of India guidelines. The general obligations and responsibilities of FIIs include appointment of a domestic custodian, appointment of a designated bank, maintenance of proper books of accounts, record, appointment of a compliance officer and submission of information, records or documents as may be required by SEBI.

In case, FII fails to comply with any condition subject to which certificate has been granted or contravenes any of the provisions of the Act then it shall be liable to the penalty of suspension or cancellation of certificate as per SEBI Regulations, 2002.

Government of India guidelines place no restriction on the volume of investment minimum or maximum for the purpose of entry for FIIs in the primary and secondary market and prescribes no lock in period of such investments. Portfolio investments in primary or secondary markets initially were subject to a ceiling of 24% of issued share capital for all the total holdings of all registered FIIs, in any one company. The limit was enhanced to 30% w.e.f. April 1997. In 2001-02 the Government raised this limit to 49% w.e.f. September, 2001, the level of FDI in various sectors has been raised to 74% or even beyond this in various sectors. The holdings of a single FII in any company is subject to a ceiling of 10% of total issued capital.

### 10.13 NRI Investments in India

Developing countries require more and more investments to accelerate the rate of growth. India has embarked on a plan to industrialize the country to accelerate antipoverty programmes. The liberalization process started since 1991 is to attract more investments from outside the country. Non-Resident Indians have always been making a contribution in Indian economy. The present policy of Indian Government is to amend laws which placed obstacles in attracting foreign investments and simplifying rules and regulations for setting up new undertakings.

Meaning of NRI: Before discussing the gambut of NRI investments, it will be necessary to know who is a Non-resident Indian. The term Non-resident is very broad and includes: (i) Non-resident persons of Indian Nationality and (ii) Non-resident foreign citizens. Non-resident foreign citizens may further be of two types: (a) Non-resident foreign citizens of Indian origin and (b) Non-resident foreign citizens of non-Indian origin.

Non-resident Indians have different meaning under Foreign Exchange Regulation Act (FERA), 1973 and Income Tax Act, 1961. It is the nationality and purpose of stay of an individual outside India which is relevant for determining the residential status for FERA whereas period of stay outside India determines the status of a person under Income Tax Act. Non-resident persons of Indian origin are given special treatment in respect of investment in India. They are almost treated at par with non-resident Indian nationals and are collectively referred to as Non-resident Indians (NRI).

Non-resident Indians are covered under the following categories:

- (a) Indian citizens who stay abroad for employment, business or vocation or for other purposes stating their intention to stay abroad for indefinite period.
- (b) Indian citizens working abroad on assignments with Foreign Government/Government Agencies or International Agencies etc.
- (c) Officials of the Central and State Government and public sector undertakings deputed abroad on temporary assignments or posted to their offices abroad.

**Modes of NRI Investment :** The role of NRI's in Indian economy has been well recognized by the Government which has constantly made efforts to encourage their deposits and investments. Government has been devising schemes which give higher

returns, providing liberalizations in existing schemes, simplifying procedures and removing bureaucratic bottlenecks. The changes in New Industrial Policy, 1991 are designed to attract significant capital flows into India on a sustained basis. They are also aimed to encourage technology collaborations between Indian and foreign companies.

NRI investments are both direct and indirect. Direct investments are in shares, debentures, other securities, etc. and indirect investments are in the form of mopping up their surplus funds into savings accounts, mutual funds etc. Some of the investment schemes for NRI's are discussed here:

- 1. Investments in Govt. Securities, UTI Units etc. NRI's can freely purchase Central and State Governments securities and units of UTI by either transferring money from foreign countries through normal banking channels or by withdrawing money from their accounts in India. The banks are also allowed to credit interest, dividend, sale and maturity proceeds to the non-resident accounts or through stock exchanges in India provided it is done through authorized dealers.
- 2. Investment in SBI Bonds and India Development Bonds. State Bank of India issued 'NRI Bonds' in 1988 and India Development bonds in 1991 for NRI's. These were close ended schemes and investments are not allowed now in these schemes.
- 3. Investments in Proprietorship/Partnership Concerns. The Central Government has allowed NRI's to invest by way of capital contribution in any proprietary or partnership concern engaged in any industrial, commercial or trading activity on re-patriation basis. The profits accruing to the NRI may be credited to ordinary Non-resident Rupee Account or may be plouged back in the business itself.

The funds must come through normal banking channels. The business where investment has to be made should not deal in land and immovable property. There is no need to obtain prior approval of Reserve Bank but it can be informed of the details later on.

4. Investment in New Issues of Shares/Debentures. In 1992, NRI's have been allowed to take up or subscribe on non-repatriation basis the shares or convertible debentures issued, whether by public issue or private placement, by a company incorporated in India. They can also be given rights/bonus shares and these certificates can be sent out of India. Any income accruing from such investments or sale price of these securities will be credited to their NRI accounts.

Investments in new issues under the forty (40) per cent scheme are now allowed on repatriation basis also. NRI's can subscribe to new issues of shares or convertible debentures of any new or existing company with the right of repatriation of the capital invested and income earned thereon, provided the aggregate issue, to non-residents quality for the facility of repatriation does not exceed 40 per cent of the face value of the new issue. Such investment can be made only in private or public limited companies raising capital for setting up new industrial/manufacturing projects or for expansion or diversification etc. Such investments can also be made in companies engaged in hospitals, hotels, shipping, development of computer software and oil exploration services.

- **5. Deposits with Companies.** Companies can accept deposits from NRI's within the limits prescribed by RBI. The company accepting such deposits will apply for permission to RBI with details of deposits and NRI's will not be required to get separate permission.
- **6. Investment in Commercial Paper & Mutual funds.** NRI's can invest in Commercial paper issued by Indian Companies in non-repatriation basis. CP issued to NRI's will not be

transferable. They are also allowed to invest in mutual funds floated by private/public sector banks/financial institutions. Such investments can also be made through secondary market. The funds accepting such investments will get an approval from RBI.

- 7. Investment in Priority Industries. NRI's are permitted to invest with full repatriation benefits up to 100 per cent in the issue of equity shares or convertible debentures of a private/public limited company engaged in or proposing to engage in high priority industries. The investments by NRI's should cover foreign exchange requirements for import of capital goods. Any income out of these investments can be freely remitted except in case of consumer goods industries where the outflow on account of dividend is balanced by export earnings of the company. The proposed project should not be located within 25 km. form the periphery of the city having a population of more than 10 lakhs as per 1991 census. It means that Government wants to utilize NRI funds for industrializing new areas or under-developed areas.
- **8. Investment in Other Industries.** NRI's can invest in sick industrial units. Such units must be incurring losses for consecutive three years, its shares are selling at a discount for 2 years and financial institutions have formulated rehabilitation plans for such sick units. Such investments are allowed on the following conditions:
  - (i) Investments can be made either by purchasing equity shares of existing share holders or by subscribing to new issues of such companies.
  - (ii) Bulk investment on private placement basis even up to 100 per cent of equity capital of sick unit.
  - (iii) The funds should come either as fresh foreign remittances or from NRI accounts.
  - (iv) The capital brought in will not be repatriated before 5 years.
  - (v) The sick unit will not be allowed to deal in real estate business or agricultural plantation activities.
- **10. Investment in Housing & Real Estate Development.** NRI's are permitted to invest up to 100 per cent in the new issue of equity shares/convertible debentures of Indian Companies engaged in the following areas:
  - (i) Development of serviced plots and construction of built up residential premises;
  - (ii) Real estate covering construction of residential and commercial premises including Business centres and offices.
  - (iii) Development of township;
  - (iv) City and region level urban infrastructure including roads bridges;
  - (v) Manufacturing of building materials
  - (vi) Financing of housing development.

A permission from RBI is essential for making investments in above mentioned schemes. Repatriation of original investment is now allowed before 3 years.

The need for NRI investments is realized by the Govt. of India and that is why it has made a number of schemes for attracting their funds. Various laws have been amended to simplify the procedures for bringing NRI funds into the country. Indian economy needs more and more investments in every activity. Infrastructural investments are inadequate to develop a base for accelerating industrialization. Both direct and indirect investments are allowed to NRI's. They can take part in industrial activity by even investing 100 per cent money in certain areas.

On the other hand they can invest in mutual fund schemes and may deposit funds with Commercial banks which too ultimately will be used for productive purposes.

## 10.14NRI Deposits

Non-resident Indian (NRI) deposits have been used as another important source of foreign capital in India. In fact, these NRI deposits constituted a major part of country's capital inflows during the past decade. The Government of India offered many incentives to non-resident Indians to set up industries in India. It also offered attractive rates of interests on NRI deposits.

NRI deposits in India have been either in the form of Non-Resident External Rupee (NRER) deposits, or in Foreign Currency Non- Residents (FCNR) accounts. The interest rates offered on NRER deposits have been 2 per cent higher than the rates applicable to domestic deposits of comparable maturities and in case of FCNR accounts, the rates of interest have been in line with interest rates prevailing in the international capital markets. RBI introduced a new scheme in November 1990 to encourage further deposits from non-resident Indians.

Inspite of the fact that NRI deposits have been an important constituent of external finance, these are not free from a few limitations:

- (a) The cost of raising external finance through NRI deposits is higher as compared to some methods.
- (b) NRI deposits are 'fair weather friends' in the sense that in difficult periods when balance of payment position is not good, these deposits are the first to take a capital flight and thus create further serious foreign reserves crisis in the country.

## 10.15 Investment Risks in India

The following are investment risk in India:

## 1 Sovereign Risk

India is a vibrant parliamentary democracy and has been one since its political independence from British rule more than 50 years ago. There is no serious revolutionary movement in India; hence there is no conceivable possibility of the state collapsing. Sovereign Risk in India is therefore zero for both "foreign direct investment" and "foreign portfolio investment." It is however advisable to avoid investing in the extreme north-eastern parts of India because of terrorist threats. Kashmir in the northern tip is also a troubled area, but investment opportunities in Kashmir are anyway restricted by law.

#### 2. Political Risk

India suffered political instability for a few years due to the failure of any party to win an absolute majority in Parliament. However, political stability has returned since the previous general elections in 1999. However, political instability did not change India's economic course through it delayed certain decisions relating to the economy. The political divide in India is not one of policy, but essentially of personalities. Economic liberalization (which is what foreign investors are interested in) has been accepted as a necessity by all parties including the Communist Party of India (Marxist).

Thus, political instability in India, in practical terms, posed no risk to foreign direct invertors because no policy framed by a past government has been reversed by any successive government so far. One can find a comparison in Italy which has had some 45 governments in 509 years, yet overall economic policy remains unchanged. Even if political instability is to return in the future, chances of a reversal in economic policy are next to nil.

As for terrorism, no terrorist outfit is strong enough to disturb the state. Except for Kashmir in the north and parts of the north-east, terrorist activity is either non-existent or too weak to be of any significance. It would take an extreme stretching of the imagination to visualize a Bangladesh-type state-disrupting revolution in India or a Kuwait-type annexation of India by a foreign power. Hence, political risk in India is practically non-existent.

### 3. Commercial Risk

Commercial risk exists in business in any country. Not each and every product or service can be readily sold, hence it is necessary to study the demand/supply situation for a particular product or service before making any major investment. There is a large number of market research firms in India which will study demand/supply situation for any product/service and advise the potential investor accordingly in exchange of a professional fee. The IndiaOneStop website provides some accurate statistics and insights into the most viable sectors for foreign direct investments.

## 4. Risk of Foreign Sanctions

India did not seem to be in the good books of the United States government due to its nuclear weapons and missiles development policy. However, US President Bill Clinton's state visit to India in 2000 was a massive hit which even saw the President dancing with a crowd of colorfully dressed women in the northwestern state of Rajasthan. Subsequent to the visit, visits between the two countries at different levels took place, and the US government has all but come to terms with the reality of a nuclear-armed India.

## 10.17 Potential for investment in India

- FDI inflows approved in the period April 1991-April 2003 stood at US \$ 76.8 billion, of which US \$ 33.37 billion has already been realized. Accordingly to Economic Intelligence Unit (EIU) report, annual average FDI inflow into India in the period 2002-06 will be around US \$ 5.3 billion per year. FDI approved in 2002-03 was US \$ 4.66 billion and in 2002 US \$ 6-13 billion.
- The Government is focusing on expansion and modernization of infrastructure and has opened this up for private sector participation. 48 new road projects worth US \$ 10 billion are under construction. Development and upgradation of the 3 million kilometers of roads will require a massive investment of US \$ 150 billion. Private sector participation in road projects will grow significantly.

- The railway sector will need an investment of US \$ 22 billion for new coaches, tracks, and communications and safety equipment over the next ten years.
- Upgradation and modernization of airports will require US \$ 33 billion investment in the next ten years.
- There is potential for investment in modernization of ports. 100 percent FDI is permitted for construction and maintenance of ports. The Government is offering incentives to investors.
- The Ministry of Power has formulated a blueprint to provide reliable, affordable and quality power to all users by 2012. This calls for investment of US \$ 73 billion in the next five years. The gap between demand and production of power is around 10000 MW. Opportunities are there for investment in power generation and distribution and development of non-conventional energy sources.
- There is potential for investment in urban infrastructure projects. Water supply and sanitation projects alone offer scope for annual investment of US \$ 5.71 billion.
- The entire gamut of exploration, production, refining, distribution and retail marketing present opportunities for FDI.
- India has an estimated 85 billion tones of mineral reserves remaining to be exploited. Potential areas for exploration ventures include gold, diamonds, copper, lead zinc, cobalt silver, tin etc. There is also scope for setting up manufacturing units for value added products.
- The telecom market, which is one of the world's largest and fastest growing, has an investment potential of US \$ 20-25 billion over the next five years. The telecom market turnover is expected to increase from US \$ 86 billion in 2003 to US \$ 13 billion by 2007. Mobile telephony has started growing at the rate of 10-12 million subscribers per year.
- The IT industry and IT-enabled services, which are rapidly growing offer opportunities for FDI.

• India has emerged as an important venue for the services sector including financial accounting, call centers, and business process outsourcing. There is considerable potential for growth in these areas.

## 10.18 Self Assessment Questions

- 1. What are the forms of foreign capital in India? Explain the need for foreign capital in India.
- 2. Define foreign direct investment. Describe the measures taken by Government of India to encourage how of foreign investment in India.
- 3. Discuss the competitive advantages of India f or foreign investors.
- 4. Discuss the Government policy towards foreign capital in India? What major initiatives have been taken in this regard by the Government.
- 5. Define Euro Issue? Why are these becoming popular?
- 6. What is Global Depository Receipt? What are its characteristics and advantages?

Biotechnology and Bioinformatics which are in the government's priority list for development offer scope for FDI. There are over 50 R&D labs in the public sector to support growth in these areas.

The Indian auto industry with a turnover US \$ 12 billion and the auto parts industry with a turnover of 3 billion dollars offer scope for FDI.

The government is encouraging the establishment of world-class integrated textile complexes and processing units. FDI is welcome.

While India has abundant supply of food, the food processing industry is relatively nascent and offers opportunities for FDI. Only 2 percent of fruits and vegetables and 15 percent of milk are processed at present.

The Indian pharmaceuticals industry, which has r eached a turnover of US \$ 6.3 billion in 2002 is expected to go up to US \$ 12 billion by 2010.

The Healthcare industry is expected to increase in size from its current US \$ 17,2 billion to US \$ 40 billion by 2012.

The government has recently established Special Economic Zones with the purpose of promoting exports and attracting FDI. These SEZs do not have duty on imports of inputs and they enjoy simplified fiscal and foreign exchange procedures and allow 100% FDI.

The entertainment industry is sent to move up from its current turnover of US \$ 5.7billion to US \$ 6.7 billion in 2005.

The travel and tourism industry has grown to size of US 32 billion and offers scope for investment in budget hotels and tourism infrastructure.

**COURSE: BUSINESS ENVIRONMENT** 

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#### INDUSTRIAL POLICY OF INDIA

**OBJECTIVE:** The present chapter explains the pattern and direction of development of Indian economy as the Industrial Policy.

#### **STRUCTURE**:

- 11.1 Introduction
- 11.2 Policy Objectives, 1991
- 11.3 An Evaluation of The Policy
- 11.4 Industrial Policy, 2004
- 11.5 Summary
- 11.6 Self-Test Questions
- 11.7 Suggested Readings

#### 11.1 INTRODUCTION

To a large extent, the Industrial Policy of a nation reflected the socio-economic and political ideology of development of it. Indeed, some people as the Economic Constitution of India described the Industrial Policy Resolution of 1956, the fundamental principles of which reined until 1991. The Industrial Policy indicated the respective roles of the public, private, joint and cooperative sectors; small, medium and large scale industries and underlined the national priorities and the economic development strategy. It also expressed government's policy towards foreign capital and technology, labour policy, tariff policy etc. in respect of the industrial sector. In short, the industrial development, and thereby the economic development to a very significant extent, has been guided, regulated and fostered by the industrial policy.

### 11.2 POLICY OBJECTIVES, 1991

Pandit Jawaharlal Nehru laid the foundations of modern India. His vision and determination have left a lasting impression on every facet of national endeavour since Independence. It is due to his initiative that India now has a strong and diversified industrial base and is a major industrial nation of the world. The goals and objectives set out for the nation by Pandit Nehru on the eve of Independence, namely, the rapid agricultural and industrial development of our country, rapid expansion of opportunities for gainful employment, progressive reduction of social and economic disparities, removal of poverty and attainment of self-reliance remain as valid today as at the time Pandit Nehru first set them out before the nation. Any industrial policy must contribute to the realisation of these goals and objectives at an accelerated pace. The present statement of industrial policy is inspired by these very concerns, and represents a renewed initiative towards consolidating the gains of national reconstruction at this crucial stage. In 1948, immediately after Independence, Government introduced the Industrial Policy Resolution. This outlined the approach to industrial growth and development. It emphasised the importance to the economy of securing a continuous increase in production and ensuring its equitable distribution. After the adoption of the Constitution and the socio-economic goals, the Industrial Policy was comprehensively revised and adopted in 1956. To meet new challenges, from time to time, it was modified through statements in 1973, 1977 and 1980.

The Industrial Policy Resolution of 1948 was followed by the Industrial Policy Resolution of 1956, which had as its objective the acceleration of the rate of economic growth and the speeding up of industrialisation as a means of achieving a socialist pattern

of society. In 1956, capital was scarce and the base of entrepreneurship not strong enough. Hence, the 1956 Industrial Policy Resolution gave primacy to the role of the State to assume a predominant and direct responsibility for industrial development. The Industrial Policy statement of 1973, *inter alia*, identified high-priority industries where investment from large industrial houses and foreign companies would be permitted. The Industrial Policy Statement of 1977 laid emphasis on decentralisation and on the role of small-scale, tiny and cottage industries. The Industrial Policy Statement of 1980 focussed attention on the need for promoting competition in the domestic market, technological up gradation and modernisation. The policy laid the foundation for an increasingly competitive export based and for encouraging foreign investment in high-technology areas. This found expression in the Sixth Five Year Plan, which bore the distinct stamp of Smt. Indira Gandhi. It was Smt. Indira Gandhi who emphasised the need for productivity to be the central concern in all economic and production activities.

These policies created a climate for rapid industrial growth in the country. Thus on the eve of the Seventh Five Year Plan, a broad-based infrastructure had been built up. Basic industries had been established. A high degree of self-reliance in a large number of items - raw materials, intermediates, and finished goods - had been achieved. New growth centres of industrial activity had emerged, as had a new generation of entrepreneurs. A large number of engineers, technicians and skilled workers had also been trained. The Seventh Plan recognised the need to consolidate on these strengths and to take initiatives to prepare Indian industry to respond effectively to the emerging challenges. A number of policy and procedural changes were introduced in 1985 and 1986 under the leadership of Shri Rajiv Gandhi aimed at increasing productivity, reducing costs and improving

quality. The accent was on opening the domestic market to increased competition and readying our industry to stand on its own in the face of international competition. The public sector was freed from a number of constraints and given a larger measure of autonomy. The technological and managerial modernisation of industry was pursued as the key instrument for increasing productivity and improving our competitiveness in the world. The net result of all these changes was that Indian industry grew by an impressive average annual growth rate of 8.5% in the Seventh Plan period.

Government is pledged to launching a reinvigorated struggle for social and economic justice, to end poverty and unemployment and to build a modern, democratic, socialist, prosperous and forward-looking India. Such a society can be built if India grows as part of the world economy and not in isolation. While Government will continue to follow the policy of self-reliance, there would be greater emphasis placed on building up our ability to pay for imports through our own foreign exchange earnings. Government is also committed to development and utilisation of indigenous capabilities in technology and manufacturing as well as its upgradation to world standards. 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 increasing competitiveness for the benefit of the common man. The spread of industrialisation to backward areas of the country will be actively promoted through appropriate incentives, institutions and infrastructure investments. Government will provide enhanced support to the small-scale sector so that it flourishes in an environment of economic efficiency and continuous technological upgradation. Foreign

investment and technology collaboration will be welcomed to obtain higher technology, to increase exports and to expand the production base. Government will endeavour to abolish the monopoly of any sector or any individual enterprise in any field of manufacture, except on strategic or military considerations and open all manufacturing activity to competition. The Government will ensure that the public sector plays its rightful role in the evolving socio-economic scenario of the country. Government will ensure that the public sector is run on business lines as envisaged in the Industrial Policy Resolution of 1956 and would continue to innovate and lead in strategic areas of national importance. In the 1950s and 1960s, the principal instrument for controlling the commanding heights of the economy was investment in the capital of key industries. Today, the State has other instruments of intervention, particularly fiscal and monetary instruments. The State also commands the bulk of the nation's savings. Banks and financial institutions are under State control. Where State intervention is necessary, these instruments will prove more effective and decisive. Government will fully protect the interests of labour, enhance their welfare and equip them in all respects to deal with the inevitability of technological change. Government believes that no small section of society can corner the gains of growth, leaving workers to bear its pains. Labour will be made an equal partner in progress and prosperity. Workers' participation in management will be promoted. Workers cooperatives will be encouraged to participate in packages designed to turn around sick companies. Intensive training, skill development and upgradation programmes will be launched. Government will continue to visualise new horizons.

The major objectives of the new industrial policy package will be to build on the gains already made, correct the distortions or weaknesses that may have crept in, maintain a sustained growth in productivity and gainful employment and attain international competitiveness. The pursuit of these objectives will be tempered by the need to preserve the environment and ensure the efficient use of available resources. All sector of industry whether small, medium or large, belonging to the public, private or cooperative sector will be encouraged to grow and improve on their past performance. Government's policy will be continuity with change.

In pursuit of the above objectives, Government have decided to take a series of initiatives in respect of the policies relating to the following areas.

- Industrial Licensing.
- Foreign Investment
- Foreign Technology Agreements.
- Public Sector Policy
- MRTP Act.

A package for the Small and Tiny Sectors of industry is being announced separately.

#### 11.2.1 INDUSTRIAL LICENSING POLICY

Industrial Licensing is governed by the Industries (Development & Regulation) Act, 1951. The Industrial Policy Resolution of 1956 identified the following three categories of industries: those that would be reserved for development in public sector, those that would be permitted for development through private enterprise with or without State participation, and those in which investment initiatives would ordinarily emanate from

private entrepreneurs. Over the years, keeping in view the changing industrial scene in the country, the policy has undergone modifications. Industrial licensing policy and procedures have also been liberalised from time to time. A full realisation of the industrial potential of the country calls for a continuation of this process of change. In order to achieve the objectives of the strategy for the industrial sector for the 1990s and beyond it is necessary to make a number of changes in the system of industrial approvals. Major policy initiatives and procedural reforms are called for in order to actively encourage and assist Indian entrepreneurs to exploit and meet the emerging domestic and global opportunities and challenges. The foundation of any such package of measures must be to let the entrepreneurs make investment decisions on the basis of their own commercial judgement. The attainment of technological dynamism and international competitiveness requires that enterprises must be enabled to swiftly respond to fast changing external conditions that have become characteristic of today's industrial world. Government policy and procedures must be geared to assisting entrepreneurs in their efforts. This can be done only if the role played by the government were to be changed from that of only exercising control to one of providing help and guidance by making essential procedures fully transparent and by eliminating delays. The winds of change have been with us for some time. The industrial licensing system has been gradually moving away from the concept of capacity licensing. The system of reservations for public sector undertakings has been evolving towards an ethos of greater flexibility and private sector enterprise has been gradually allowed to enter into many of these areas on a case by case basis. Further impetus must be provided to these changes, which alone can push this country towards the attainment of its entrepreneurial and industrial potential.

This calls for bold and imaginative decisions designed to remove restraints on capacity creation, while at the same, ensuring that over-riding national interests are not jeopardised.

In the above context, industrial licensing will henceforth be abolished for all industries, except those specified, irrespective of levels of investment. These specified industries (Annex-II), will continue to be subject to compulsory licensing for reasons related to security and strategic concerns, social reasons, problems related to safety and over-riding environmental issues, manufacture of products of hazardous nature and articles of elitist consumption. The exemption from licensing will be particularly helpful to the many dynamic small and medium entrepreneurs who have been unnecessarily hampered by the licensing system. As a whole the Indian economy will benefit by becoming more competitive, more efficient and modern and will take its rightful place in the world of industrial progress.

#### 11.2.2 FOREIGN INVESTMENT

While freeing Indian industry from official controls, opportunities for promoting foreign investments in India should also be fully exploited. In view of the significant development of India's industrial economy in the last 40 years, the general resilience, size and level of sophistication achieved, and the significant changes that have also taken place in the world industrial economy, the relationship between domestic and foreign industry needs to be much more dynamic than it has been in the past in terms of both technology and investment. Foreign investment would bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for promotion of exports. This is particularly necessary in the

changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore welcome foreign investment, which is in the interest of the country's industrial development. In order to invite foreign investment in high priority industries, requiring large investments and advanced technology, it has been decided to provide approval for direct foreign investment upto 51% foreign equity in such industries. There shall be no bottlenecks of any kind in this process. This group of industries has generally been known as the "Appendix I Industries" and is areas in which FERA companies have already been allowed to invest on a discretionary basis. This change will go a long way in making Indian policy on foreign investment transparent. Such a framework will make it attractive for companies abroad to invest in India. Promotion of exports of Indian products calls for a systematic exploration of world markets possible only through intensive and highly professional marketing activities. To the extent that expertise of this nature is not well developed so far in India, Government will encourage foreign trading companies to assist us in our export activities. Attraction of substantial investment and access to high technology, often closely held, and to world markets, involves interaction with some of the world's largest international manufacturing and marketing firms. The Government will appoint a special board to negotiate with such firms so that we can engage in purposive negotiation with such large firms, and provide the avenues for large investments in the development of industries and technology in the national interest.

#### 11.2.3 FOREIGN TECHNOLOGY AGREEMENT

There is a great need for promoting an industrial environment where the acquisition of technological capability receives priority. In the fast changing world of technology the relationship between the suppliers and users of technology must be a continuous one. Such a relationship becomes difficult to achieve when the approval process includes unnecessary governmental interference on a case-to-case basis involving endemic delays and fostering uncertainty. The Indian entrepreneur has now come of age so that he no longer needs such bureaucratic clearances of his commercial technology relationships with foreign technology suppliers. Indian industry can scarcely be competitive with the rest of the world if it is to operate within such a regulatory environment. With a view to injecting the desired level of technological dynamism in Indian industry, Government will provide automatic approval for technology agreement related to high priority industries within specified parameters. Similar facilities will be available for other industries as well if such agreements do not require the expenditure of free exchange. Indian companies will be free to negotiate the terms of technology transfer with their foreign counterparts according to their own commercial judgement. The predictability and independence of action that this measure is providing to Indian industry will induce them to develop indigenous competence for the efficient absorption of foreign technology. Greater competitive pressure will also induce our industry to invest much more in research and development and they have been doing in the past. In order to help this process, the hiring of foreign technicians and foreign testing of indigenously developed technologies, will also not require prior clearance as prescribed so far, individually or as a part of industrial or investment approvals.

#### 11.2.4 PUBLIC SECTOR POLICY

The public sector has been central to our philosophy of development. In the pursuit of our development objectives, public ownership and control in critical sector of the economy has played an important role in preventing the concentration of economic power, reducing regional disparities and ensuring that planned development serves the common

good. The Industrial Policy Resolution of 1956 gave the public sector a strategic role in the economy. Massive investments have been made over the past four decades to build a public sector, which has a commanding role in the economy. Today key sectors of the economy are dominated by mature public enterprises that have successfully expanded production, opened up new areas of technology and built up a reserve of technical competence in a number of areas. After the initial exuberance of the public sector entering new areas of industrial and technical competence, a number of problems have begun to manifest themselves in many of the public enterprises. Serious problems are observed in the insufficient growth in productivity, poor project management, overmanning, lack of continuous technological upgradation, and inadequate attention to R&D and human resource development. In addition, public enterprises have shown a very low rate of return on the capital invested. This has inhibited their ability to re-generate themselves in terms of new investments as well as in technology development. The result is that many of the public enterprises have become a burden rather than being an asset to the Government. The original concept of the public sector has also undergone considerable dilution. The most striking example is the take over of sick units from the private sector. This category of public sector units accounts for almost one third of the total losses of central public enterprises. Another category of public enterprises, which does not fit into the original idea of the public sector being at the commanding heights of the economy, is the plethora of public enterprises, which are in the consumer goods and services sectors. It is time therefore that the Government adopt a new approach to public enterprises. There must be a greater commitment to the support of public enterprises, which are essential for the operation of the industrial economy. Measures must be taken to make these enterprises more growth oriented and technically dynamic. Units, which may be faltering at present but are potentially viable must be restructured and given a new lease of life. The priority areas for growth of public enterprises in the future will be the following.

- Essential infrastructure goods and services.
- Exploration and exploitation of oil and mineral resources.
- Technology development and building of manufacturing capabilities in areas which are crucial in the long term development of the economy and where private sector investment is inadequate.
- Manufacture of products where strategic considerations predominate such as defense equipment.

At the same time the public sector will not be barred from entering areas not specifically reserved for it. In view of these considerations, Government will review the existing portfolio of public investments with greater realism. This review will be in respect of

industries based on low technology, small scale and non-strategic areas, inefficient and unproductive areas, areas with low or nil social considerations or public purpose, and areas where the private sector has developed sufficient expertise and resources. Government will strengthen those public enterprises which fall in the reserved areas of operation or are in high priority areas or are generating good or reasonable profits. Such enterprises will be provided a much greater degree of management autonomy through the system of memoranda of understanding. Competition will also be induced in these areas by inviting private sector participation. In the case of selected enterprises, part of Government holdings in the equity share capital of these enterprises will be disinvested in order to provide further market discipline to the performance of public enterprises. There are a large number of chronically sick public enterprises incurring heavy losses, operating in a competitive market and serve little or no public purpose. These need to be attended to. The country must be proud of the public sector that it owns and it must operate in the public interest.

# 11.2.5 MONOPOLIES AND RESTRICTIVE TRADE PRACTICES ACT (MRTP ACT)

The principal objectives to be achieved through the MRTP Act are as follows:

Prevention of concentration of economic power to the common detriment, control of monopolies, and Prohibition of monopolistic and restrictive and unfair trade practices. The MRTP Act became effective in June 1970. With the emphasis placed on productivity in the Sixth Plan, major amendments to the MRTP Act were carried out in 1982 and 1984 in order to remove impediments to industrial growth and expansion. This process of change was given a new momentum in 1985 by an increase of threshold limit of assets.

With the growing complexity of industrial structure and the need for achieving economies of scale for ensuring high productivity and competitive advantage in the international market, the interference of the Government through the MRTP Act in investment decisions of large companies has become deleterious in its effects on Indian industrial growth. The pre-entry scrutiny of investment decisions by so-called MRTP companies will no longer be required. Instead, emphasis will be on controlling and regulating monopolistic, restrictive and unfair trade practices rather than making it necessary for the monopoly house to obtain prior approval of Central Government for expansion, establishment of new undertakings, merger, amalgamation and takeover and appointment of certain directors. The thrust of policy will be more on controlling unfair or restrictive business practices. The MRTP Act will be restructured by eliminating the legal requirement for prior governmental approval for expansion of present undertakings and establishment of new undertakings. The provisions relating to merger, amalgamation, and takeover will also be repealed. Similarly, the provisions regarding restrictions on acquisition of and transfer of shares will be appropriately incorporated in the Companies Act. Simultaneously, provisions of the MRTP Act will be strengthened in order to enable the MRTP Commission to take appropriate action in respect of the monopolistic, restrictive and unfair trade practices. The newly empowered MRTP Commission will be encouraged to require investigation suo motto or on complaints received from individual consumers or classes of consumers.

In view of the considerations outlined above Government have decided to take a series of measures to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic control. These measures complement the other series of measures being taken by Government in the areas of trade policy, exchange rate management, fiscal policy, financial sector reform and overall macro economic management.

### 11.3 AN EVALUATION OF THE POLICY

The economic reforms ushered in since 1991 are revolutionary indeed in comparison with the policy and procedural reforms hitherto attempted in India. It, undoubtedly, is a bold step in the direction of freeing the Indian industry from the shackles of abortive and crippling controls. Although further policy changes and reform are needed, changes already introduced, if implemented in real earnest, will certainly provide a considerable growth impetus. However, real debureaucratising is a challenging task. The bureaucracy has a tendency to attempt to defeat the measures aimed at deregulations. A strong mandate and political will and bold administrative measures are essential for implementing several of the proposals. The government, however, often shows signs of confusion and lack of boldness on the face of opposition from trade unions, politicians and bureaucrats. There will certainly be strong opposition from these groups to protect their vested interests. For example, in the face of the strong opposition from the trade unions, the government's stand on privatisation has not been clear. In our country the might of the organised minority often gets prominence over the rights and welfare of the unorganised majority. The policy environment now in India is much more conducive for both domestic and foreign investments than in the past. However, there are now a host of countries trying to woo foreign investment with much more conducive economic environment than in India. Further, cultural factors also tilt the balance in favour of other nations as far as foreign investment is concerned. Further, foreign business still regards

the policy and procedural system in India perplexing. Even many Indian entrepreneurs feel that the policy/procedural and development environments in countries like China are much superior to that in India and a number of them prefer to locate production bases abroad. The development of the infra structural sector has been tardy in India even after the liberalization. Because of these factors one should not expect wonders out of the belated measures. However, for the first time the domestic industry has been given a considerable leeway to, prove its mettle. This dynamism coupled with an enhanced external collaboration and competition should be expected to provide a considerable momentum for development. At the same time, the government should strive to remove the remaining lacunae and to implement the proposed reforms in letter and spirit. Although the economic policy liberalisation of 1991 came in for scathing criticism by the opposition parties, when these parties drew up their election manifestoes in April, 1996, their antiliberalisation stand was conspicuous by its inconspicuousness. More interestingly, when the short lived BJP government and the United Front government that followed announced their economic policies, they amounted not only to endorsing the liberalisation policy ushered in by the Congress government under Narasimha Rao but also to carrying forward the process of deregulation and decontrol to achieve faster economic growth. The economic policy of the United Front (UF) government as expressed in the Common Minimum Programme (CMP), which observed that there was no substitute for growth, and that the country's GDP needed to grow' at over seven per cent in the next 10 years in order to abolish endemic poverty and unemployment, stated that the UF government is committed to faster economic growth. The document on the CMP observed that further deregulation and decontrol might be required in the

agricultural, industrial and other sectors to accelerate economic development. In short, all political parties almost unanimously accept India's economic liberalisation so that it is irreversible. The Union Budget 2001-2002 was hailed for initiating the second generation reforms. Whichever political party or combine comes to power in future, the difference will be, at the most, in it's fine-tuning. In other words, the major differences between the political parties in India will no more be related to economic policies or ideologies; the differences will pertain rather to ethnic and related factors (including the issue of secularism and regional factors). The ubiquitous support to liberalisation seen now is due to the good liberalisation can do for the economic development of the country. Developments since 1991 have demonstrated the growth and competitive impulses that the liberalisation can generate. There is also a lot of lessons to be learnt from the Chinese experience of liberalisation.

## 11.4 INDUSTRIAL POLICY, 2004

Objectives of the Industrial Policy of the Government are -

- to maintain a sustained growth in productivity;
- to enhance gainful employment;
- to achieve optimal utilisation of human resources;
- to attain international competitiveness and
- to transform India into a major partner and player in the global arena.

Policy focus is on: Deregulating Indian industry; Allowing the industry freedom and flexibility in responding to market forces and Providing a policy regime that facilitates and fosters growth of Indian industry. Following are some important policy measures

announced by the Ministry of Finance, Department of Industrial policy to pursue the above objectives.

- Liberalisation of Industrial Licensing Policy: At present, only six industries are under compulsory licensing mainly on account of environmental, safety and strategic considerations. Similarly, there are only three industries reserved for the public sector.
- Introduction of Industrial Entrepreneurs' Memorandum (IEM): Industries not requiring compulsory licensing are to file an Industrial Entrepreneurs' Memorandum (IEM) to the Secretariat for Industrial Assistance (SIA). No industrial approval is required for such exempted industries. Amendments are also allowed to IEM proposals filed after 1.7.1998.
- Liberalisation of the Location Policy: A significantly amended locational policy in tune with the liberalized licensing policy is in place. No industrial approval is required from the Government for locations not falling within 25 kms of the periphery of cities having a population of more than one million except for those industries where industrial licensing is compulsory. Non-polluting industries such as electronics, computer software and printing can be located within 25 kms of the periphery of cities with more than one million population. Permission to other industries is granted in such locations only if they are located in an industrial area so designated prior to 25.7.91. Zoning and land use regulations as well as environmental legislations have to be followed.
- 4 Policy for Small Scale: A differential investment limit has been adopted since 9th October 2001 for 41 reserved items where the investment limit upto rupees five

tiny units is Rs. 25 lakhs. 749 items are reserved for manufacture in the small scale sector. All undertakings other than the small scale industrial undertakings engaged in the manufacture of items reserved for manufacture in the small scale sector are required to obtain an industrial licence and undertake an export obligation of 50% of the annual production. This condition of licensing is, however, not applicable to those

undertakings operating under 100% Export Oriented Undertakings Scheme, the

Export Processing Zone (EPZ) or the Special Economic Zone Schemes (SEZs).

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crore is prescribed for qualifying as a small scale unit. The investment limit for

Non-Resident Indians Scheme: The general policy and facilities for Foreign Direct Investment as available to foreign investors/company are fully applicable to NRIs as well. In addition, Government has extended some concessions specially for NRIs and overseas corporate bodies having more than 60% stake by the NRIs. These inter-alia includes (i) NRI/OCB investment in the real estate and housing sectors upto 100% and (ii) NRI/OCB investment in domestic airlines sector

NRI/OCBs are also allowed to invest upto 100% equity on non-repatriation basis in all activities except for a small negative list. Apart from this, NRI/OCBs are also allowed to invest on repatriation/non-repatriation under the portfolio investment scheme.

6 Electronic Hardware Technology Park (EHTP)/Software Technology Park (STP) Scheme: For building up strong electronics industry and with a view to enhancing export, two schemes viz. Electronic Hardware Technology Park

(EHTP) and Software Technology Park (STP) are in operation. Under EHTP/STP scheme, the inputs allowed be procured free are to of duties. The Directors of STPs have powers to approved fresh STP/EHTP proposals and also grand post-approval amendment in respect of EHTP/STP projects as have been given to the Development Commissioners of Export Processing Zones in the case of Export Oriented Units. All other application for setting up projects under these schemes, are considered by the Inter-Ministerial Standing Committee (IMSC) Chaired by Secretary (Information Technology). The IMSC is serviced by the SIA.

Policy for Foreign Direct Investment (FDI): The Department has put in place a liberal and transparent foreign investment regime where most activities are opened to foreign investment on automatic route without any limit on the extent of foreign ownership. Some of the recent initiatives taken to further liberalise the FDI regime, inter alia, include opening up of sectors such as Insurance (upto 26%); development of integrated townships (upto 100%); defense industry (up to 26%); tea plantation (upto 100% subject to divestment of 26% within five years to FDI); Enhancement of FDI limits in private sector banking, allowing FDI up to 100% under the automatic route for most manufacturing activities in SEZs; opening up B2B e-commerce; Internet Service Providers (ISPs) without Gateways; electronic mail and voice mail to 100% foreign investment subject to divestment condition;

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The Department has also strengthened investment facilitation measures through Foreign Investment Implementation Authority (FIIA). 8 Current Industrial Performance: The industrial sector has shown a sustained increase during the fiscal year 2003-04. The overall growth in industrial production, as measured by the index of industrial production (IIP) has increased from 2.7% in 2001-02 to 5.7% in 2002-03. Further, it grew by 6/.9% during April- March, 2003-04 (Table 11.1 and 11.2).

**Table 11.1: SECTORAL INDUSTRIAL GROWTH (%)** 

PERIOD	MINING & QUARRYING	MANUFACTURING	ELECTRICITY	OVERALL
(WEIGHT)	(10.47)	(79.36)	(10.17)	(100.00)
1997-98	6.9	6.7	6.6	6.7
1998-99	-0.8	4.4	6.5	4.1
1999-00	1.0	7.1	7.3	6.7
2000-01	2.8	5.3	4.0	5.0
2001-02	1.2	2.9	3.1	2.7
2002-03	5.8	6.0	3.2	5.7
2003-04	5.1	7.2	5.0	6.9

Table 11.2: COMPARATIVE GROWTH RATES FOR SIX INDUSTRIAL INDUSTRIES (%)

Base Year-1993-94=100

SECTOR (in IIP)	Weight	1997- 98	1998- 99	1999- 00	2000- 01	2001- 02	2002- 03	2003- 04
Electricity Generation	10.17	6.6.	6.6	7.2	3.9	3.1	3.2	5.0
(a) Hydel		8.5	11.1	-2.5	-7.6	-0.7	-13.7	15.6
(b) Thermal Nuclear		6.2	5.7	9.3	7.4	2.5	6.2	3.5
Coal	3.22	3.6	-2.1	3.1	3.5	4.2	4.6	5.1
Finished Steel	5.13	6.3	1.4	15.0	6.4	3.6	10.1	6.9
Crude Petroleum	4.17	3.0	-3.4	-2.4	1.5	-1.2	3.2	1.0
Petroleum Refinery Products	2.00	3.7	5.2	25.4	20.3	3.7	4.9	8.2
Cement	1.99	9.1	5.7	14.2	0.9	7.4	8.8	6.1
Overall	26.68	5.7	2.8	9.1	5.1	3.2	5.6	5.4

9. Investment Climate: Due to many positive developments in the Indian Economy have further improved the investment climate of the country. The overall growth in GDP as per CSO in real terms is 8.2%. in 2003-04. During April-March 2003-04, growth rate in industrial output was 6.9% against 5.7% in corresponding period in previous year. Further surge in foreign exchange reserves, which not only strengthens India's external sector, is also a source of confidence to prospective foreign investors. The soft interest rate is helping the industry to improve its competitiveness. Investments by Foreign Institutional Investors (FIIs) have shown a significant increase on account of economic recovery. According to data published in the RBI Bulletin of May 2004, there was an inflow of FII investment in Dollar terms of US \$9947 million during 2003-04 against US \$562 million in the corresponding period last year.

### 11.5 SUMMARY

Until 1991, the industrial policy of India was characterized by a monopoly or dominant role for the public sector in strategic basic and heavy industries; preference for small scale units and reservation of a large number of items for the SSI sector; preference for cooperative sector and joint sector in several areas; a host of entry, growth, and operational and functional restrictions on the private sector; and a very restrictive attitude towards foreign capital and technology. The industrial policy announced in July 1991 along with other economic policy changes and measures ushered in a process of economic reforms in India. Now there are no entry and growth restrictions on the private sector, except in a very small number of industries. The policy towards foreign capital

and technology has been substantially liberalised. Imports have been very significantly liberalized; quantitative restrictions on imports, by and large, have been removed.

## 11.6 SELF-TEST QUESTIONS

- 1. What do you mean by the provisions of industrial policy of India?
- 2. How can you evaluate the industrial policy of India?
- 3. What steps has been taken by the government of India to prevent the monopolistic practices?
- 4. What steps has been taken by government of India to promote the foreign investment?

## 11.7` SUGGESTED READINGS

- 1. Cherrunilam, Francis, (2003), *Business Environment*, New Delhi: Vikas Publishing House Private Limited.
- 2. Rao, M.B. (2001), "WTO & International Trade", New Delhi: Vikas Publishing House Private Limited.
- 3. WTO (2005), "WTO Reports", http://www.wto.org/english.htm, March.

#### **ANNEXURE 19.1**

### PROPOSED LIST OF INDUSTRIES TO BE RESERVED

## FOR THE PUBLIC SECTOR

- Arms and ammunition and allied items of defense equipment, Defense aircraft and warships.
- 2. Atomic Energy.
- 3. Coal and lignite.
- 4. Mineral oils.
- 5. Mining if iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond.
- 6. Mining of copper, lead, zinc, tin, molybdenum and wolfram.
- Minerals specified in the Schedule to the Atomic Energy (Control of Production and Use)
   Order, 1953.
- 8. Railway transport.

## **ANNEXURE 19.2**

## LIST OF INDUSTRIES IN RESPECT OF WHICH INDUSTRIAL

## LICENSING WILL BE COMPULSORY

- 1. Coal and Lignite.
- 2. Petroleum (other than crude) and its distillation products.
- 3. Distillation and brewing of alcoholic drinks.
- 4. Sugar.
- 5. Animal fats and oils.

- 6. Cigars and cigarettes of tobacco and manufactured tobacco substitutes.
- 7. Asbestos and asbestos-based products.
- 8. Plywood, decorative veneers, and other wood based products such as particle board, medium density fibre board, block board.
- 9. Raw hides and skins, leather, chamois leather and patent leather.
- 10. Tanned or dressed furskins.
- 11. Motor cars.
- 12. Paper and Newsprint except bagasse-based units.
- 13. Electronic aerospace and defense equipment; All types.
- 14. Industrial explosives, including detonating fuse, safety fuse, gun powder, nitrocellulose and matches.
- 15. Hazardous chemicals.
- 16. Drugs and Pharmaceuticals (according to Drug Policy).
- 17. Entertainment electronics (VCRs, colour TVs, C.D. Players, Tape Recorders).
- 18. White Goods (Domestic Refrigerators, Domestic Dishwashing machines, Programmable Domestic Washing Machines, Microwave ovens, Airconditioners).
- 19. Note: The compulsory licensing provisions would not apply in respect of the small-scale units taking up the manufacture of any of the above items reserved for exclusive manufacture in small scale sector.

# **ANNEXURE 19.3**

LIST OF INDUSTRIES FOR AUTOMATIC APPROVAL OF FOREIGN
TECHNOLOGY AGREEMENTS AND FOR 51% FOREIGN EQUITY APPROVALS

### 1. Metallurgical Industries

- 1. Ferro alloys.
- 2. Castings and forgings.
- 3. Non-ferrous metals and their alloys.
- 4. Sponge iron and pelletisation.
- 5. Large diameter steel welded pipes of over 300 mm diameter and stainless steel pipes.
- 6. Pig iron.

## 2. Boilers and Steam Generating Plants

#### 3. Prime Movers (other than electrical generators)

- 1. Industrial turbines.
- 2. Internal combustion engines.
- 3. Alternate energy systems like solar wind etc. and equipment therefore.
- 4. Gas/hydro/steam turbines upto 60 MW.

## 4. Electrical Equipment

- 1. Equipment for transmission and distribution of electricity including power and distribution transformers, power relays, HT-switch gear synchronous condensers.
- 2. Electrical motors.
- 3. Electrical furnaces, industrial furnaces and induction heating equipment.
- 4. X-ray equipment.
- 5. Electronic equipment, components including subscribers' end telecommunication equipments.
- 6. Component wires for manufacture of lead-in wires.
- 7. Hydro/steam/gas generators/generating sets upto 60 MW.

- 8. Generating sets and pumping sets based on internal combustion engines.
- 9. Jelly-filled telecommunication cables.
- 10. Optic fibre.
- 11. Energy efficient lamps and
- 12. Midget carbon electrodes.

## 5. Transportation

- 1. Mechanised sailing vessels upto 10,000 DWT including fishing trawlers.
- 2. Ship ancillaries.
  - (a) Commercial vehicles, public transport vehicles including automotive commercial three wheeler jeep type vehicles, industrial locomotives.
  - (b) Automotive two wheelers and three wheelers.
  - (c) Automotive components/spares and ancillaries.
- 3. Shock absorbers for railway equipment and
- 4. Brake system for railway stock and locomotives.

## **6.** Industrial Machinery

Industrial machinery and equipment.

- 7. i. Machine tools and industrial robots and their controls and accessories.
  - ii Jigs, fixtures, tools and dies of specialized types and cross land tooling, and
  - iii. Engineering production aids such as cutting and forming tools, patterns and dies and tools.

### 8. Agricultural Machinery

- 1. Tractors.
- 2. Self-propelled Harvestor Combines.

3. Rice transplanters.

## 9. Earth Moving Machinery

Earth moving machinery and construction machinery and components thereof.

#### **10.** Industrial Instruments

Indicating, recording and regulating devices for pressures, temperatures, rate of flow weights levels and the like.

### 11. Scientific and Electromedical Instruments and Laboratory Equipment.

### 12. Nitrogenous & Phosphatic Fertilizers falling under

Inorganic fertilizers under '18-Fertilizers' in the First Schedule to IDR Act, 1951.

## 13. Chemicals (other than fertilizers).

- 1. Heavy organic chemicals including petrochemicals.
- 2. Heavy inorganic chemicals.
- 3. Organic fine chemicals.
- 4. Synthetic resins and plastics.
- 5. Man made fibres.
- 6. Synthetic rubber.
- 7. Industrial explosives.
- 8. Technical grade insecticides, fungicides, weedicides, and the like.
- 9. Synthetic detergents
- 10. Miscellaneous chemicals (for industrial use only).

### 14. Drugs and Pharmaceuticals

According to Drug Policy.

**15.** i. Paper and pulp including paper products.

- ii. Industrial laminates.
- **16.** i. Automobile tyres and tubes.
  - ii. Rubberised heavy duty industrial beltings of all types.
  - iii. Rubberised conveyor beltings.
  - iv. Rubber reinforced and lined fire fighting hose pipes.
  - v. High pressure braided hoses.
  - vi. Engineering and industrial plastic products.

#### 17. Plate Glass

- 1. Glass shells for television tubes.
- 2. Float glass and plate glass.
- 3. H.T. insulators.
- 4. Glass fibres of all types.

#### 18. Ceramics

i. Ceramics for industrial uses.

## 19. Cement Products

- 1. Portland cement.
- 2. Gypsum boards, wall boards and the like.

## 20. High Technology Reproduction and Multiplication Equipment.

## 21. Carbon and Carbon Products

- 1. Graphite electrodes and anodes.
- 2. Impervious graphite blocks and sheets.

## 22. Pretensioned High Pressure RCC Pipes.

## 23. Rubber Machinery

### 24. Printing Machinery.

- 1. Web-fed high speed off-set rotary printing machine having output of 30,000 or more impressions per hour.
- 2. Photo composing/type setting machines.
- 3. Multi-colour sheet-fed off-set printing machines of sizes 18"x25" and above.
- 4. High speed rotograture printing machines having output of 30,000 or more impressions per hour.

## 25. Welding Electrodes other than those for Welding Mild Steel

## 26. Industrial Synthetic Diamonds.

- **27.** i Photosynthesis improvers.
  - ii. Genetically modified free living symbiotics nitrogen fixer.
  - iii. Pheromones.
  - iv. Bio-insecticides.

## 28. Extraction and Upgrading of Minor Oils

## 29. Pre-fabricated Building Material.

### 30. Soya Products

- 1. Soya texture proteins.
- 2. Soya protein isolates.
- 3. Soya protein concentrates.
- 4. Other specialised products of soyabean.
- 5. Winterised and deodourised refined soyabean oil.

- 31. (a) Certified high yielding hybrid seeds and synthetic seeds and
  - (b) Certified high yielding plantlets developed through plant tissue culture.
- **32.** All food processing industries other than milk food, malted foods, and flour, but excluding the items reserved for small-scale sector.
- **33**. All items of packaging for food processing industries excluding the items reserved for small scale sector.
- **34.** Hotels and tourism-related industry.

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Subject : Business Environment

# LESSON-12 INDIAN FINANCIAL ENVIRONMENT

**OBJECTIVE:** The present lesson discusses Indian Financial Environment including the

institutions and instruments comprising it.

#### **STRUCTURE**

12.1 Introduction

- 12.2 Financial Institutions
- 12.3 Financial Markets
- 12.3.1 Money Market
- 12.3.2 Capital Market
- 12.4 Financial Instruments
- 12.5 Summary
- 12.6 Self Assessment Questions

## 12.1 introduction

Economic growth and development of any country depends upon a well-knit financial system. Financial System comprises, a set of sub-systems of financial institutions financial markets, financial instruments and services which help in the formation of capital. It provides a mechanism by which savings are transformed into investments. Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

The financial system is characterized by the presence of an integrated, organized and regulated financial markets, and institutions that meet the short terms and long terms financial need of both the household and corporate sector. Both financial markets and financial institutions play an important role in the financial system by rendering various financial services to the community. They operate in close combination with each other. The following are the four major components that comprise the Indian Financial System:

- 1. Financial Institutions
- 2. Financial Markets
- 3. Financial Instruments/Assets/Securities

# 12.2 Financial Institutions

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities (individual, business, government) seeking advice on various issues ranging from restricting to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere.

Financial Institutions are also termed as financial intermediaries because they act as middlemen between the savers (by accumulating funds from them) and borrowers (by lending these funds). Banks also act as intermediaries because they accept deposits from a set of customers (savers) and lend these funds to another set of customers (borrowers). Like-wise investing institutions such as GIC, LIC, mutual funds etc. also accumulate savings and lend these to borrowers, thus performing the role of financial intermediaries.

Financial institution's role as intermediary differs from that of a broker who acts as an agent between buyer and seller of a financial instrument (equity shares, preference, debt); thus facilitating the transaction but does not personally issue a financial instrument. Whereas, financial intermediaries mobilize savings of the surplus units and lend them to the borrowers in the form of loans and advances (i.e. by creating a financial asset). They earn profit from the difference between rate of interest charged on loans and rate of interest paid on deposits (savings). In short, they repackage the depositor's savings into loans to the borrowers.

## 12.3 Financial Markets

Finance is the pre-requisite for modern business and financial institutions play a vital role in the economic system. It is through financial markets and institutions that the financial system of an economy works. Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds, etc.

Financial markets may be broadly classified as negotiated loan markets and open markets. The negotiated loan market is a market in which the lender and the borrower personally negotiate the terms of the loan agreement, e.g. a businessman borrowing from a bank or from a small loan company. On the other hand, the open market is an impersonal market in which standardized securities are treated in large volumes. The stock market is an example of an open market. The financial markets, in a nutshell, are the credit markets catering to the various credit needs of the individuals, firms and institutions. Credit is supplied both on a short as well as a long term basis.

### **Functions**

The main functions of the financial markets are:

- (i) to facilitate creation and allocation of credit and liquidity;
- (ii) to serve as intermediaries for mobilization of savings;
- (iii) to assist the process of balanced economic growth;
- iv) to provide financial convenience; and
- (v) to cater to the various credit needs of the business houses.

# Types of Financial Market

On the basis of credit requirement for short-term and long term purposes, financial markets are divided into two categories :

- 1. Money Market
- 2. Capital Market

## 12.3.1 Money Market

The term money market is used in a composite sense to mean financial institutions which deal with short-term funds in the economy. It refers to the institutional arrangements facilitating borrowing and lending of short-term funds. The money market brings together the lenders who have surplus short term investible funds and the borrowers who are in need of short-term funds. In a money market, funds can be borrowed for a short period varying from a day, a week, a month, or 3 to 6 months and against different types of instruments, such as bill of exchange, banker's acceptances, bonds, etc., called 'near money'. Thus money market has been defined by Crowther as, "the collective name given to the various firms and institutions that deal in the various grades of near money".

The Reserve Bank of India describes the money market as, "the center for dealings, mainly of a short-term character, in monetary assets, it meets the short-term requirements of borrowers and provides liquidity or cash to the lenders". The borrowers in the money market are generally merchants, traders, manufacturers, business concerns, brokers and even government institutions. The lenders in the money market, on the other hand, include the Central Bank of the country, the commercial banks, insurance companies and financial concerns.

The organization of the money market is formed. There is no definite place or location where money is borrowed and lent by the parties concerned, it is not necessary for the borrowers and the lenders to have a personal contact with each other. Negotiations between the parties may be carried through telephone, telegraph or mail. Thus, money market is simply an arrangement that brings about a direct or indirect contact between the lender and the borrower.

# Functions of the Money Market

The money market performs the following functions:

- 1. The basic function of money market is to facilitate adjustment of liquidity position of commercial banks, business corporations and other non-bank financial institutions.
- 2. It provides outlets to commercial banks, business corporations, non-bank financial concerns and other investors for their short-term surplus funds.
- 3. It provides short-term funds to the various borrowers such as businessmen, industrialists, traders etc.
- 4. Money market provides short-term funds even to the government institutions.
- 5. The money market constitutes a highly efficient mechanism for credit control. It serves as a medium through which the Central Bank of the country exercises control on the creation of credit.
- 6. It enables businessmen to invest their temporary surplus for a short-period.
- 7. It plays a vital role in the flow of funds to the most important uses.

# Structure of Money Market

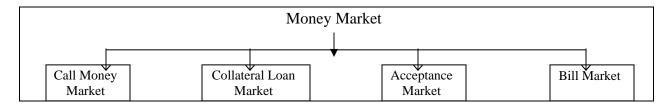
The structure of money market can be studied as follows:

Money Market

Components Institutions Instruments

## The Components or Sub Markets of Money Market

The money market is not homogenous in character. This is a loosely organized institution with a number of divisions and sub-divisions. Each particular division or sub-division deals with a particular type of credit operations. All the sub-markets deal in short-term credit. The following are the important constituents or sectors of money markets:



# 1. Call Money Market

Call money market refers to the market for very short period. Bill brokers and dealers in stock exchange usually borrow money at call from the commercial banks. These loans are given for a very short period not exceeding seven days under any circumstances, but more often from day-to-day or for overnight only i.e. 24 hours. There is no demand of collateral securities against call money. They posses high liquidity, the borrowers are required to pay the loan as and when asked for, i.e. at a very short notice. It is on account of this reason that these loans are called 'call money' or call loans. Thus, call money market is an important component of the money market.

The investment of funds in the call market meets the need of liquidity but not that of profitability because the rate of interest on call loans is very low and changes several times during the courses of the day. Call loans are useful to the commercial banks because these can be converted into cash at any time. They are almost like cash. It is a form of secondary cash reserves for the commercial banks from which they earn some income too.

#### 2. Collateral Loan Market

It is another specialized sector of the money market. The market for loans secured by stocks and market is geographically most diversified and most loosely organized. The loans are generally advanced by the commercial banks to private parties in the market. The collateral loans are backed by the securities, stocks and bonds. The collateral securities may be in the form of some valuable, say government bonds which are easily marketable and do not fluctuate much in prices. The collateral money is returned to the borrower when the loan is repaid. Once the borrower is unable to repay the loan, the collateral becomes the property of the lender. These loans are given for a few months. The borrowers are generally the dealers in stocks and shares. But even smaller commercial banks can borrow collateral loans from the bigger banks.

# 3. Acceptance Market

Bank's acceptances are very old form of commercial credit. Acceptance market refers to the market for banker's acceptances involved in trade transactions. This market deals with banker's acceptances which may be defined as a draft drawn by a business firm upon a bank and

accepted by it. It is required to pay to the order of a particular party or to the bearer a certain specific amount at a specific date in the future. These acceptances emerge out of commercial transactions both within the country and abroad. The market where the banker's acceptances are easily sold and discounted is known as acceptance market. Raymond P. Kent, in his book 'Money and Banking' has stated that banker's acceptance is "a draft drawn by an individual or firm upon a bank and accepted by the bank whereby it is ordered to pay to the order of a designated party or to bearer a certain sum of money at a specified time in future." There is a distinction between a banker's acceptance and a cheque. A banker's acceptance is payable at a specified future date whereas a cheque is payable on demand. Banker's acceptances can be easily discounted in the money market because they carry the signature of the bankers.

In case of acceptance houses, no bank funds are involved. The bank has merely added its guarantee to the draft. But a note-worthy point is that the banker's acceptances are used primarily in international trade. In the London Money Market there are specialized firms known as accepting houses which accept bills drawn on them by traders instead of drawing on the true debtors. In the past the acceptance houses were very important in the London Money Market but now their importance has declined considerably. In the Indian Money Market these have no significance because there is no development of the acceptance market.

### 4. Bill Market

It is a market in which short term papers or bills are bought and sold. The important types of short term papers are : (a) Bills of exchange (b) Treasury bills.

- (a) Bills of exchange. Bills of exchange are commercial papers. A bill of exchange is a written unconditional order which is signed by the drawer requiring the drawee to pay on demand or at a fixed future time, a definite sum of money. Once the buyer signifies his acceptance on the bill itself, it becomes a legal document. Such bills are discounted or rediscounted by commercial banks to lend credit to the bill-holders or to borrow from the central bank.
- (b) Treasury bills. The treasury bills are government papers securities for a short period usually of 91 days' duration. The treasury bills are the promissory notes of the government to pay a specified sum after a specified period. These are sold by the central bank on behalf of the government. An important aspect of a treasury bills is that there is no fixing of rate of interest beforehand. The treasury offers the bills on the basis of competitive bidding, so one who is satisfied with minimum interest would be allotted the bills. Since the treasury bills are government papers, they inspire public confidence in the minds of the investors. As no risk is involved in their purchase, they become good papers for the commercial banks to invest their short term funds. Since discounting is the main process of exchange, so it is called 'discount market' also. A pertinent point is that the market for bonds, government long term loan market or treasury bonds, and the stock exchange, etc. deal with a long period; so they cannot be regarded as constituents of money market.

Thus from the above discussion it is clear that different markets form part of money market. The call money market, for example, refers to the borrowing and lending of call loans and advances. The loans backed by securities, stocks and bonds are called collateral loans. The acceptance market refers to the acceptances of bills which leads to the discounting of bills. The bill market refers to buying and selling of bills.

## The Institutions of Money Market

The institutions of money markets are those which deal in lending and borrowing of short term funds. The institutions of money market are not the same in all the countries of the world, rather they differ from country to country. The commercial banks, central banks, acceptance houses, non-banking financial intermediaries (NBFI), brokers, etc. are the major institutions of money market. These are discussed as under:

- 1. Commercial Banks. Commercial banks are the back bone of the money market. They form one of the major constituents of money market. These banks use their short term deposits for financing trade and commerce for short periods. The commercial banks invest their funds in the discounting of bills of exchange, i.e. both exchange bills or commercial bills and treasury bills or government bills to facilitate trade and commerce by mobilizing the flow of money. The commercial banks lend against promissory notes and through advances and overdrafts. The call money loans are also provided by these banks to the bill brokers and dealers in the stock exchange market. The commercial banks put their excess reserves in different forms or channels of investments which satisfy their conflicting principles of liquidity and profitability. The aim is that the funds invested not only remain liquid in form but also earn high interest or yield income on them. A noteworthy point is that in addition to commercial banks there are cooperative banks, savings banks, financial companies, etc. also which form part of the money market.
- **2. Central Bank.** The central bank plays a vital role in the money market. It is the monetary authority and is regarded as an apex institution. No money market can exist without the central bank. The central bank is the lender of the last resort and controller and guardian of the money market. The member banks may approach the central bank for loans and advances during emergency. It controls and guides the institutions working in the money market. It raises or reduces the money supply and credit to ensure economic stability in the economy.

In other words, it helps in averting the possibilities of inflation and deflation. A pertinent point is that the performance of the central bank depends on the character and composition of the money market. But the central bank does not enter into direct transactions, it controls the money market through changes in the bank rate and open market operations.

- **Acceptance Houses.** The acceptance houses and bill brokers are the main institutions 3. dealing in the bill market. The institution of acceptance houses developed in England where merchant bankers transferred their headquarters to London Money Market in the late 19<sup>th</sup> and the early 20<sup>th</sup> century. They function as intermediaries between importers and exporters, and between lenders and borrowers in the short period. In the London Money Market the acceptance houses performed a very useful role as merchant bankers. These houses specialized in the acceptance of trade bills/commercial bills. They accepted those bills which were drawn on merchants whose financial standing was not known in order to make the bills negotiable in the London Money Market. In this way, they handled the international transactions without any problem. A noteworthy point is that by accepting a trade bill, they guaranteed the payment of the bill on maturity. For this guarantee, these houses charged a commission. The discounting of such accepted bills was done by another specialized agency known as 'discount houses'. This institution was an important segment of the London Money Market in the past but now its importance has declined because the commercial banks have undertaken the business of acceptance houses.
- **4. Non-banking Financial Intermediaries.** In addition to commercial banks, there are non-banking financial intermediaries who resort to lending and borrowing of short term funds in the money market. In non-banking financial intermediaries, savings banks, investment houses,

insurance companies, building societies, provident funds and other business corporations like chit funds are included.

5. Bill Brokers. In the developed money markets like the London Money Market and the New York Money Market, private companies act as discount houses. The main function of these companies is to discount bills on behalf of others. Besides these companies, there are bill-brokers who work as intermediaries between the borrowers and lenders by discounting bills of exchange at a small commission. In an under-developed money market, bill brokers are quite important intermediaries.

# Money Market Instruments

The following are the money market instruments:

(a) Treasury Bill. Treasury bill represents short-term borrowings of the government. Treasury bill market refers to the market where treasury bills are bought and sold. Treasury bills may be classified into four categories:

14-day treasury bill: it was introduced on May 20, 1997. The auction of 14-day treasury bills are held on a weekly basis. The 14-day intermediate treasury bills were introduced on April, 1997. It was introduced to cater to the needs of investing the surplus funds of state government, foreign and central banks, etc.

91-day treasury bills: There are two types of 91-day treasury bills, namely, (i) ordinary treasury bills and (ii) ad hoc treasury bills. 'Ordinary' treasury bills are issued to the public and other financial institutions for meeting the short-term financial requirements of the central government. These bills are freely marketable; can be bought and sold at any time; and have a secondary market.

'Ad hoc ' treasury bill is always issued in favour of the RBI. These are not sold through tender or auction. The ad hoc treasury bills are purchased by the RBI on tap and RBI is authorized to issue currency notes against them. The holder of these bills can always sell them back to the RBI.

182-day treasury bills: These are introduced by RBI and initially issued by RBI on monthly basis. RBI does not purchase the treasury bills before the maturity period but they can be sold by the investors in the secondary market through Discount and Finance House of India (DFHI). The DFHI makes advances getting the financial support from RBI.

364-day treasury bills: It was introduced in at the end of April 1992. These are sold through auction which is conducted once in a fortnight. The 364-day treasury bills have become popular due to their higher yield with liquidity and safety. These bills are not rediscountable with the Reserve Bank of India.

- **(b) Commercial bills :** Banks make advances to the customers against commercial bills. In the needs of fund by bankers it can be rediscounted in the money market to get ready money. This rediscount period is 90 days but it can be rediscounted earlier in the secondary market.
- (c) Inter bank call money: The inter bank call money market is the core of the formal money market. Banks borrow from the call money market in order to meet sudden demand for funds for payments and to obtain funds to meet any likely shortfalls in their cash reserves to meet the Cash Reserve Ratio (CRR) stipulation. In India, inter bank call money market is the single most important source for banks for getting overnight and short-term funds.
- (d) Commercial paper: Commercial paper is a short-term unsecured instrument issued by a company in the form of promissory notes with fixed maturities. The maturity period ranges from 15 days to less than 1 year. Since it is a short-term debt, the issuing company is required

to meet dealers' fees, rating agency fees, and any other relevant charges. Commercial Paper (CP) has gained popularity all over the world because it provides funds at a relatively lower cost. Another important feature of CP is that through this instrument the firm may raise large amount of funds which is not possible through a single bank.

**Eligibility for issue of commercial paper.** In India, the emergence of CP has added a new dimension to the money market. Hence, the RBI has relaxed the initial guidelines which were laid down for the issue of CPs. The following are the guidelines governing the issue of commercial paper:

- (i) The CP has to be issued at discount in the forms of promissory note where interest is always front-ended and maturity value is always equal to face value.
  - (ii) The issuing firm must have a net worth of at least Rs. 4 crores and the company

should have fund based working capital limit of Rs. 4 crores.

- (iii) The current ratio should be 1.33:1 and debt-equity ratio not more than 1.5:1.
- (iv) It must have a credit rating of P2/A2 or higher from the CRISIL/ICRA of not less than two months old at the time of issue of CP but this condition has become optional since the latter part of 1994.
- (v) The RBI has made mandatory for banks, consortia, and syndicates to restrict the cash credit component to 75 per cent of the maximum permissible bank finance and the overall capacity of each borrower to issue CPs is 56 per cent of a borrower's maximum permissible bank finance.
- (vi) The company must be listed on one or more stock exchanges but the Government companies are exempted from this stipulation.
- (vii) The issue of a CP also bears the expenses of stamp duty and requires to obtain the approval of the Reserve Bank for each issue of the commercial paper.
- (viii) Now the RBI has abolished the facility of stand by arrangement as a result, it is no longer mandatory for banks to automatically restore the cash credit limits of corporate bodies.
- (ix) CP can be issued to any person or corporate bodies registered or incorporated in India (including banks), as well as non-incorporated bodies.
- (x) The issuing company is required to appoint a bank or leader of the consortium bank to verify the signature of the issuing company who have signed in the CP.
- (xi) The issuing company is required to appoint a dealer who would arrange the investor for the commercial paper.
- (xii) CP is generally issued at a discount and is freely transferable by endorsement. Its delivery is not subject to tax deducted at source.
- (xiii) The face value of a single commercial paper should not be less than Rs. 25 Lakh and in multiples of Rs. 5 Lakh thereafter.
- (xiv) The commercial paper shall be issued for a minimum maturity period of 15 days to one year.
- (xv) The minimum size of an issue is R. 1 crore and the minimum unit of subscription is Rs. 25 lakh.

Advantage of commercial papers: The advantage of CPs lies in the simplicity they offer, as large amounts can be raised without having any underlying transaction. Secondly, CPs provide flexibility to the company to raise funds in the money market wherever it is favorable. Thirdly, CPs can raise fund from the inter corporate market which is not under the control of any monetary authority. Also CPs provide cheapen finance to the borrowers and at the same time offer good rate of return to the investors.

(e) Certificate of Deposit (CD): This is a bearer certificate and is negotiated in the market. CDs can be issued by scheduled commercial banks at a discount on face value and the discount rates are determined by the market. CDs were introduced in June 1989. The minimum denomination of CD was reduced to Rs. 1 Lakh in June 2002, and new and outstanding CDs were converted to demat form by October 2002. It should be noted that maturity period and interest rates are no longer controlled by RBI and the instrument has now become a market determined instrument. The RBI guidelines for the issue of CDs can be listed as follows:

## **RBI** guidelines

- (i) The denomination of CDs should be in multiples of Rs. 5 lakh subject to the condition that minimum size of an issue to a single investor is Rs. 25 Lakh.
- (ii) CDs can be issued to individuals, corporations, companies, trust funds, associations, etc. Non Resident Indians can also subscribe to CDs but only on non-repatriation basis.
- (iii) The maturity period of CDs should not be less than 3 month and not more than a year. The minimum lock-in-period for CDs is 15 days.
- (iv) Banks have to maintain CRR and SLR on the price of issue of CDs.
- (v) CDs are freely transferable by endorsement and delivery but only after 45 days of the date of issue to the primary investor.
- (v) CDs are freely transferable by endorsement and delivery but only after 45 days of the date of issue to the primary investor.
- (vi) CDs are issued in the form of usual promissory notes payable on a fixed date without any grace period. CDs are subject to the payment of stamp duty.
- (vii) Banks cannot grant loans against CDs an neither can they buy back their own CDs before maturity.
- **Repurchase option**: The major development in the government securities market is the (f) introduction of a repurchase facility. This instrument of Repurchase Agreement (REPOs) between the RBI and commercial banks started in December 1992. REPO includes the acquisition of funds through sale of agreed securities and is simultaneously committed to repurchase the same at a predetermined price, generally within a period of 14 days to one year. REPO is thus a collateral borrowing and represents a liability to the seller at the purchase price, and effects the conceptual obligations to transfer funds to the banks on the date of maturity of agreement. To improve the transmission mechanism of monetary policy and further develop the money and debt markets in the light of the recommendations made by the "Narasimhan Committee" it has been decided to develop the REPOs market with appropriate regulatory safeguards. These safeguards include delivery versus payment, uniform accounting, valuation and disclosure norms, and restricting REPOs to instruments held in dematerialized form with a depository. These prudential safeguards have been designed to ensure transparency and accountability as also at the same time increasing liquidity and depth in the securities market. Accordingly, it has been decided to allow UTI, LIC, IDBI and other non-bank participants in the money market to access short-term liquidity through REPOs thereby facilitating their cash management and gradual move out of the call money market.
- (g) Money market mutual funds: In order to create an additional short-term avenue for investment and to bring money market instrument within the reach of individuals and smaller bodies, the Reserve Bank of India set up money market mutual funds (MMMFs) in April 1991. The MMMFs invariably and excessively invest their investing resources in very high quality money market instruments. Recently, some liquid schemes of private sector mutual funds have

started offering 'cheque writing' facility. Such facility provides more liquidity to unit holders and hence has been advocated in the interest of the savers investors.

**RBI guidelines for setting up MMMFs:** The RBI announced norms for setting money market mutual funds on April 21, 1992. The following are the guidelines for setting up MMMFs:

- 1. **Eligibility:** Scheduled commercial banks and public financial institutions can set up MMMFs under section 4A of the Companies Act, 1956 or through their existing mutual funds/subsidiaries engaged in funds management.
- **Structure :** MMMFs can be set up departmentally in the form of a division/department of the bank i.e. "in house" MMMFs wherein the assets and liabilities of such MMMFs would form a part of the banks' balance sheet or a separate entity i.e. a "trust".
- (i) MMMFs can be operated either as money market deposit accounts or MMMFs. Money market deposit accounts scheme can be operated either by issuing a deposit receipt or through the issue of passbook without cheque book facilities. The MMMFs can float both openended and schemes. According to the RBI's credit policy announced on October 29, 1999 MMMFs can be set up only as trusts for operational convenience.
- (ii) When MMMFs are set up as a trust, the sponsoring bank should appoint a board of trustees to manage it.
- (iii) The day-to-day management of the schemes under the fund, as may be delegated by the board of trustees where the fund is set up as a trust, should be looked after by a full time executive trustee or a separate fund manager if set up as division of a bank or a financial institution.
- (iv) The banks and public financial institutions are free to formulate special schemes as per their requirements, subject to the guidelines stipulated by the RBI. The MMMFs have to forward the details of the scheme together with the copies of the offer letter, application form and so on to the RBI, at least one month before announcing the launch of any scheme.
- **3. Size of MMMFs :** There is no restriction on the minimum size of MMMFs. There are also no ceilings for raising resources under various schemes by MMMFs.
- **Subscriber:** MMMFs can be issued only to individuals. Individuals, inclusive of Non Resident Indians (NRIs), may also subscribe to shares/units of MMFs on a repairable basis.
- **5. Minimum size of investment :** MMMFs are free to determine the minimum size of investment by a single investor. The investor cannot be guaranteed a minimum rate of return on investment while announcing any scheme.
- **6. Minimum period :** The minimum lock-in-period is 15 days.
- 7. **Investments:** The resources mobilized are invested exclusively in various money market instruments like treasury bills, call/notice money, commercial paper, and certificates of deposits.
- **8. Resource requirements:** Resource requirements do not apply to stamp duty.
- **9. Stamp duty :** The shares/units issued by MMMFs are a subject to stamp duty.
- **10. Insurance cover :** The funds invested in a MMMFs do not come under the insurance cover from the Deposits Insurance and Credit Guarantee Corporation of India. This aspect must be clearly stated in the offer document of the MMMFs.
- **11. Delivery of instrument :** MMMFs should invariably take delivery of the money market instruments purchased and must give delivery of the instrument sold.

- **12. Format of certificates of MMMFs :** The units of MMMFs should be issued in the form of a certificate indicating the number of units purchased by the investor.
- **13. Application form :** MMMFs may devise suitable application form for subscribing to their schemes.
- **14. Security aspect :** Since the units are freely transferable, due care must be exercised by the MMMFs in the matters of printing or ensuring safe custody of the instruments. They should be signed by two or more authorized signatories.
- **15. Regulatory authority:** The setting up of MMMFs requires prior authorization of Reserve Bank of India. MMMFs started by a financial institution are required to comply with the guidelines that may be issued by RBI from time to time.
- 16. Accounting: The accounts of the MMMFs are to be kept distinct and separate from those of their parent institutions. In the case of "in house" MMMFs, it is to be ensured that there is no conflict of interest between the MMMFs and their parent organization. The transfer of assets between the MMMFs and the sponsoring institutions has to be at the market rates and is subject to the approval of the Sponsoring Institution Board.
- 17. Statement of accounts and disclosures: The MMMFs have to maintain a separate account of each scheme launched by it, segregating the assets under each scheme. They have to prepare an annual statement of accounts which contain, inter alia, statement of the assets and liabilities, and the income and expenditure account duly audited by qualified auditors, other than the auditors of the parent organization. An abridged version of the annual accounts together with the reports of the auditors has to be published for the information of the subscriber to the concerned schemes.
- **18. Management of MMMFs:** In house MMMFs have to take adequate measures to ensure that the management, accounting, and custody of their assets are kept distinct and separate from those relating the sponsoring institutions.
- **19. Net asset value :** The MMMFs have to calculate the NAV of each scheme and disclose it periodically for the benefit of the investor. To start with , NAV can be determined and disclosed once a week.
- **20. Expenses:** The total expenses of the fund including pre-issue expenses, trusteeship fees/management fees, etc. are to be kept at reasonable levels and disclosed fully in the fund's annual reports or balance sheets.
- **21. Furnishing report to Reserve Bank of India:** The sponsor banks and the financial institutions should furnish to Reserve Bank of India, in duplicate, the following reports on a regular basis:
  - (i) The quarterly report indicating the performance of the MMMF as a whole and each scheme thereof.
  - (ii) The audited annual statement of accounts, together with the reports of the auditors.
  - (iii) Scheme—wise details of the investment portfolio of the funds, value of such investment charges in portfolio since the annual report and asset-wise exposure.

# Discount and Finance House of India (DFHI)

The Discount and Finance House of India (DFHI) was set up in April 1988 in pursuance of the recommendations of the working group on money market under the chairmanship of Mr. N. Vaghul. The DFHI was set up jointly by the Reserve Bank of India, public sector banks, and

financial institutions to deal in short-term money market instruments. The paid – up capital of Rs. 100 crores was contributed jointly by the RBI (Rs. 51 crores), public sector banks (Rs. 33 crores), and financial institutions (Rs. 16 crores). The main objectives of DFHI are to:

- provide liquidity to money market instruments.
- provide safe and risk free short- term investments avenues to institutions.
- facilitate money market transactions of small- and medium sized institutions that are not regular participants in the market.

The main functions of DFHI are as follows:

- (1) To discount, discount, purchase and sell treasury bills, trade bills, bills of exchange, commercial bills and commercial papers.
- (2) To play an important role as a lender, borrower, or broker in the inter-bank call money market.
- (3) To promote and support company funds, trusts and other organizations for the development of short-term money market.
- (4) To advise governments, banks, and financial institutions in evolving schemes for growth and development of money market.The DFHI participates in the call, notice and term markets as a borrower and as a lender.

## Features of the Indian Money Market

In money market short term surplus funds with banks, financial institutions and others are bid by borrowers i.e., individuals, companies and the Government. In the Indian money market RBI occupies the pivotal position. The Indian money market can be divided into two sectors i.e. unorganized and organized. The organized sector comprises of Reserve Bank of India, SBI group and commercial banks foreign, public sector and private sector. The unorganized sector consists of indigenous bankers and money lenders. The organized money market in India has number of sub-markets such as the treasury bills market, the commercial market and inter-bank call money market. The following are the characteristics of the Indian Money Market:

- 1. Existence of Unorganized Money Market. The most important defect of the Indian money market in the existence of unorganized segment. In this segment of the market the purpose as well period are not clearly demarcated. In fact, this segment thieves on this characteristic. This segment undermines the role of the RBI in the money market. Efforts of RBI to bring indigenous bankers within statutory frame work have not yielded much result.
- 2. Lack of Integration. Another important deficiency is lack of intergration of different segments or functionaries. However, with the enactment of the Banking Companies Regulation Act 1949, the position has changed considerably. The RBI is now almost fully effective in this area under various provisions of the RBI Act and the Banking Companies Regulation Act.
- **3. Disparity in interest rates.** There have been too many interest rates prevailing in the market at the same time like borrowing rates of government, the lending rates of

commercial banks, the rates of cooperative banks and rats of financial institutions. This was basically due to lack of mobility of funds from one sub-segment to another.

However, with changes in financial sector the different rates of interest have been quickly adjusting to changes in the bank rate.

- 4. Seasonal Diversity of Money Market. A notable characteristic is the seasonal diversity. There are very wide fluctuations in the rates of interest in the money market from one period to another in the year. November to June is the buy period. During this period crops from rural areas are moved to cities and parts. The wide fluctuations create problems in the money market. The Reserve Bank of India attempts to lessen the seasonal fluctuations in the money market.
- 5. Lack of Proper Bill Market. Indian Bill market is an underdeveloped one. A well organized bill market or a discount market for short term bills is essential for establishing an effective link between credit agencies and Reserve Bank of India. The reasons for the situation are historical, like preference for cash to bills etc.
- **6. Lack of very well Organized Banking System.** Till 1969, the branch expansion was very slow. There was tremendous effort in this direction after nationalization. A well developed banking system is essential for money market. Even, at present the lack of branches in rural areas hinders the movement of funds. With emphasis on profitability, there may be some problems on this account.

In totality it can be said that Indian Money Market is relatively under developed. In no case it can be compared with London Money Market or New York Money Market. There are number of factors responsible for it in addition to the above discussed characteristics. For example, lack of continuous supply of bills, a developed acceptance market, commercial bills market, dealers in short term assets and coordination between different sections of the money market.

# 12.3.2 Capital Market

Capital Market is generally understood as the market for long-term funds. This market supplies funds for financing the fixed capital requirement of trade and commerce as well as the long-term requirements of the Government. The long-term funds are made available through various instruments such as debentures, preference shares, and common shares. The capital market can be local, regional, national, or international. The capital market is classified into two categories, namely, (i) primary market or new issue market, and (ii) secondary market or stock exchange. As a rule, only when a country's primary market is alone, it is possible to ensure a

good degree of activity in the secondary market because it is the primary market which ensures a continuous flow of securities to the secondary market. On the contrary, if secondary marker is only active but not transparent and disciplined, it becomes difficult to develop and sustain the cult of equity and related investment in the primary market. This is because the liquidity which the secondary market imparts to such investments in the hands of the investors is adversely affected.

# Importance of Capital Market

Capital markets are markets where productive capital is raised and made available for industrial purposes. It provides an avenue for investors and household sector to invest in financial assets which are more productive than physical assets. A developed capital market can solve the problem of paucity of funds. It facilitates increase in production and productivity in the economy and hence enhances the economic welfare of the society. Indian capital market acts as an intermediary to mobilize savings and to channelize the same for productive use consistent with national priorities. The industrial securities issued through the primary market are traded in the secondary market which provides liquidity and short-term as well as long-term yields. An efficient primary market prepares base for effective and cost efficient mobilization of resources by bringing together the users and investors of funds. Thus, both the primary and secondary markets helps each other and make the capital market efficient, healthy, and strong. The number of listed companies and the investors. Table I shows the upsurge of market capitalization, trading volume, and number of listed companies for the years 1990-2003.

Table I Growth in the Indian Capital Market

At the end	No. of	No. of	No. of	Market	Turnover	SGL	Derivatives
of financial	stock	brokers	Listed	capitalization		turnover	turnover
year	exchange		companies				
1990-91	20	-	6229	1,10,279	-	ı	-
1991-92	20	-	6480	3,54,106	-	1	-
1992-93	22	-	6925	2,28,780	-	-	-
1993-94	23	-	7811	4,00,077	2,03,703	-	-
1994-95	23	6711	9077	4,73,349	1,62,905	50,569	-
1995-96	23	8476	9100	5,72,257	2,27,368	1,27,179	-
1996-97	23	8867	9890	4,88,332	6,46,116	1,22,941	-
1997-98	23	9005	9833	5,89,816	9,08,681	1,85,708	-
1998-99	23	9069	9877	5,74,064	10,23,382	2,27,228	-
1999-00	23	9192	9871	11,92,630	20,67,031	5,39,232	-
2000-01	23	9782	9954	7,68,683	28,80,990	6,98,121	4038
2001-02	23	9687	9644	7,49,248	8,95,817	15,55,653	1,03,847
2002-03	23	9519	9413	6,31,921	9,86,908	19,55,731	4,42,343

The growth in the Indian capital market is presented in the Table I The number of stock exchanges increased from 9 in 1980 to 23 in 2002-03. All the exchanges are fully computerized and offer 100% online trading. 9,413 companies were available for trading on stock exchanges

at the end of March 203. The market capitalization grew ten fold between 1990-91 and 1999-2000. All India market capitalization is estimated at Rs. 6,31,921 crores at the end of March 2003. The trading volumes on exchanges have been witnessing phenomenal growth during 1990s. The average daily turnover grew from about Rs. 150 crores in 1990 to Rs. 12,000 cores in 2000, peaking at over Rs. 20,000 crores. However it declined substantially to Rs. 9,86,908 crores in 2002-03.

The resource mobilization from the primary market is depicted in the Table II Average annual capital mobilization by non-government public companies from the primary market increased manifold during the 1980s, with the amount raised in 1990-91 being Rs. 4312 crores. Again the capital raised by these companies rising sharply to Rs. 26,417 crores in 1994-95. However, it decreased to 1,878 crores in 2002-03. The market appears to have dried up since 1995-96 due to interplay of demand and supply side forces.

 ${\it Table~II: Resource~mobilization~from~the~primary~market}$ 

(Rs. In crores)

<b>Mutual Funds</b>	7508	11,253	13,021	11,244	12,274	-5,833	-2,036	4,064	3,611	19,953	11,135	7,137	4,580
Total	25,777	28,650	41,227	99,031	91,315	83,472	79,835	109,511	166,259	185,786	206,879	226,838	252,018
State Governments	2,569	3,364	3,805	4,145	5,123	6,274	6,536	7,749	12,114	13,706	13,300	18,707	30,853
Central Government	8,989	8,919	13,8856	50,388	38,108	40,509	36,152	59,637	93,953	99,630	115,183	133,801	151,126
<b>Government Securities</b>	11,558	12,284	17,690	54,533	43,231	46,783	42,688	67386	106,067	113,336	128,483	152,508	181,979
Euro Issues			702	7,898	6,743	1,297	5,594	4,009	1,148	3,487	4,197	2,343	3,426
Private Placement	4,244	4,463	1,635	7,466	11,174	13,361	15,066	30,099	49,679	61,259	67,836	64,876	61,746
Banks & Fls			356	3,843	425	3,465	4,352	1,476	4,352	2,551	1,472	1,070	2,989
Govt. Companies			430	819	888	1,000	650	43					
PSU Bonds	5,663	5,710	1,062	5,586	3,070	2,292	3,394	2,982					
Public Co.	4,312	6,193	19,803	19,330	26,417	16,075	10,410	3,138	5,013	5,153	4,890	5,692	1,878
Non Govt.													
Domestic Issues	14,219	16,366	23,286	37,044	41,974	36,193	33,872	,37,738	59,044	68,963	74,199	71,988	66,613
<b>Corporate Securities</b>	14,219	16,366	23,537	,44,498	48,084	36,689	37,147	42,125	60,192	72,450	78,396	74,330	70,039
Issues Year	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	2000- 01	2001- 02	2002- 02

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Indian market is getting integrated with the global market though in a limited way through Euro issues. Since 1992, Indian companies have raised over Rs. 40,000 crores through ADRs/GDRs. By the end of December 2003, 517 FIIs were registered with SEBI. They had net cumulative investments of over US\$ 23 billion by the end of December 2003.

In the total amount raised through the public offerings, share of equity in relation to debentures and bonds has increased significantly over the years which is shown in the Tables III.

It is evident that Indian capital market has become an even more important place of activity in the newly unveiled economic regime. Thus the growth of capital market has posed new challenges to economic and financial stability. As a result, a number of new innovative financial instruments have surfaced in recent years as an offshoot of the wide ranging developments taking place in the financial sector throughout the world.

# Distinction Between Capital Market and Money Market

The capital market should be distinguished from money market. The capital market is the market for long-term funds. On the other hand money market is primarily the market for short-term funds. However, the two markets are closely related as the same institution many a times deals in both types of funds, i.e. short-term as well as long-term.

The main points of distinction between the two markets are as under:

Capital Market	Money Market
1. It provides finance/money capital for long-term investment.	It provides finance/money for short-term investment.
2. The finance provided by the capital market may be used both for fixed and working capital.	2. The finance provided by money market is utilized, usually for working capital.
3. Mobilisation of resources and effective utilization of resources through lending are its main functions.	3. Lending and borrowing are its principal functions to facilitate adjustment of liquidity position.
4. It's one of the constituents, Stock Exchange acts as an investment market for buyers and sellers of securities.	4. It does not provide such facilities. The main components include call loan market, collateral loan market, bill market and acceptance houses.
5. It acts as a middleman between the investor and the entrepreneur.	5. It acts as a link between the depositor and the borrower.
6. Underwriting is one of its primary activities.	6. Underwriting is a secondary function.
7. Its investment institutions raise capital from public and invest in selected securities so as to give the highest possible return with the lowest risk.	7. It provides outlets to commercial banks, business corporations, non-bank financial concerns and other for their short-term surplus funds.

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- 8. It provides long-term funds to Central and State Governments, public and local bodies for development purposes.
- 8. It provides short-term funds to Government by purchasing treasury bills and to others by discounting bills of exchange etc.

## 12.4 Financial Instruments

The following are some of the new innovative financial instruments devised for raising funds:-

Euro convertible bond: Euro convertible bond is an unsecured security which can be converted into depository receipts or local shares. It offers the investors an option to convert the bond into equity at a fixed price after a minimum lock-in-period. Thus call option allows the company to force conversion if the market price exceeds the particular percentage of the conversion price. Indian companies prefer to issue GDRs whereas foreign investors favour convertible bonds. Fully convertible cumulative preference shares (Equipper is a very recent introduction in the market. The shares have to be listed on one or more stock exchanges in the country. It has two parts. The first part is convertible into equity shares automatically and second part is converted into equity shares after a lock-in-period at the request of the investors. Conversion into equity shares after the lock-in-period takes place at a price which is 30% lower than the average market price. The dividend on fully convertible cumulative preference shares is fixed and shall be given only for the portion that represents second part shares. Only a few companies have tried this instrument. Equiprefs are presently being offered largely to the financial institutions like the UTI. Uniworth International Ltd. (UIL)was the first company to issue these shares and succeeded in mopping up to Rs. 16 crores. UIL's equipref shares were a combination of equity and preference shares.

Table III New capital issues by non-government public limited companies

(Rs. in crores)

Security & Types of issue		2001-02		2002-03		2002-03		2003-04	
		(April-March) No. of Amount		(April-March)		(April- January)		(April-January)	
			Amount	No. of	Amount	No. of	Amount	No. of	Amount
		issues		issues		issues		issues	
1	1		3	4	5	6	7	8	9
(1)	Equity shares (a+b)	6	860.4	5	460.2	3	431.6	8	674.6
	(a) Prospectus	4	852.7	3	206.7	1	178.1	6	577.9
		(2)	(653.7)	(3)	(201.0)	(1)	(176.4)	(4)	(539.3)
	(b) Rights	2	7.7	2	253.5	2	253.5	2	96.7
		(1)	(0.6)	(2)	(190.2)	(2)	(190.2)	(1)	(26.0)
(2)	Preference shares	-	-	-	-	-	-	-	-
	(a+b)								
	(a) Prospectus	-	-	-	-	-	-	-	-
	(b) Rights	-	-	-	-	-	-	-	-
(3)	Debentures (a+b)	4	774.0	1	217.5	1	217.5	-	-
	(a) Prospectus	1	69.5	-	-	-	-	-	-
	(b) Rights	3	704.5	1	217.5	1	217.5	-	ı
of wh	of which:								
(i)	Convertible (a+b)	3	518.1	1	217.5	1	217.5	-	-
	(a) Prospectus	1	69.5	ı	1	-	-	-	-
	(b) Rights	2	448.6	1	217.5	1	217.5	-	-
(ii)	Non-Convertible	1	255.9	-	-	-	1-1	-	-

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	(a+b)								
	(a) Prospectus	-	-	-	-	-	-	-	-
	(b) Rights	1	255.9	-	-	-	-	-	-
(4)	Bonds (a+b)	9	4,058.0	3	1,200.0	1	400.0	3	1,250.9
	(a) Prospectus	9	4,058.0	3	1,200.0	1	400.0	3	1,250.9
	(b) Rights	-	-	-	-	-	-	-	-
(5)	Total (1+2+3+4)	19	5,692.4	9	1,877.7	5	1,049.1	11	1,925.5
	(a) Prospectus	14	4,980.2	6	1,406.7	2	578.1	9	1,828.8
	(b) Rights	5	712.2	3	471.0	3	471.0	2	96.7

**Triple option convertible debentures:** Every debenture holder has an opportunity to acquire two equity shares at par for each debenture. As regards the non-convertible portion which had warrants attached to them, investors were given three options. They can retain the non-convertible portion and sell the warrants and get equity shares in return or retain non-convertible portion, surrounding the warrants and apply for equity shares.

**Warrants:** A warrant is an option, issued by a company, granting the buyer the right to purchase a number of shares of its equity share capital at a given exercise price during a given period. An equity warrant increases the marketability of debentures and reduces the need for the efforts of brokers/sub-brokers by way of private placement. Thus, it provides an effective tool for lesser dependence on financial institution and mutual funds for subscribing to the security. Many companies including Deepak Fertilizers, Essar Gujarat, Reliance Industries, CEAT Tyres, Ranbaxy Laboratories, Bharat Forge, Proctor & Gamble, ITC Agro-Tech, and Tata Steel have issued warrants. In a situation, where the market is lukewarm in its response to new issues, equity warrants can be an added attraction for investors to apply for the issues offering equity warrants with their securities.

Secured premium notes (SPNs): SPN is issued along with a detachable warrant, and is redeemable after a notified period with features of medium to long-term notes. Each SPN has a warrant attached to it which gives the holder the right to apply for, or seek allotment of one equity share, provided the SPN is fully paid. The conversion of detachable warrant into equity shares is done within the time limit notified by the company. There is a lock-in-period for SPN during which no interest is paid for the invested amount. In July 1992, Tata Iron and Steel Co. Ltd. (TISCO) was the first company to issue SPNs to the public along with the right issue. The main objective of this issue was to raise money for its modernization programme without expanding its equity excessively in the next few years. The SPN was issued with a face value of Rs. 300 to be repaid in four equal annual installments of Rs. 75 each from the end of the fourth year together, with an equal amount of Rs. 75 with each installment which will consist of a mix of interest and premium on redemption. This instrument has a low borrowing cost and is beneficial for capital intensive projects.

**Zero interest convertibles:** Also known as zero coupon bonds, the zero interest convertibles refer to those convertibles which are sold at discount from their eventual maturing value and have zero interest rate. One advantage from the investors' point of view is that it eliminates reinvestment risk. From the companies' point of view, it is attractive to issue these convertibles as there is no immediate interest commitment. The companies like Mahindra & Mahindra, and HB Leasing and Finance have adopted this scheme.

**Deep discount bonds (DDB):** Deep discount bonds pay a coupon rate which is substantially lower than the market rate at the time of issue. One of the advantages of DDB is the elimination of investment risk. It helps the companies which take time to stabilize their operations and which have initial small cash flow rising steadily to a high level to take care of the redemption. The investors also gain the benefit of capital gains taxation.

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**Floating rate bonds (FRB):** Floating rate bonds made their first appearance in the Indian capital market in 1993 when State Bank of India adopted a reference rate of the highest rate of interest on fixed deposit receipt of the bank, providing floor rate for minimum interest payable at 12% p.a. and call option to the bank after 5 years to redeem the bonds earlier than the maturity period of 10 years at certain premium. The floating rates are set equal to the treasury bill rate plus a predetermined spread.

Securitization: Securitization is a synthetic technique of conversion of assets into securities, securities into liquidity and subsequently into assets, on an ongoing basis. This increases the turnover of business and profit while providing for flexibility in yield, pricing pattern, issue, risk and marketability of instruments used to the advantage of both borrowers and lenders. In securitization, generally a financial institution holds a pool of individual loans and receivables, creates securities against them, get them rated and sell them to investors at large. The most suitable assets for securitization for the banks are housing loans, auto loans, lease rentals, corporates trade receivables etc. Indian financial market is still at an infancy stage. So securitization is emerging to be a very innovative technique enabling finance companies to retail market their liabilities in order to lower their cost of funds besides increasing the liquidity. The initial headway has already been made by Citi Bank in association with ICICI.

**Layered premium issue:** The layered premium issue was introduced by Merchant Bankers to overcome the inherent dangers of fixing premia for issues. A floor rate is fixed with the consensus of the shareholders. The underwriters will also be given the option of underwriting from the highest premia to the lowest. The issue is then auctioned to the investors. This innovation will provide tremendous flexibility to the issue.

**Repurchase of shares:** Repurchase of shares by companies is a part of the capitalization process. The company repurchases the shares to reduce the share capital by two methods. As per the first method, the shares are purchased from the floor of the stock exchanges. The second method asks for purchasing the shares directly from the shareholders. Repurchase of shares is an alternative to cash dividend.

**Derivatives:** Financial intermediaries abroad have created new varieties of instruments and transaction called derivatives and to create risk managements tools such as options, futures and swaps are used to transform one or more properties of an asset or liability. Financial liberalization has brought inherent risk, and as a result, corporate and institutional investors are looking towards derivatives for hedging the risks. Since the volume of international trade and capital flows are rising, more and more banks are exposed to various currencies and the emerging derivatives in foreign countries are increasingly used by banks to bring variations in the sensitivity of their funds and also the underlying portfolio. So it is high time for the Forex dealers in India to familiarize with the complexity of the instruments and acquire skills to handle them.

**Options:** Options are basically derivatives in the nature of legal contracts. They are derived from underlying assets which could be stocks, bonds, or currencies. An option contract gives the holder the right to buy or sell the underlying stock at a price on a future date. This price is referred to as the strike price. Depending on whether the holder is a buyer or a seller, the options are termed put and call. A call option conveys the right of the holder to buy a specified quantity of the stock while a put option conveys the right of the holder to sell. The buyer or the holder gets the right as laid down in the option, while the writer is the one who has the obligation to honour the terms when the option is exercised. Option trading has a good market in India since there is enough scope for speculation.

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**Futures:** A future contract is essentially a series of forward contracts. Thee are two types of people who deal in futures—speculators and hedgers. Speculators buy and sell futures for the sole purpose of marketing a profit by selling them at a price that is higher than their buying price. Such people neither produce nor use the asset in the ordinary course of business. In contrast, hedgers buy and sell futures to offset an otherwise risky position in the spot market. In the ordinary course of business, they either produce or use the asset. In a forward contract, the trader who promises to buy is said to be in 'Long position' and the one who promises to sell is said to be in 'Short position' in future. The long position in a future contract is the agreement to take delivery and short position in a future contract is the legally binding agreement to deliver. **Swaps:** A swap deal is a transaction in which the bank buys and sells the specified foreign currency simultaneously for different maturity dates which would help banks to eliminate exposure risk. It can also be used as a tool to enter arbitrary operations that led the economy to be fully opened up.

**Non-voting shares:** Non-voting shares enable a company to raise capital without diluting the promoter's holding. The finance ministry guidelines say that non-voting shares should not exceed 25% of the total paid-up capital of the company. Shareholders buying these shares gain through a dividend which is 20% higher than on voting shares.

A major indicator of the level of development of an economy is the sophistication of its capital market. Since liberalization has begun, the response measures for handling the capital market has been enormous. It is visible with the creation of SEBI, NSE, regulated BSE, floating of mutual funds, financing institutions, and credit rating system.

## 12.5 Summary

Four and half decades of Indian economic planning and subsequent liberalization had led the country to an ecstatic phase of development. The development through disinter mediation, deregulation, globalization, and emergence of vibrant capital market has contributed to the expansion of opportunities. As a result, capital market has emerged as the major contributor to the growth of foreign exchange reserves of the country. In fact, in the emerging world market, India has beaten several developing countries. In the post liberalization era, the finance sector has witnessed a complete metamorphosis. The recent economic reforms encompassed a series of measures to promote investors protection and encourage the growth of capital market. Free entry into capital market for new issues by companies and free pricing of shares for new issues has been ensured. Different financial institutions and markets complete for a limited pool of savings by offering different instruments. Money and capital markets increase competition between suppliers. Capital market enables contractual savings and collective investment institutions to play a more active role in the financial system.

## **Self Assessment Questions**

- "Financial markets and financial institution play an important role in financial system".
   Do you agree? Explain.
- 2. Discuss the types of financial markets. How the two markets are interrelated?

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- 3. What functions does money market perform? Discuss the features of Indian money market.
- 4. Discuss the various types of instruments that are dealt in money market.
- 5. State the objectives and functions of Discount and Finance House of India.
- 6. Explain the various new financial instruments introduced in the capital market.

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Subject : Business Environment

### LESSON-13 BANKING AND FINANCIAL INSTITUTIONS

**OBJECTIVE:** The objective of the present lesson is to discuss the role of banking

and financial institutions in Indian Economy.

#### **STRUCTURE**

- 13.1 Origin and Growth of Banking
- 13.2 Meaning and Definition of a Bank
- 13.3 Types of Banks
- 13.4 Functions of Commercial Banks
- 13.5 Meaning of Financial Institutions
- 13.6 Types of Financial Institutions
- 13.7 Setting up of Financial Institutions
- 13.8 Role and Importance of Financial Institutions
- 13.9 Summary
- 13.10 Self Assessment Questions

# 13.1 Origin and Growth of Banking

As for as the origin of the present banking system in the world is concerned, the first bank called the "Bank of Venice" is believed to be established in Italy in the year 1157. The first bank in India was started in the year 1770 by the Alexander & Co., an English Agency as "Bank of Hindustan" which failed in 1782 due to the closure of the Agency House in India. The first bank in the modern sense was established in the Bengal Presidency as "Bank of Bengal" in the year 1806.

According to G. Crowther the modern banking has three ancestors in the history of banking in this world namely (i) The Merchants (ii) The Goldsmiths and (iii) The Money Lenders:

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- the trading activities required remittances of money from one place to another place which is one of the important functions of a bank even now. Because of the possibility of theft of money during physical transportation of money, the traders began to issue the documents which were taken as titles of money. This system gave rise to the institution of "Hundi" which means a letter of transfer whereby a merchant directs another merchant to pay the bearer of Hundi the specified amount of money in the Hundi and debit this amount against the drawer of Hundi.
- ii) The Goldsmiths: The second stage in the growth of banking was the role of goldsmiths. The business of goldsmiths was such that he had to secure safe to protect the gold against theft and take special precautions. In a period when paper was not in circulation and the money consisted of gold and silver, the people started leaving their precious bullion and coins in the custody of goldsmiths. As this practice spread, the goldsmiths started charging something for taking care of the gold and silver. As the evidence of receiving valuables, he stared to issue a receipt. Since the gold and silver coins had no mark of the owners, the goldsmiths started lending them. The goldsmiths were prepared to issue an equal amount of gold or silver money to the receipt holder, the goldsmith receipts became like cheques as a medium of exchange and a means of payment by one merchant to the other merchant.
- the money lenders: The third stage in the growth of banking system is the changing of the character of goldsmiths into that of the money lenders. With the passing of time and on the basis of experience the goldsmiths found that the withdrawals of coins were much less than the deposits with them and it was not necessary to hold the whole of the coins with them. After keeping the contingency reserve, the goldsmiths started advancing the coins on loan by charging interest. In this way the goldsmith money lender became a banker who started performing two important functions of the modern banking system that of accepting deposits and

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advancing loans. The only difference is that now it is the paper money and then its was gold or silver coins.

# 13.2 Meaning and Definition of a Bank

It is very difficult to give a precise definition of a bank due to the fact that a modern bank performs a variety of functions. Ordinarily a 'Bank' is an institution which deals with the money and credit in such a manner that it accepts deposits from the public and makes the surplus funds available to those who need them, and helps in remitting money from one place to another safely. Different economists have given different definition of a bank. Some of the important definitions are as under:

"A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it."

#### **G.Crother**

"Banking means the accepting for the purpose of Indian companies lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise."

### The Banking Companies (Regulation) Act, 1949

An ideal definition of a bank can be given as "A bank is a commercial establishment which deals in debts and aims at earning profits by accepting deposits from general public at large, which is repayable on demand or otherwise through cheques or bank drafts and otherwise which are used for lending to the borrowers or invested in Government securities."

## 13.3 Types of Banks

Banks are of various types and can be classified:

- A. On the basis of Reserve Bank Schedule.
- B. On the basis of ownership.
- C. On the basis of domicile.

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- D. On the basis of functions.
- **A.** On the basis of Reserve Bank Schedule: Bank can be of the two types on the basis of Second Schedule of the Reserve Bank of India Act, 1934 : (i) Scheduled Banks and (ii) Non-scheduled Banks.
- i) Scheduled Banks: All those banks which are included in the list of Schedule Second of the Reserve Bank of India are called the Scheduled Bank. Only those banks are included in the list of scheduled banks which satisfy the following conditions:
  - a) That it must have a paid up capital and reserves of Rs.5 lakhs.
  - b) That it must ensure the Reserve Bank that its operations are not detrimental to the interest of the depositors.
  - c) That it must be a corporation or a cooperative society and not a single owner firm or a partnership firm.
- **ii)** Non-scheduled Banks: The banks which are not included in the second schedule of the Reserve Bank of India Act, 1934 are called non-scheduled banks. They are not included in the second schedule because they does not fulfill the three preconditions laid down in the act to qualify for the induction in the second schedule.
- **B.** On the basis of Ownership: Banks can be classified on the basis of ownership in the following categories: (i) Public Sector Banks (ii) Private Sector Banks and (iii) Cooperative Banks
- i) Public Sector Banks: The banks which are owned or controlled by the Government are called "Public Sector Banks". In 1955 the first public sector commercial bank was established by passing a special Act of Parliament which is known as State Bank of India. Subsequently the Government took over the majority of shares of other State Banks which were operating at the state levels namely State Bank of Patiala, State Bank of Bikaner & Jaipur, State bank of Travancore, State Bank of Mysore, State Bank

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of Indore, State Bank of Saurashtra and State Bank of Hyderabad presently working as subsidiaries of State Bank of India.

In the field of banking, the expansion of public sector was marked with the nationalization of 14 major commercial banks by Mrs. Indira Gandhi on July 19, 1969 through an ordinance. Again on April 15, 1980 another group of 6 commercial banks were nationalized with the deposits Rs.200 crores each, resulting in the total of 20 such banks. But due to the merger of New Bank of India with the Punjab National Bank in 1993-94, the number of nationalized bank has been reduced to 19. The State Bank of India and its seven subsidiaries had already been nationalized. The progressive nationalization of bank has increased the role of public sector banking in the country.

Under the new liberalization policy of the Government, The Oriental Bank of Commerce, State Bank of India, Corporation Bank, Bank of India and Bank of Baroda have offered their share to the general public and financial institutions and therefore these banks are no longer 100% owned by Government of India. Although majority of the shares is still with the Government, therefore these are still public sector banks.

- those banks which are owned and controlled by the private sector i.e. private individuals and corporations. The private sector played a strategic role in the growth of joint stock banks in India. In 1951 there were in all 566 private sector banks of which 92 banks were scheduled banks and the remaining 474 were non-scheduled banks. At the time there was not even a single public sector bank. With the nationalization of banks in 1969 and 1980 their role in commercial banking had declined considerably. Since then the number of private sector banks is decreasing and the number of public sector banks is increasing.
- *iii)* **Co-operative Banks**: The word 'cooperative' stands for working together. Therefore cooperative banking means an institution which is

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established on the principle of cooperation dealing in ordinary banking business. Cooperative banks are special type of banks doing ordinary banking business in which the members cooperate with each other for the promotion of their common economic interests.

**Features of Cooperative Banking:** Following are the distinguishing main features of a cooperative bank:-

- i) Membership of Cooperative Banks is voluntary.
- ii) Functions of a Cooperative Bank are common banking functions.
- iii) Organization and management of a Cooperative Bank is based on democratic principles.
- iv) Main objectives of a Cooperative bank are to promote economic, social and moral development of its members.
- v) Basic principle of Cooperative Bank is equality.
- C) On the basis of domicile: The banks can be classified into the following two categories on the basis of domicile: (i) Domestic Banks and (ii) Foreign Banks.
- *i)* **Domestic Banks:** Those banks which are incorporated and registered in the India are called domestic banks.
- ii) Foreign Banks: Foreign Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having business branches in India. Foreign Banks are also known as Foreign Exchange Banks or Exchange Banks. Traditionally these banks were set up for financing the foreign trade in India and discounting the foreign exchange bills. But now these banks

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are also accepting deposits and making advances like other commercial banks in India.

- **D)** On the basis of functions: The banks can be classified on the basis of functions in the following categories: (i) Commercial Banks (ii) Industrial Banks (iii) Agricultural Banks (iv) Exchange Banks and (v) Central Bank.
- i) Commercial Banks: Commercial Banks are those banks which perform all kinds of banking business and functions like accepting deposits, advancing loans, credit creation, and agency functions for their customers. Since their major portion of the deposits are for the short period, they advance only short term and medium term loans for business, trade and commerce. Majority of the commercial banks are in the public sector. Of late they have started giving long term loans also to compete in the commercial money market.
- ii) Industrial Banks: The Industrial banks are those banks which provide medium term and long term finance to the industries for the purchase of land and building, plant and machinery and other industrial equipment. They also underwrite the shares and debentures of the industries and also subscribe to them. The main functions of an Industrial Banks are as follows:
  - i) They provide long term finance to the industries to purchase land and buildings, plant and machinery and construction of factory buildings.
  - ii) They also accept long term deposits.
  - iii) They underwrite the shares and debentures of the industry and sometimes subscribe to them.

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In India there are number of financial institutions which perform the function of an Industrial Bank. Major financial institutions are as under:-

- i) Industrial Development Bank of India (IDBI)
- ii) Industrial Finance Corporation of India (IFCI)
- iii) State Industrial Development Corporation such as Haryana State Industrial Development Corporation (HSIDC)
- *iii)* Agriculture Banks: The needs of agricultural credit are different from that of industry, business, trade and commerce. Commercial banks and industrial banks do not deal with agriculture credit financing. An agriculturist has both type of needs:
  - i) He requires short term credit to purchase seeds, fertilizers and other inputs and
  - ii) He also requires long term credit to purchase land, to make permanent improvement on land, to purchase agricultural machinery and equipment such as tractors etc.

Agricultural credit is generally provided in India by the Cooperative institutions. The Cooperative Agricultural Credit Institutions are divided into two categories:-

- A) Short term agricultural credit institutions and
- B) Long term agricultural credit institutions
- A) Short term agricultural credit institutions: The short term agricultural credit institutions cater to the short term financial needs of the agriculturists which have the following three tier federal structure:-

a) At the Village level : Primary Agricultural Credit Societies

b) At the District level : Central Cooperative Banks

c) At the State level : State Cooperative Banks

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- B) Long term agricultural credit institutions: The long term agricultural credit is provided by the Land Development Banks which were earlier known as Land Mortgage Banks. The land development banks provide long term to agriculturists for a period ranging from 5 years to 25 years.
- iv) Exchange Banks: The exchange banks are those banks which deal in foreign exchange and specialised in financing the foreign trade.

  Therefore, they are also called foreign exchange banks. Foreign Exchange Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having business branches in India.
- v) Central Bank: The Central Bank is the apex bank of a country which controls, regulates and supervises the banking, monetary and credit system of the country. The Central Bank is owned and controlled by the Government of the country. The Reserve Bank of India is the Central Bank in India. The important function of central bank are as follows:
  - i) It acts as banker to the Government of the country.
  - ii) It also acts as agent and financial advisor to the Government of the country.
  - iii) It has the monopoly to issue currency of the country.
  - iv) It serves as the lender of the last resort.
  - v) It acts as the clearing house and keeps cash reserves of commercial banks.

## 13.4 Functions of Commercial Banks

The Commercial Banks perform a variety of functions which can be divided in the following three categories namely (a) Basic Functions (b) Agency Functions and (c) General Utility Functions

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1. **Basic Functions:** The basic functions of bank are those functions without performing which an institution cannot be called a banking institution at all. That is why these functions are also called primary or acid test function of a bank. The basic/primary/acid test function of a bank are Accepting Deposits, Advancing of Loans and Credit Creation.

- a) Accepting Deposits: The first and the most important function of a bank is to accept deposits from those people who can save and spare for the safe custody with the bankers. It serves two purposes for the customers. On one hand their money is safe with the bank without any fear of theft and on the other hand they also earn interest as per the kind of saving they have made. For this purpose the banks have different kinds of deposit accounts to attract the people which are as Saving Deposit Account, Fixed Deposit Account, Current Deposit Account, Recurring Deposit Account and Home Loan Account.
- i) Saving Deposit Account: The Saving Bank Account is the most common bank account being utilized by the general public. The basic purpose of this account is to mobilize the small savings of the general public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and amount to be withdrawn in a given period of time. Generally the rate of interest paid by the bank on these deposits is low as compared to recurring or fixed deposit account. Cheque facility is also provided to the depositors with certain extra restrictions on the depositors.
- *ii)* Fixed Deposit Account: This is an account where money can be deposited for a fixed period of time say one year or two years or three years of five years and so on. Once the money is deposited for a fixed

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period of time, the depositor is prohibited from withdrawal of money from the bank before the expiry of the stipulated period of time. The basic advantage to be customer is that he is offered interest at the higher rate of interest and the banker is free to utilize the money for that fixed period.

- the number of withdrawals that can be made. Therefore it does not suit to the needs of traders and businessmen who has to make several payments daily and deposits money in a similar manner. Therefore, there is a facility for them in the shape of another account called Current Deposit Account. Money from this account can be withdrawn by the account holder as many times as desired by the customer. Normally bank does not pay any interest on these current accounts, rather some incidental charges are charged by the banker as service charges. These accounts are also called demand deposits or demand liabilities.
- **Recurring Deposit Account:** To encourage regular savings by the general public, another account is opened in the banks called Recurring Deposit Account. This account is preferred by the fixed income group, because a particular amount fixed at the time of opening the account has to be deposited in the account every month for a stipulated period of time. Generally the bank pays rate of interest higher than that of a saving account and just equal to the fixed deposit account on such recurring deposit accounts.
- w) Home Loan Account: Home loan account facility has been introduced in some scheduled commercial banks to encourage savings for the purchasing of or construction of a house to live. In this account the customer is required to deposit a particular amount per month or half yearly or even yearly for a period of five years. After the stipulated period bank provide three to five times of the deposited amount a loan to the subscribers to purchase or construct a house. Rate of interest is also very attractive on this account nearly equal to that of the fixed deposit account. Even the rebate of Income Tax is also available on the amount contributed in this account under Section 88 of the Income Tax Act, 1961. Facility to close the account after the stipulated period of time is also allowed.

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- b) Advancing of Loans: Advancing of loans is the second acid test function of the commercial banks. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. It is one of the primary functions without which an institution can not be called a bank. The bank lends a certain percentage of the cash lying in the deposits on a higher rate of interest than it pays on such deposits. The longer the period for which the loan is required the higher is the rate of interest. Similarly higher the amount of loan, the higher shall be the rate of interest. Before advancing the loans the bank satisfy themselves about the credit worthiness of the borrowers. This is how a bank earns profits and carries on its banking business. There are various types of loans which are provided by the banks to the borrowers. Some of the important ways of advancing loans are as (i) Call Money Advances (ii) Cash Credits (iii) Overdrafts (iv) Discounting Bills of Exchange and (v) Term Loans
- i) Call Money Advances: The Call Money Market which is also known as inter-bank call money market deals with very short period loans called call loans. The Call Money Market is a very important constituent of the organized money market which functions as an immediate source of very short term loans. The major suppliers of the funds in the call money market are All Commercial Banks, State Bank of India (SBI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC), Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI) and the major borrowers are the scheduled Commercial Banks. No collateral securities are required against these call money market loans.

As the participants are mostly banks, it is also called inter-bank call money market. The Scheduled Commercial Banks use their surplus funds to lend for very short

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period to the bill brokers. The bill brokers and dealers in the stock exchanges generally borrow money at call from the commercial banks. The bill brokers in turn use them to discount or purchase the bills. Such funds are borrowed at the call rate which varies with the volume of funds lent by the commercial banks. When the brokers are asked to pay off the loans immediately, then they borrow from SBI, LIC, GIC, and UTI etc. These loans are granted by the commercial banks for a very short period, not exceeding seven days in any case. The borrowers have to repay the loan immediately when ever the lender bank call them back.

- *ii)* Cash Credits: This is a type of loan which is provided to the businessmen against their current assets such as shares, stocks, bonds etc. These loans are not based on credit worthiness or personal security of the customers. The bank provides this loan through opening an account in the name of the customer and allows them to withdraw borrowed amount of loan from time to time upto the limit fixed by the bank which is determined by the value of security provided by the borrowers. Interest is charge only on the amount of money actually withdrawn from the banks and not on the amount of the sanctioned amount of loan.
- through current accounts for which the banks charge interest on the outstanding balance of the customers. A limit is fixed by the bankers for withdrawal of over drafts and the customer is not allowed to withdraw more than that limit from his Over Draft Current Account. This facility is required by the traders and businessmen because they issue several cheques in a day and similarly deposits so many cheques daily in their current accounts. They may not be knowing at a particular day that whether there is a balance in the account or not and their issued cheques are not dishonored so they are provided with the facility of overdrafts.

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- iv) **Discounting Bills of Exchange:** This is another popular type of lending by the commercial banks. A holder of a bill of exchange can get it discounted with a commercial bank. Bills of Exchange are also called the Commercial Bills and the market dealing with these bills is also called commercial bill market. Bills of exchange are those bills which are issued by the businessmen or firms in exchange of goods sold or purchased. The bill of exchange is a written unconditional order signed by the drawer (seller) requiring the drawee (buyer) to pay on demand or at a fixed future date, (usually three months after date written on the bill of exchange), a definite sum of money. After the bill has been drawn by the drawer (seller), it is accepted by the drawee (buyer) by countersigning the bill. Once the buyer puts his acceptance on the bill by signing it, it becomes a legal document. They are like post dated cheques issued by the buyers of goods for the goods received. The bill holder can get this bill discounted in the bill market if he wants the amount of the bill before its actual maturity. These bills of exchange are discounted and re-discounted by the commercial banks for lending credit to the bill brokers or for borrowing from the central bank. The bill of exchange market is not properly developed in India. The Reserve Bank of India introduced the bill market scheme in 1952. Its main aim was to provide finance against bills of exchange for 90 days. The scheduled commercial banks were allowed to convert a part of their advances into promissory notes for 90 days for lodging as collateral security for advances from Reserve Bank of India.
- v) Term Loan: Earlier the commercial banks were advancing only short term loans. The commercial banks have also started advancing medium term and long term loans. Now the maturity period of term loans is more than one year. The amount of the loan sanctioned is either paid to the

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borrower or it is credited to the account of the borrower in the bank. The interest is charged on the whole amount of loan sanctioned irrespective of the amount withdrawn by the borrower from his account. Repayment of the loan is accepted in lump sum or in the installments.

c) Credit Creation: Credit Creation is one of the basic functions of a commercial bank. A bank differ from the other financial institutions because it can create credit. Like other financial institutions the commercial banks also aim at earning profits. For this purpose they accept deposits and advance loans by keeping a small cash in reserve for day-to-day transactions. In the layman's language when a bank advances a loan, the bank creates credit or deposit. Every bank loan creates an equivalent deposit in the bank. Therefore the credit creation means multiple expansion of bank deposits. The word creation refers to the ability of the bank to expand deposits as a multiple of its reserves.

The credit creation refers to the unique power of the banks to multiply loans and advances, the hence deposits. With a little cash in hand, the banks can create additional purchasing power to a considerable extent. It is because of this multiple credit creation power that the commercial banks have been named the "factories of creating credit" or manufacturers of money.

- 2. **Agency Functions:** The commercial banks also perform certain agency functions for and on behalf of their customers. The bank acts as the agent of the customer while performing these functions. Such services of the banks are called agency services. Some of the important agency services are as under
- i) Remittance of funds: Commercial banks provide a safe remittance of funds of their customers from one place to another through cheques, bank drafts, telephone transfers etc.

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ii) Collection and Payment of Credit Instruments: The commercial banks used to collect and pay various negotiable instruments like cheques, bills of exchange, promissory notes, hundis, etc.

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- *iii)* **Execution of Standing Orders**: The commercial banks also execute the standing orders and instruments of their customers for making various periodic payments like subscriptions, rents, insurance premiums and fees on behalf of the customers out of the accounts of their customers.
- *iv)* Purchase and Sale of Securities: The commercial banks also undertake the sale and purchase of securities like shares, stocks, bonds, debentures etc., on behalf of their customers performing the function as a broker agent.
- v) Collection of dividends on shares and interest on debentures: Commercial banks also make collection of dividends announces by the companies of which the customer of the bank is a shareholder, and also collects the interest on the debentures which becomes due on particular dates generally half yearly or annually.
- vi) Trustees and Executors of wills: The commercial banks preserves the wills of their customers as their trustees and execute the wills after the death of the customer as per the will as the executors.
- vii) Representation and Correspondence: The commercial banks also act as the representative and correspondents of their customers and get passports, traveler's tickets, book vehicles and plots for their customers on the directions of the customers.
- 3. General Utility Functions: In addition to basic functions and agency functions the commercial banks also provide general utility services for their customers which are needed in the various walks of life and the commercial banks provide a helping hand in solving the general

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problems of the customers, like safety from loss or theft and so many other facilities some them are locker facility, traveler's cheque facility, gift cheque facility, letter of credit, underwriting contract, provides statistical data, foreign exchange facilities, merchant banking services and acting as referee.

## 13.5 Meaning of Financial Institutions

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize saving of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities (individual, business, government) seeking advice on various issues ranging from restructing to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere.

Financial Institutions are also termed as financial intermediaries because they act as middlemen between the savers (by accumulating funds from them) and borrowers (by lending these funds). Banks also act as intermediaries because they accept deposits from a set of customers (savers) and lend these funds to another set of customers (borrowers). Like-wise investing institutions such as GIC, LIC, mutual funds etc. also accumulate savings and lend these to borrowers, thus performing the role of financial intermediaries.

Financial institution's role as intermediary differs from that of a broker who acts as an agent between buyer and seller of a financial instrument (equity shares, preference, debt); thus facilitating the transaction but does not personally issue a financial instrument. Whereas, financial intermediaries mobilize savings of the surplus units and lend them to the borrowers in the form of loans and advances (i.e. by creating a financial asset). They earn profit from the difference between rate of interest charged on loans and rate of interest paid on deposits (savings). In short, they repackage the depositor's savings into loans to the borrowers. As financial intermediaries, they meet the short-term as well as

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long-term needs of the borrowers and provide liquidity to the savers. Deposits are payable on demand by the customers. Banks are in a position to avoid the situation of ill-liquidity while borrowing for short periods and lending for long term by mobilizing savings from diversified set of depositors. RBI also has made it mandatory for the banks to keep a certain percentage of deposits as cash reserves with itself to avoid the situation of ill-liquidity.

# 13.6 Types of Financial Institutions

Financial institutions can be classified into two categories:

- I. Banking Institutions
- II. Non-Banking Financial Institutions

### I. Banking Institutions

Indian banking industry is subject to the control of the Central Bank (i.e. Reserve Bank of India). The RBI as the apex institution organizes, runs, supervises, regulates and develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulation Act, 1949. The Indian banking institutions can be broadly classified into two categories:

- 1. Organized Sector
- 2. Unorganized Sector
- 1. Organized Sector: The organized banking sector consists of commercial banks, cooperative banks and the regional rural banks.
- (a) Commercial Banks: The commercial banks may be scheduled banks or non-scheduled banks. At present only one bank is a non-scheduled bank. All other banks are scheduled banks. The commercial banks consist of 27 public sector banks, private sector banks and foreign banks.

Traditionally, commercial banks accepted deposits and met the short and medium term funding needs of the industry. But now, since 1990's, banks are also funding the

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long terms needs of the industry particularly the infrastructure sector. The liberalization measures initiated in the Indian economy, led to the entry of large private sector banks in 1993. This has increased competition among public sector banks and quality of services has improved. A major development in the Indian banking industry was the entry of major banks in merchant banking. The merchant bankers are financial intermediaries providing a range of financial services to the corporate and investors. Some of the merchant banker's activities include issue management and underwriting, project counseling and finance, mergers and acquisition advice, portfolio management service etc.

**(b) Co-operative Banks**: An important segment of the organized sector of Indian banking is the co-operative banking. The segment is represented by a group of societies registered under the Acts of the States relating to co-operative societies. In fact, co-operative societies may be credit societies or non-credit societies.

Different types of co-operative credit societies are operating in the Indian economy. These institutions can be classified into two broad categories: (a) Rural credit societies which are primarily non-agricultural. For the purpose of agricultural credit there are different co-operative credit institutions to meet different kinds of needs. For example, short and medium term credit is provided through three tier federal structure. At top is the apex body i.e., state co-operative bank; in the middle there are district co-operative banks or central co-operative banks, at the grass root level i.e., village level there are primary agricultural credit societies. For medium to long terms loans to agriculture, specialized co-operative societies have been formed. These are called 'Land Development Banks'. The Land Development Banks movement started in 1929. In the beginning they were named "Central Land Mortgage Banks". Land development banking is a two tier structure. At the state level there are state or central land development banks. At local level there are branches of these banks and primary land development banks. At the national level they have formed All-India Land Development Bank's Union.

(c) Regional Rural Banks (RRBs): Regional Rural Banks were set by the state government and the sponsoring commercial banks with the objective of developing the

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rural economy. Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas. The regional rural banks were set up with a view to provide credit facilities to weaker sections. They constitute an important part of the rural financial architecture in India. There were 196 RRBs at the end of June 2002, as compared to 107 in 1981 and 6 in 1975. RBI extends refinance assistance at a concessional rate of 3 per cent below the bank rate to RRBs. IDBI, NABARD and SIDBI are also required to provide managerial and financial assistance to RRBs under the Regional Rural Bank Act.

Government decided to restructure the RRB's on the recommendation of Bhandari Committee in 1994-95. As a result, an amount of Rs.360 crores was allocated towards the restructuring programme. The State Bank of India took several measures of managerial and financial restructuring including enhancement of issued capital and placement of officers of proven ability to head the RRBs. NABARD took several policy measures such as quarterly / half yearly review of RRBs by the sponsor banks, framing of Appointment and Promotion Rules (1998) for the staff of RRBs, introduction of Kissan Credit Cards, introduction of self-help groups etc., for improving the overall performance of RRBs.

(d) Foreign Banks: Foreign Banks have been in India from British days. ANZ Grindlays Bank has its presence in number of places with 56 branches. The Standard and Chartered Bank has 24 branches and Hongkong Bank has 21 branches. All other foreign banks have branches less than 10. Obviously, these banks have concentrated on corporate clients and have been specializing in area relating to international banking. With the deregulation of banking in 1993, a number of foreign banks are entering India or have got the licenses. Such new foreign banks are: Barclays Bank, Bank of Ceylon,Bank Indonesia International, State Commercial Bank of Mauritius, Development Bank of Singapore, Chase Manhattan Bank, Dresdner Bank, Overseas Chinese Bank Corporation, Chinatrust Commercial Bank, Krug Thai Banking Public Company Ltd., Cho Hung Bank, Commerz Bank, Fuji Bank and Toronto Dominion Bank. The list is indicative of the fact that India is going to have greater presence of foreign banks in future. However,

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despite low deposits these foreign banks reflect greater degree of efficiency and productivity.

- 2. **Unorganized Sector:** In the unorganized banking sector are the indigenous bankers, money lenders, seths, sahukars carrying out the function of banking.
- (a) Indigenous Bankers: Indigenous bankers are the fore gathers of modern commercial banks. These are the individuals or partnership firms performing the banking functions. They also act as financial intermediaries. As the term indigenous indicates, they are the local bankers. The geographical area covered by the indigenous bankers is much larger than the area covered by commercial banks. They can be found in all parts of the country although their names, styles of functioning and the functions performed by the them may differ. In west India they may be known as Gujarati shroffs or Marwar, in South India they may be called Chettiars, in North India they may be called sahukars, etc.

Indigenous bankers provide finance for productive purpose directly to trade and industries, and indirectly, through money lenders and traders to agriculturists with whom they find it difficult to establish direct relations. They keep in touch with traders and small industrialists and finance marketing on a sizeable scale. Lending is conducted on the basis of promissory notes, or receipts signed by borrowers acknowledging loans, and stating the agreed rate of interest, or bonds written out on stamped legal forms, or through signing of bankers books by borrowers. For large land, houses or other property are held as mortgage.

**(b) Money Lenders**: Money lenders depends entirely on their own funds for the working capital. Money lenders may be rural or urban, professional or non-professional. They include large farmers merchants, traders, arhatias, goldsmiths, village shopkeepers, sardars of labourers, etc. The methods and areas of operation differ from money lender to money lender.

### II NON-BANKING INSTITUTIONS

The non-banking institutions may be categorized broadly into two groups:

(a) Organized Financial Institutions.

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- (b) Unorganized Financial Institutions.
- (a) **Organized Financial Institutions:** The organized non-banking financial institutions include:
- **1. Development Finance Institutions**: These include:
- (a) The institutions like IDBI, ICICI, IFCI, IIBI, IRDC, at all India level.
- (b) State Finance Corporation (SFCs), State Industrial Development Corporation (SIDCs) at the state level.
- (c) Agriculture Development Finance Institutions as NABARD, Land Development Banks etc.

Development banks provide medium and long term finance to the corporate and industrial sector and also takes up promotional activities for economic development of the country.

- 2. Investment Institutions: It includes those financial institutions which mobilize savings of the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, UTI, and mutual funds.
- (b) Unorganized Financial Institutions: The unorganized non-banking financial institutions include number of non-banking financial companies (NBFCs) providing whole range of financial service. These include hire-purchase and consumer finance companies, leasing companies, housing finance companies, factoring companies, credit rating agencies, merchant banking companies etc. NBFCs mobilize public funds and provide loanable funds. There has been remarkable increase in the number of such companies since 1990's.

#### 13.7 SETTING UP OF FINANCIAL INSTITUTIONS

Government control over the sources of credit and finance led to the establishment of many financial institutions in the public sector. The main objective was to provide medium and long-term industrial finance to the corporate sector. These financial institutions included:

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### **Development Finance Institutions**

Development banks are the institutions engaged in the promotion and development of industry, agriculture and other key sector. A number of development finance institutions at National/All India Level as well as Regional/State Level were set up.

The foreign rulers in India did not take much interest in the industrial development of the country. They were interested to take raw materials to England and bring back finished goods to India. The Government did not show any interest for setting up institutions needed for industrial financing. The recommendation for setting up industrial financing institutions was made in 1931 by Central Banking Enquiry Committee but no concrete steps were taken. In 1948, Reserve Bank had undertake a detailed study to find out the need for specialized institutions. It was in 1948 that the first development bank i.e. industrial Finance Corporation of India (IFCI) was established. IFCI was assigned the role of a gap- filler which implied that it was not expected to compete with the existing channels of industrial finance. It was expected to provide medium and long term credit in industrial concerns only when they could not raise sufficient finances by raising capital or normal banking accommodation.

In view of the vast size of the country and needs of the economy it was decided to set up regional development banks to cater to the needs of the small and medium enterprises. In 1951, Parliament passed State Financial Corporation Act. Under this Act state governments could establish financial corporation for their respective regions. At present there are 18 State Financial Corporations (SFC's) in India.

The IFCI and State Financial Corporation served only a limited purpose. There was a need for dynamic institution which could operate as true development agencies. National Industrial Development Corporation (NIDC) was established in 1954 with the objective of promoting industries which could not serve the ambitious role assigned to it and soon turned to be a financing agency restricting itself to modernization and rehabilitation of cotton and jute textile industries.

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The Industrial Credit and Investment Corporation India Ltd. (ICICI) was established in 1955 as a joint stock company. ICICI was supported by Government of India, World Bank, Common Wealth Development Finance Corporation and other foreign institutions. It provides term loans and take an active part in the underwriting of and direct investment in the shares of industrial units. Though ICICI was established in private sector but its pattern of shareholding and methods of raising funds gives it the characteristic of a public sector financial institution. ICICI Ltd. has now merged into ICICI Bank.

Another institution, Refinance Corporation for Industry Ltd. (RCI) was set up in 1958 by Reserve Bank of India, LIC and Commercial Banks. The purpose of RCI was to provide refinance to commercial banks and SFC's against term loans granted by them to industrial concerns in private sector. In 1964, Industrial Development Bank of India (IDBI) was set up as an apex institution in the area of industrial finance. RCI was merged with IDBI, IDBI was a wholly owned subsidiary of RBI and was expected to co-ordinate the activities of the institutions engaged in financing, promoting to developing industry. However, it is no longer a wholly owned subsidiary of the Reserve Bank of India. Recently it made a public issue of shares to increase its capital.

In order to promote industries in the state another type of institutions, namely, the State Industrial Development Corporations (SIDC's) were established in the sixties to promote medium scale industrial units. The state owned corporation have promoted a number of projects in the joint sector and assisted sector. At present there are 28 SIDC's in the country. The State Small Industries Development Corporations (SSIDC's) were also set up to cater to the needs of industry at state level. These corporations manage industrial estates, supply raw materials, run common service facilities and supply machinery on hire-purchase basis. Some states have established specialized corporations for the development of infrastructure, agro–industries, etc.

#### **Investing Institutions**

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A number of other institutions also participated in industrial financing by mobilizing public savings through introduction of insurance schemes, mutual funds, units etc. These institutions also called investing included Unit Trust of India (UTI) established in 1964, Life Insurance Corporation of India in 1956 and General Insurance Corporation in 1973.

#### **Other Institutions**

Some more units were set up to provide help in specific areas such as rehabilitation of sick units, export finance, agriculture and rural development. Industrial Reconstruction Corporation of India Ltd. (RCI) was set up in 1971 for the rehabilitation of sick units. In 1982 the Export – Import Bank of India (Exim Bank) was established to provide financial assistance to exporters and importers. In order to meet credit needs of agriculture and rural sector, National Bank for Agriculture and Rural Development (NABARD) was set up in 1982. It is responsible for short term, medium – term and long term financing of agriculture and allied activities. The institutions such as Film Finance Corporation, Tea Plantation Finance Scheme, Shipping Development Fund, Newspaper Finance Corporation, Handloom Finance Corporation, Housing Development Finance Corporation also provide financial and other facilities in various areas.

Indian financial system has undergone massive changes since the announcement of new economic policy in 1991. Liberalization/globalisation/deregulation has transformed Indian economy from closed to open economy. The corporate industrial sector structure has also undergone changes due to deli censing of industries, financial sector reforms or reforms in banking/capital market, disinvestments in public sector undertakings(PSUs), reforms in taxation and company law etc. Government role in the distribution of finance and credit has declined over the years. Financial system is focusing more attention towards the development of capital market which is emerging as the main agency for the allocation of resources among the public, private sector and state government. Major development that have taken place in the Indian financial system are briefly discussed below:

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1. Entry of Private Sector: Since 90's, Government control over financial institutions has diluted in a phased manner. Public/Development Financial Institutions have been converted into companies, allowing them to issue equity/bonds to the public. Government has allowed private sector to enter into banking and insurance sector. IFCI has been converted into a public company.

- **2.** Changing Role of Development Finance Institutions (DFIs): DFIs performed the role of term-lending institutions extending loans for project finance, underwriting, direct subscription, lease financing etc. They received funds from the Government and the RBI. But now, there is remarkable shift in the activities of DFIs:
- (a) DFIs are engaged in non-fund based financial activities such as merchant banking, project counseling, portfolio management services, mergers and acquisitions, new issue management etc.
- (b) DFIs raise funds through issue of bonds carrying floating rate of interest or bonds without government guarantee.
- (c) Earlier, DFIs sponsored infrastructural institutions such as Technical Consultancy Organisation (TCOs), Management Development Institution (MDI) and The Institute for Financial Management and Research (IFMR). Then, focus shifted to development of capital market. As a result, following institutions were promoted by the DFIs.
  - (i) Credit Rating Information Services of India Ltd. (CRISIL).
  - (ii) Investment Information and Credit Rating Agency Ltd. (ICRA)
  - (iii) Credit Analysis and Research Ltd. (CARE)
  - (iv) Over the Counter Stock Exchange of India. (OTCEI) Ltd.
  - (v) National Stock Exchange (NSE) Ltd.
  - (vi) Stock Holding Corporation of India (SHCI) Ltd.
  - (vii) IFCI Financial Services Ltd.

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- (viii) IFCI Investors Services Ltd.
- (ix) IFCI Custodial Services Ltd.
- (x) ICICI- Securities and Finance Ltd.
- 3. Emergence of Non- Banking Financial Companies (NBFCs): In the unorganized non-banking sector, number of non-banking financial companies have emerged providing financial services partly fee-based and partly asset/fund based. Their activities include equipment leasing, hire-purchase finance, bills discounting, loans/investments, venture capital, housing finance etc. Fee based services include portfolio management, issue management, loan syndication, merger and acquisition etc.
- 4. Growth of Mutual Funds Industry: Initially, UTI was the single organisation issuing the mutual funds units. But presently, the mutual funds are sponsored not only by UTI but also by banks, insurance organisation. FIIs, private sector. There are off-share/country funds being sponsored by FIIs and Indian FIs. Mutual funds are gaining popularity among the small investors due to (i) tax exemption on income from mutual funds and (ii) units of mutual funds if held for 12 months are to be treated as long-term asset, for the purpose of capital gains tax.
- **5. Securities and Exchange Board of India (SEBI) :** The Securities and Exchange Board of India was established under the SEBI Act, 1992 with the following purposes : -
  - (i) to protect the interest of investors in securities;
  - (ii) to promote the development of the securities market;
  - (iii) to regulate the securities market; and
  - (iv) for matters connected therewith or incidental thereto.

#### **Significant Changes in Financial System**

Some of the significant changes that have taken place over the last few years and that may have implications on the Indian financial system are listed below.

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- 1. The Unit Trust of India, the leading mutual fund organisation has been split into two parts as a consequence of the repeal of the UTI Act.
- 2. Private sector has been allowed in the insurance sector thus breaking the monopoly of LIC and GIC. GIC has been delinked from its four subsidiaries.
- 3. The introduction of derivative trading including index/stock/interest futures and options has also been one of the significant development having implications on the financial system.
- 4. The merger of the ICICI Ltd. and IDBI into ICICI Bank and IDBI and respectively and the proposed merger of IFCI into Punjab National Bank.

#### 13.8 ROLE AND IMPORTANCE OF FINANCIAL INSTITUTIONS

Financial institutions (intermediaries) are business organisations serving as a link between savers and investors and so help in the credit–allocation process. Good financial institutions are vital to the functioning of an economy. If finance were to be described as the circulatory system of the economy, financial institutions are its brain. They make decisions that tell scarce capital where to go and ensure that it is used most efficiently. It has been confirmed by research that countries with developed financial institutions grow faster and countries with week ones are more likely to undergo financial crises.

Lenders and borrowers differ in regard to terms of risk, return and term of maturity. Financial institutions assist in resolving this conflict between lenders and borrowers by offering claims against themselves and, in turn, acquiring claims on the borrowers. The former claims are referred to as indirect (secondary) securities and the latter as direct (primary) securities.

Financial institutions provide three transformation services:

(i) Liability, asset and size transformation consisting of mobilization of funds, and their allocation by providing large loans on the basis of numerous small deposits.

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- (ii) Maturity transformation by offering the savers tailor-made short-term claims or liquid deposits and so offering borrowers long-term loans matching the cash flows generated by their investment.
- (iii) Risk transformation by transforming and reducing the risk involved in direct lending by acquiring diversified portfolios.

Through these services, financial institutions are able to tap savings that are unlikely to be acceptable otherwise. Moreover, by facilitating the availability of finance, financial institutions enable the consumer to spend in anticipation of income and the entrepreneur to acquire physical capital.

Financial institutions provide means and mechanism of transferring resources from those who have an excess of income over expenditure to those who can make productive use of the same. The commercial banks and investment institutions mobilize savings of people and channelize them into productive uses. Economic development of a country needs sufficient financial resources, adequate infrastructural faculties and persons who can take the initiative of setting up units for providing goods and services. Financial institutions provide all types of assistance required for development. These institutions help economic development in the following ways:

- 1. Providing Funds. The underdeveloped countries have low levels of capital formation. Due to low incomes, people are not able to save sufficient funds which are needed for setting up new units and also for expansion, diversification and modernization of existing units. These persons who have the capability of starting a business but does not have requisite help approach financial institutions for help. These institutions help large number of persons for taking up some industrial activity. The addition of new industrial units and increasing the activities of existing units will certainly help in accelerating the pace of economic development. Financial institutions have large investible funds which are used for productive purpose.
- 2. Infrastructural Facilities. Economic development of a country is linked to the availability of infrastructural facilities. There is a need for roads, water, sewerage,

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communication facilities, electricity etc. Financial institutions prepare their investment policies by keeping national priorities in mind. The institutions invest in those areas which can help in increasing the development of the country. Indian industry and agriculture is facing acute shortage of electricity. All Indian institutions are giving priority to invest funds in projects generating electricity. These investments will certainly increase the availability of electricity. Small entrepreneurs cannot spare funds for creating infrastructural facilities. To overcome this problem institutions at state level are developing industrial estates and provide sheds, having all facilities, at easy installments. So financial institutions are helping in the creation of all those facilities which are essential for the development of a country.

- 3. Promotional Activities. An entrepreneur faces many problems while setting up a new unit. One has to undertake a feasibility report, prepare project report, complete registration formalities, seek approval from various agencies etc. All these things require time, money and energy. Some people are not able to undertake this exercise or some do not even take initiative. Financial institutions have the expertise and manpower resources for undertaking the exercise of starting a new unit. So these institutions take up this work on behalf of entrepreneurs. Some units may be set up jointly with some financial institutions and in that case the formalities are completed collectively. Some units may not have come up had they not received promotional help from financial institutions. The promotional role of financial institutions is helpful in increasing the development of a country.
- 4. Development of Backward Areas. Some areas remain neglected because facilities needed for setting up new units are not available there. The entrepreneurs set up new units at those places which are already developed. It causes imbalance in economic development of some areas. In order to help the development of backward areas, financial institutions provide special assistance to entrepreneurs for setting up new units in these areas. IDBI, IFCI, ICICI give priority in giving assistance to units set up in backward areas and even charge lower interest rates on lending. Such efforts certainly encourage entrepreneurs to set up new units in backward areas. The industrial units in the

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these areas improve basic amenities and create employment opportunities. These measures will certainly help in increasing the economic development of backward areas.

- 5. Planned Development. Financial institutions help in planned development of the economy. Different institutions earmark their spheres of activities so that every business activity is helped. Some institutions like SIDBI, SFC's especially help small scale sector while IFCI and SIDC's finance large scale sector or extend loans above a certain limit. Some institutions help different segments like foreign trade, tourism etc. In this way financial institutions devise their roles and help the development in their own way. Financial institutions also follow the development priorities set by central and state Governments. They give preference to those industrial activities which have been specified in industrial policy statements and in five year plans. Financial institutions help in the overall development of the country.
- 6. Accelerating Industrialization. Economic development of a country is linked to the level of industrialization there. The setting up of more industrial units will generate direct and indirect employment, make available goods and services in the country and help in increasing the standard of living. Financial institutions provide requisite financial, managerial, technical help for setting up new units. In some areas private entrepreneurs do not want to risk their funds or gestation period is long but the industries are needed for the development of the area, financial institutions provide sufficient funds for their development. Since 1947, financial institutions have played a key role in accelerating the pace of industrialization. The country has progressed in almost all areas of economic development.
- 7. Employment Generation. Financial institutions have helped both direct and indirect employment generation. They have employed many persons to man their offices. Besides office staff, institutions need the services of experts which help them in finalizing lending proposals. These institutions help in creating employment by financing new and existing industrial units. They also help in creating employment opportunities in backward areas by encouraging the setting up of units in those areas. Thus financial institutions have helped in creating new and better job opportunities.

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In India, various financial institutions were set up after independence. The Government of India has taken steps to set up institutions which assist various sectors of the economy. The working of some financial institutions is discussed in the following pages:

#### 1. IFCI and Industrial Finance

#### Financial Assistance

The sanctions of financial assistance by IFCI went up to Rs.6579.7 crores in 1995-96 from Rs.32.3 crores in 1970-71. But it declined to Rs. 778.0 crores by 2001-02. The figures in Table show that the sanctions of financial assistance again went up to Rs. 2035.1 in 2002-03 crores registering an increase of 161.6% over the last year. Up to March 2003, total sanctioned assistance was Rs. 45426.7 crore while disbursements were Rs. 44169.2 crore.

Tab	ole I : Trend in As	ssistance Sancti	oned and Disbur	sed
				(Rs. Crore)
Year	Sanctions	Growth Rate (%)	Disbursements	Growth Rate (%)
1970-71	32.3	1400 (70)	17.4	11000 (73)
1971-72	28.7	-11.1	23.3	33.9
1972-73	45.7	59.2	28.0	20.2
1973-74	41.9	-8.3	31.9	13.9
1974-75	29.2	30.3	37.0	16.0
1975-76	51.3	75.7	34.7	-6.2
1976-77	76.6	49.3	54.9	58.2
1977-78	113.4	48.0	57.5	4.7
1978-79	138.5	22.1	73.5	27.8
1979-80	137.9	-0.4	91.0	23.8
1980-81	206.6	49.8	108.9	19.7

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1981-82	218.1	5.6	169.4	55.6
1982-83	230.2	5.5	196.1	15.8
1983-84	321.9	39.8	224.5	14.5
1984-85	415.4	29.0	272.9	21.6
1985-86	499.2	20.2	403.9	48.0
1986-87	798.1	59.9	451.6	11.8
1987-88	922.6	15.6	657.1	45.5
1988-89	1635.5	77.3	997.5	51.8
1989-90	1817.0	11.1	1121.8	12.5
1990-91	2429.8	33.7	1574.3	40.3
1991-92	2421.2	-0.4	1604.4	1.9
1992-93	2347.9	-3.0	1733.4	8.0
1993-94	3745.9	59.5	2163.1	24.8
1994-95	4327.0	15.5	2838.7	31.2
1995-96	6579.7	52.1	4586.5	61.6
1996-97	3952.2	-39.9	5175.5	12.8
1997-98	5708.2	44.4	5615.0	8.5
1998-99	3622.7	-36.5	4836.4	-13.9
1999-2000	2045.6	-43.5	3374.3	-30.2
2000-2001	1417.9	-30.7	2152.7	-36.2
2001-2002	778.0	-45.1	1069.9	-49.0
2002-2003	2035.1	161.6	1796.5	63.8
Cumulative upto end March 2003	45426.7		44169.2	

Source: IDBI Report.

#### **Product-Wise Assistance**

IFCI has been substantially increasing financial assistance to industrial sector. IFCI provides direct financial assistance for financing projects in terms of rupee loans, foreign currency loans and by underwriting and direct subscription to shares, debentures and bonds. It also provides direct financial assistance for financing equipments/asset, for meeting working capital requirements, for equipment leasing etc. It also provides discounting facilities and undertakes investments in shares/bonds of FIs. The product-wise assistance sanctioned and disbursed by IFCI for the last 5 years is presented in table II below.

The table II shows that upto March, 2003 total project finance sanctioned amounted to Rs. 37122.6 crore out of total assistance of Rs. 45426.7 crore. Most of the funds were disbursed in terms of rupee loans which accounted for Rs. 22516.0 crore upto

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March, 2003 out of the total funds disbursed for project finance which stood at a figure of Rs. 35926.4 crore.

**Equipment Finance.** IFCI has been operating a scheme of Equipment Finance since 1984-85 to help industrial concern in purchasing capital equipment. Under the scheme assistance of the order of Rs. 3971.8 crore was sanctioned and disbursed up to March, 2003.

			Table I	I : Product	-Wise Assi	stance Sanct	ioned And	Disbursed					
													(Rs. Crore)
Sr. Product			San	ctions					Disbu	irsments			Assistance
No.	1998-99	1999-2000	2000-01	2001-02	2002-03	Commulative upto end March 2003	1998-99	1999-2000	2000-01	2001-02	2002-03	Commulative upto end March 2003	outstanding March 2003
1. Direct Finance													
A. Project Finance													
(i) Loans													
(a) Rupee loans	2097.8	1282.0	710.4	539.8	1531.9	23269.6	2339.2	1690.4	1081.4	810.6	1298.2	22516.0	8572.8
<ul><li>(b) Foreign currency loans</li><li>(ii) Underwriting &amp; direct subscription</li></ul>	9.7		145.7		45.8	5276.8	366.1	252.1	138.3	29.7		5162.6	3537.7
(a) Shares	35.7	152.3	73.6	31.5	220.6	1029.9	139.8	66.4	100.1	66.3	203.3	1047.3	1092.8
(b) Debentures/bonds	557.5	345.3	325.9	115.9	173.1	3699.0	550.3	492.6	291.6	132.0	281.6	3600.3	2010.5
(iii) Deferred payment guarantees	428.9	120.6	115.5	34.2	50.3	3784.3	834.2	525.7	481.8	27.0		3600.2	1933.8
Sub Total (A)	3129.6	1900.2	1371.1	721.4	2021.7	37122.6	4229.6	3027.2	2093.2	1065.6	1783.1	35926.4	17147.6
B. Non-Project Finance													
(i) Asset credit/equipment finance	241.7	25.2				3971.8	222.3	146.7	6.0			3971.8	170.7
(ii) Corporate loans	123.7	46.3		3.5		1198.1	142.8	101.1	1.7	8.2		1198.1	770.7
(iii) Working capital/short- term loans	50.2	14.7	35.0	35.0	9.7	2201.6	55.7	5.0	35.0	5.0	9.7	2156.4	161.0
(iv) Equipment leasing	13.0					763.2	121.5	35.1	5.0			747.1	219.1
Sub Total (B)	428.6	86.2	35.0	38.5	9.7	8134.7	542.3	287.9	47.7	13.2	9.7	8073.4	1321.5
Total (1)	3558.2	1986.4	1406.1	759.9	2031.4	45257.3	4771.9	3315.1	2140.9	1078.8	1792.8	43999.8	18469.1
2. Direct discounting			3.8			3.8			3.8			3.8	
3. Loans to and investments in shares/bonds of FIs	64.5	59.2	8.0	18.1	3.7	165.6	64.5	59.2	8.0	18.1	3.7	165.6	317.0
Grand Total (1+2+3)	3622.7	2045.6	1417.9	778.0	2035.1	45426.7	4836.4	3374.3	2152.7	1096.9	1796.5	44169.2	18786.1

Source: IDBI Report, 2002-2003

**Equipment Leasing.** IFCI also provides financial assistance by way of leasing arrangement for the equipment indigenous/imported to the existing industrial concerns. The overall sanctions under the scheme up to 31<sup>st</sup> March, 2003 accounted to Rs. 763.2 crore out of which Rs. 747.1 crore were disbursed.

**Investment in Shares/Bonds.** IFCI has been investing in the shares and bonds of financial Institutions. Up to March, 2003 loans and investments in shares/bonds of FIs stood at a figure of Rs. 165.6 crore.

## Purpose-wise Assistance

In the purpose-wise sanctions and disbursements, new projects got Rs. 15919.6 crore which is 35.17 percent of total sanctions up to March 31, 2003. The second category which got more funds sanctioned was expansion/diversification programmes.

Table I	Table III: Purpose –wise Assistance sanctioned and disbursed upto									
March,	2003									
			(Rs. crore)							
S.No.	PURPOSE	Sanctions	Disbursements							
1.	New	15919.6	15611.3							
2.	Expansion/diversification/									
	acquisition	6649.2	6547.5							
3.	Rehabilitation	115.7	114.1							
4.	Modernization/balancing									
	equipment	5459.7	5480.4							
5.	Working Capital	837.5	774.2							
6.	Others <sup>(a)</sup>	16279.4	15476.1							
	Total	45261.1	44003.6							

<sup>(</sup>a) Others include corporate loans, short – term loans, bridge loans, overruns, financial restricting etc.

Source: IDBI Report.

The table III depicts that modernization schemes got Rs. 5459.7 crore as sanctions while Rs. 837.5 crore was provide for meeting working capital needs. So the main thrust has been on new projects, expansion and modernization schemes.

#### Sector-Wise Assistance

The corporation provided maximum financial assistance to the private sector by sanctioning Rs. 40660.9 cores as on March, 2003. This constituted over 89 per cent of the

total assistance sanctioned by IFCI. The public sector got sanctioned and disbursed Rs. 1541.1 crore and Rs. 1539.1 crore respectively. Till 31<sup>st</sup> March, 2003, cooperative sector received assistance to the tune of Rs. 838.4 crore out of Rs. 44003 crore disbursed.

	Table IV : Sector-wise Assistance Sanctioned and disbursed as on 31 <sup>st</sup> March, 2003								
S.No. Sector Sanctions Disbursements									
1.	Public	1541.1	1539.1						
2.	Joint	2192.0	2146.0						
3.	Co-operative	867.1	838.4						
4.	Private	40660.9	39480.1						
	Total	45261.1	44003.6						

#### 2. Financial Performance of IDBI

The main objective of IDBI is to provide term finance and financial services for establishment of new project as well as the expansion, diversification, modernization and technology upgradations of existing industrial enterprises. It is one of the important financial institutions which has provided lot of funds for industrial activities in the country.

Purpose- wise Assistance Sanctioned

	TABLE -V PURPOSE -WISE ASSISTANCE SANCTIONED											
Sr.	Purpose		Sanctions									
No.		1998-99	1999-2000	2000-01	2001-02	2002-03	Cumulative up to end-March 2003					
1	New	5743.9	6987.4	7954.6	2596.8	830.2	67498.8					
2	Expansion/ diversification/ acquisition	6608.5	3809.8	4383.1	2104.4	212.1	50627.3					
3	Modernization/ balancing equipment	1339.6	1095.6	1145.8	371.6	102.2	12976.5					
4	Rehabilitation	13.4	99.3	672.5	133.7	114.0	1415.8					
5	Working capital	5138.4	9099.4	8283.1	7781.5	1464.3	44086.5					
	Total	18843.8	21091.5	22439.1	12988.0	2722.8	176604.9					

**Source**: IDBI Report.

IDBI was setup to provide financial assistance to both new as well as to the existing ones for expansion diversification purposes. Almost one third of the total

assistance amounting to Rs. 67498.8 crore was extended to finance new projects as on March, 2003. Rs. 50627.3 crore (i.e. 28.6% of the total assistance) was provided for expansion/diversification programmes, Rs. 44086.5 crore(i.e. almost one – fourth of the total assistance of Rs. 176604.9 crore) was provided for meeting working capital needs. The cumulative assistance disbursed for all purposes under direct finance upto end March, 2003 amounted to Rs. 1,31,112. 3 crore.

#### Sector-wise Distribution of Assistance Sanctioned

IDBI meets the financial need of public, private, cooperative and trusts also. Table VI exhibits sector-wise distribution of IDBI's assistance. The private sector has been the main beneficiary as 77% of the total assistance (i.e. Rs. 169304.4 crore out of Rs. 217873.3 crore) was extended to private sector as on March 2003.

Table V	/I: Sector-wise Assistar	nce Sanctioned and disburse	ed as on March, 2003
			(Rs. crore)
S.No.	SECTOR	Amount	Percentage
1.	Public	34963.0	16.05
2.	Joint	11753.7	5.39
3.	Co-operative	1802.2	.83
4.	Private	169304.4	77.71
5.	Trust	50.0	.02
	Total	217873.3	100.0

Table VI depicts that 16.05 per cent share in finance sanctioned was enjoyed by the public sector, remaining 6-7 per cent was shared by joint, cooperative and trusts.

#### Institution-wise Assistance

Institution-wise finance was provided to SFCs and SIDCs by IDBI under refinance scheme. The finance sanctioned declined from Rs. 129.8 crore in 2000-01 to

Rs. 87.7 crore in 2001-02 in case of SFCs and from Rs. 233.2 crore in 2000-01 to Rs. 99.6 crore in 2000.02 in respect of SIDCs (see table VII).

Table \	Table VII: Institution wise Refinance Assistance									
			(Rs. crore)							
S.No.	Institution	2000-01	2001-02							
1.	SFCs	129.8	87.7							
2.	SIDCs	233.2	99.6							
	Total	363.0	187.3							

## 3. Working of ICICI

The primary aim of setting up ICICI was to provide foreign currency finance to industrial project and promote industries in private sector. In due course of time it diversified into a number of other activities and now offers a complete package of financial services either directly or through its subsidiaries. It has also been managing United States Agency for International Development (US AID) and World Bank funds through its technological financing programmes. ICICI provides financial packages for research and development, commercialization of technology, venture capital and special technologies relating to pollution control and environment protection.

The trend in assistance sanctioned and disbursed by ICICI has been shown in Table VIII. The cumulative sanctions up to end March, 2002 amounted to Rs. 2,83,510.9 crore whereas disbursements amounted to Rs. 1,71,698.3 crore. Project- wise assistance sanctioned and disbursed has been presented in Table IX. Table X shows sector-wise and Table-XI purpose-wise assistance sanctioned and disbursed.

TABLE	VIII: TREND IN A	SSISTANCE SAN	CTIONED AND I	DISBURSED
Year	Sanctions	Growth Rate (%)	Distribution Rate (%)	Growth
1970-71	43.9		28.9	
1971-72	39.7	9.6	30.0	4.8
1972-73	49.4	24.4	39.7	31.0
1973-74	61.1	23.7	43.5	9.6
1974-75	62.9	2.9	45.4	4.4
1975-76	78.6	25.0	61.1	34.6
1976-77	98.7	25.6	67.3	10.1
1977-78	108.3	9.7	91.6	36.1
1978-79	182.8	68.8	109.2	19.2
1979-80	204.3	11.8	135.8	24.4
1980-81	314.1	53.7	185.3	36.5
1981-82	302.4	-3.7	264.7	42.8
1982-83	392.1	29.7	282.2	6.6
1983-84	507.6	29.5	334.2	18.4
1984-85	620.7	22.3	292.7	17.5
1985-86	708.2	14.1	482.2	22.8
1986-87	1118.3	57.9	695.5	44.2
1987-88	1231.7	10.1	771.2	10.9
1988-89	1978.1	60.6	1085.6	40.8
1989-90	2850.6	44.1	1357.1	25.0
1990-91	3744.0	31.3	1967.5	45.0
1991-92	4094.9	9.4	2351.3	19.5
1992-93	5771-8	41.0	3315.2	41.0
1993-94	8491.4	47.1	4413.3	33.1
1994-95	14527.9	71.1	6879.3	55.9
1995-96	14594.9	0.5	7120.4	3.5
1996-97	14083.8	-3.5	11180.9	57.0
1997-98	24717.5	75.5	15806.9	41.4
1998-99	32370.6	31.0	19225.1	21.6
1999-2000	43522.8	34.5	25835.7	34.4
2000-01	55815.2	28.2	31664.5	22.6
2001-02	36229.2	-35.1	25831.0	-18.4
Cumulative upto	283510.9		171698.3	
end-March 2002				

Note: Following the merger of ICICI Ltd. along with two of its subsidiaries with ICICI Bank Ltd., effective May 3,2002, ICICI Ltd. ceased to exist.

**Source :** IDBI Report.

			Table IX : Pr	oduct-Wise A	ssistance Sai	nctioned And	Disbursed				
											(Rs. Crore)
Sr.	Product			Sanctions				]	Disbursments		
No.		1998-99	1999-2000	2000-01	2001-02	Commulative upto end March 2002	1998-99	1999-2000	2000-01	2001-02	Commulative upto end March 2002
1.	Direct Finance										
Α.	<b>Project Finance</b>										
	(i) Loans										
	(a) Rupee loans	15605.0	16511.1	19744.0	12297.0	99713.8	10632.2	10473.6	10867.4	8902.9	63718.9
	(b) Foreign currency loans	2694.6	5529.7	5985.0	987.2	42941.0	1183.6	2947.4	3132.8	460.1	27872.0
	(ii) Underwriting & direct subscription										
	(a) Shares	329.4	2270.0	1200.5	1103.6	10537.0	116.8	716.8	857.1	875.8	5324.4
	(b) Debentures/bonds	3390.5	5735.9	6502.7	3689.0	33186.9	2336.3	4530.7	3382.2	2471.9	20308.5
	(iii) Deferred payment guarantees	2655.3	2317.5	4661.9	3880.4	25316.1	15.3	36.2	330.9	241.4	909.2
Sub T	Total (A)	24674.8	32364.2	38094.1	21957.7	211700.0	14284.7	18704.7	18570.4	12952.1	118133.0
В.	Non-Project Finance										
	(i) Asset credit/equipment finance					2008.2					1565.4
	(ii) Corporate loans	4431.8	5878.5	6857.4	3345.8	30019.0	3294.7	4139.4	4780.4	3006.8	22097.1
	(iii) Working capital/short-term			3511.5	1462.7	4974.2			3400.6	1922.4	5323.0
	loans										
	(iv) Equipment leasing	1005.1	1621.5	1889.6	19.0	9700.0	683.1	953.1	969.0	66.0	6980.9
Sub T	Total (B)	5436.9	7500.0	12258.5	4827.5	46701.4	3977.8	5092.5	9150.0	4995.2	35966.4
Total	(1)	30111.7	39864.2	50352.6	26785.2	258401.4	18262.0	23797.2	27720.4	17947.3	154099.4
2.	Direct discounting	1838.7	2722.1	1302.6	273.0	10421.7	542.9	1330.1	480.4	276.7	5399.5
3.	Loans to and investments in	420.2	936.5	4160.0	9171.0	14687.8	420.2	708.4	3463.7	7607.0	12199.4
	shares/bonds of FIs	- <u></u>									
Gran	d Total (1+2+3)	32370.6	43522.8	55815.2	36229.2	283510.9	19225.1	25835.7	31664.5	25831.0	171698.3

**Source: IDBI Report** 

		1	Table X : SEC	TOR -WISE	ASSISTANO	CE SANCTIO	NED AND I	DISBURSED			
											(Rs. Crore)
Sr.	Product			Sanctions				]	Disbursments		
No.	_	1998-99	1999-2000	2000-01	2001-02	Commu-	1998-99	1999-2000	2000-01	2001-02	Commul-
						lative					ative upto
											end March
											2002
1	Public	7301.1	11102.0	9568.5	7129.0	45976.5	3887.9	5706.8	6438.4	3834.9	24289.8
2	Joint	346.5	706.9	593.5	84.6	6733.0	718.4	516.9	470.8	22.9	4483.0
3	Cooperative	-	357.0	210.0	100.0	2465.6	0.1	253.5	310.0	0.8	1760.3
_	D:	2.4722.0	212560	45442.0	20015	220227.0	14610.7	10250.5	24445.2	21072.4	1411650
4	Private	24723.0	31356.9	45443.0	28915.6	228335.8	14618.7	19358.5	24445.3	21972.4	141165.2
	Total	32370.6	43522.8	55815.0	36229.2	283510.9	19225.1	25835.7	31664.5	25831.0	171698.3

Source: IDBI Report

		Table XI : P	URPOSE -WISE	ASSISTANCE	SANCTIONED	AND DISBUR	RSED		
									(Rs. Crore)
Sr.	Product		Sancti	ons		Disburs	ments		
No.	•	1998-99	1999-2000	2000-01	2001-02	1998-99	1999-2000	2000-01	2001-02
1	New	5245.3	3302.3	8714.2	4149.2	1747.1	1037.4	1610.5	1114.3
2	Expansion/ Diversification/ Acquisition	6639.1	7530.3	5073.5	693.9	3821.1	3517.3	2656.3	1464.5
3	Modernisation/ Balancing Equipment	2408.8	4328.0	4415.9	307.9	1685.3	2525.0	2389.1	1034.0
4	Rehabilitation	5.0	3.2	2.7		3.0	3.4	3.8	3.6
5	Other	18072.4	28359.0	37608.9	31078.2	11968.6	18752.6	25004.8	22214.6
	Total	32370.6	43522.8	55815.2	36229.2	19225.1	25835.7	31664.5	25831.0

Source: IDBI Report

## 4. Working of Industrial Investment Bank of India (IIBIL) Product–wise Assistance

IIBIL offers a variety of financial products such as project finance, short duration non-project asset- backed financing and working capital/other short-term loans to companies.

Table XII : Sector-wise Assistance Sanctioned and disbursed as on 31st March, 2003						
			(Rs. Crore)			
S.No.	Product	Sanctions	Disbursements			
(1)	Direct Finance					
	(a) Project Finance	4252.1	3678.4			
	(b) Non-Project Finance	4370.2	4155.7			
	Total (1)	8622.3	7834.1			
(2)	Secondary Market Operations	3240.2	3228.7			
	Grand Total	11862.5	11062.8			

The IIBIL sanctioned almost equal amount to finance both project and non-project purposes. As on 31<sup>st</sup> March, 2003 direct finance sanctioned and disbursed for financing projects stood at Rs. 4252.1 crore and Rs. 3678.4 crore respectively. Where as the corresponding figures for non-project category were Rs. 4370.2 crore and Rs. 4155.7 crore respectively. IIBIL also undertook investments in shares and debenture and bonds of financial institutions in secondary market.

#### Trend in Assistance Sanctioned and Disbursed

Table XIII depicts that w.e.f. 1997-98 till 2000-01 there was remarkable increase in the amount of assistance sanctioned and disbursed as compared to last 25 years. The amount sanctioned stood at Rs. 816 crore during the year 1996-97 and it rose to Rs.2338.1 crore by 1999-2000. By the end of March, 2003, total assistance provided was Rs. 11862.5 crore as against Rs. 11062.8 crore disbursed.

Table XIII Assistance Sanctioned and Disbursed						
				(Rs. crore)		
Year	Sanctions	Growth rate (%)	Disbursements	Growth rate(%)		
1971-72	6.6		1.1			
1972-73	6.1	-7.6	3.5	218.2		
1973-74	7.2	18.0	5.2	48.6		
1974-75	7.6	-5.6	8.0	53.8		
1975-76	5.3	-30.3	4.7	41.3		
1976-77	10.0	88.7	10.8	129.8		
1977-78	10.9	9.0	9.1	-15.7		
1978-79	10.7	-1.8	12.6	38.5		
1979-80	15.2	42.1	12.5	-0.8		
1980-81	19.4	27.6	16.9	35.2		
1981-82	50.4	159.8	28.4	68.0		
1982-83	62.3	23.6	37.9	33.5		
1983-84	69.5	11.6	41.4	9.2		
1984-85	110.8	59.4	54.8	32.4		
1985-86	75.2	-32.1	67.8	23.7		
1986-87	149.9	98.0	94.7	39.7		
1987-88	186.5	25.3	101.9	7.6		
1988-89	208.8	12.0	116.5	-14.3		
1989-90	146.6	29.8	141.1	21.1		
1990-91	234.7	60.1	153.9	9.1		
1991-92	277.7	18.3	185.2	20.3		
1992-93	294.3	6.0	183.9	-0.7		
1993-94	425.8	44.7	188.6	2.6		
1994-95	777.9	82.7	397.6	110.8		
1995-96	897.3	15.3	528.6	32.9		
1996-97	816.0	-9.1	549.6	4.0		

1997-98	2061.0	152.6	1153.2	109.8
1998-99	21752	5.5	1688.5	46.4
1999-2000	2338.1	7.5	1439.6	-14.7
2000-01	2102.3	-10.1	1709.8	18.8
2001-02	1320.7	-37.2	1070.0	-37.4
2002-03	1206.4	-8.7	1091.9	2.0
Cumulative upto end-March 2002	11862.5		11062.8	

**Source :** IDBI Report.

### **Sector-wise Classification of Assistance**

The IIBIL provides assistance to public, joint cooperative and private sectors. However, the major beneficiary has been the private sector. Upto March, 2003, the assistance sanctioned and disbursed to private sector stood at Rs. 8416.8 crore and Rs. 7691.7 crore respectively as shown in Table XIV below:

Tabl	Table XIV Sector-wise Assistance Sanctioned and Disbursed					
Sr.No.	Sector	Sanctions as on 31 March, 2003	Disbursements as on 31 <sup>st</sup> March, 2003			
1	Public	2813.0	2765.8			
2	Joint	585.0	557.6			
3	Co-operative	47.7	47.7			
4	Private	8416.8	7691.7			
	Total	11862.5	11062.8			

## Purpose-wise Distribution of Finance

IIBIL has provided assistance to new projects as well as existing one for their expansion, diversification and modernization and for equipments finance. Recently, it has started rendering assistance for meeting working capital margin, short, medium and long-term resources, strengthening liquidity etc.

Table XV clearly depicts that IIBI has been providing more assistance for the expansion, diversification purpose as the amount of assistance sanctioned stood at Rs. 4410.4 crore as compared to the assistance sanctioned for new projects which is just Rs. 1208.3 crore as on March, 2003. More than 20% of the total assistance accounted for working capital.

	Table XV : PURPOSE-WISE ASSISTANCE SANCTIONED AND DISBURSEMENTS												
Sr. No.	Purpose	Sanctions				Disbursements (Rs. Crore)							
		1998- 99	1999- 2000	2000-0	2001- 02	2002-	Cumulative to end – March 2003	1998- 99	1999- 2000	2000 -01	2001- 02	2002-	Cumulative to end – March 2003
1	New	369.6	38.5		-	-	1208.3	263.3	126.7	-	-	-	661.4
2	Modernization/ balancing equipment	565.5	854.0	1335	397.3	117.6	4410.4	279.8	241.7	1196.1	166.9	41.0	4325.1
3	Rehabilitation	33.1	-		-	-	873.6	25.7	-	-	-	-	643.3
4	Working capital	823.8	626.4	766	162.5	105.5	2416.9	710.8	564.7	513.7	115.7	20.5	2495.2
5	Others	383.2	819.2	1	760.9	983.3	2953.3	408.9	506.5	-	787.4	1030.4	2937
	Total	2175.2	2338.1	2102	1320.7	1206.4	11862.5	1688.5	1439.6	1709.8	1070.0	1091.9	11062.8

Source: IDBI Report, 2002-2003

## 5. Operations of SFC's

State Financial Corporations have been framing lending policies depending upon the requirements of the state. SFC's sanctioned a total amount of Rs. 30374.5 crore up to March 1999 and the amounts disbursed were Rs. 24867.8 crore. The amounts sanctioned by these corporations have shown a decline in the last few years. In the year 1994-95 the amounts sanctioned were Rs. 4188.5 crore and it came down to Rs. 1864.2 crore in the year 1998-99. The small scale sector is the main beneficiary of lendings of these corporations. These corporations have been giving more emphasis on investing in new units and more than 70 per cent of their funds went to these units.

Rs. 273.2 crore in 1998-99 from Rs. 594.5 crore in 1996-97. There is an overall decline in lending by SFC in the last some years which indicates a declining industrial growth trend. The small scale sector is facing a stiff competition from multinationals which have entered the country after globalization of Indian economy. The quantitative restrictions on imports have completely been removed by Govt. of India from April 1, 2001 and this will expose this sector to a global competition.

State Financial Corporations have been framing lending policies depending upon the requirements of the state. The amounts sanctioned by these corporations have shown a decline in the last few years. In the year 1995-96, the amounts sanctioned were Rs. 4188.5 crore and it came down to Rs. 1864.2 crore in the year 1998-99. Similarly, Rs. 2790 crore were sanctioned during the year 2000-2001 but it declined to Rs. 1855.9 crore during the year 2002-2003. The following table gives details of the amount sanctioned and disbursed for the last few years.

Financial Assistance Sanctioned and Disbursed (Rs. crore)						
Period	<b>Amount Sanctioned</b>	Amount disbursed				
1991-92	2190.3	1536.8				
1992-93	2015.3	1557.4				
1993-94	1908.8	1563.4				
1994-95	2702.4	1880.9				
1995-96	4188.5	2961.1				
1996-97	3544.8	2782.7				
1997-98	2626.1	2110.2				
1998-99	1864.2	1624.7				
1999-2000	2237.8	1825.1				
2000-2001	2790.7	2008.1				
2001-2002	2075.9	1762.5				
2002-2003	1855.9	1454.0				

**Source:** Economic Survey.

## 13.9 SUMMARY

Banks and financial institutions are intermediaries that mobilize savings and facilitate the allocation funds in an efficient manner. Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true in case of non-banking financial institutions. In India, non-banking financial institutions are the major institutional purveyors of credit. In the post reforms era, the role and nature of activity of financial institutions have undergone tremendous change. Banks and financial institutions have now undertaken non-bank activities and financial institutions are planning to undertake banking function. Most of the financial institutions now resort to financial markets for raising funds.

## 13.10 Self Assessment Questions

- 1. Define financial institutions. Discuss the various type of financial institutions.
- 2. Discuss the development that have taken place in Indian Financial System since independence.
- 3. What role do financial institution play as a financial intermediary in financial market? Discuss.

#### **COURSE: BUSINESS ENVIRONMENT**

COURSE CODE: MC-103 AUTHOR: SURINDER S. KUNDU

LESSON: 14 VETTER: Dr Karam Pal

#### ROLE OF FOREIGN BANKS AND NBFCs

- ODODE II V D THE present enapter explains the role of foreign values and tron-danking

Financial Companies in of Indian economy.

#### **STRUCTURE**

- 14.1 Introduction
- 14.2 Foreign Banks in India
- 14.3 Obstacle before Foreign Banks
- 14.4 Prospect of Foreign Banks in India
- 14.5 Non-Banking Finance Companies
- 14.6 Types of NBFCs
- 14.7 Growth of NBFCs
- 14.8 Regulations of NBFCs
- 14.9 Summary
- 14.10 Self-Test Questions
- 14.11 Suggested Readings

#### 14.1 INTRODUCTION

The past decade has seen a transformation of the role of foreign banks in emerging markets. It has been a process that has often aroused considerable controversy, and featured prominently in many cases. The benefits foreign banks can offer are now much more widely recognised. But it would be naive to pretend that there are no drawbacks or no difficult choices for local supervisory authorities. The supervisory response to the rapid rise of foreign banks is still being refined - and, in some countries, remains an important task. Foreign banks have become well established as key vehicles in the international integration of the financial systems of emerging market economies. There has been a strategic shift by foreign banks away from pursuing internationally active corporate clients towards the exploration of business opportunities in the domestic market. Financial sector reforms were initiated as part of overall economic reforms in the country and wide ranging reforms covering industry, trade, taxation, external sector, banking and financial markets have been carried out since mid 1991. A decade of economic and financial sector reforms has strengthened the fundamentals of the Indian economy and transformed the operating environment for banks and financial institutions in the country. The sustained and gradual pace of reforms has helped avoid any crisis and has actually fuelled growth. As pointed out in the RBI Annual Report 2001-02, GDP growth in the 10 years after reforms i.e. 1992-93 to 2001-02 averaged 6.0% against 5.8% recorded during 1980-81 to 1989-90 in the pre-reform period. The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitisation, etc. At the same time, liberalisation has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs, post office, etc.

#### 14.2 FOREIGN BANKS IN INDIA

The Hong Kong and Shanghai Banking Corporation's association with the banking industry in India has been for about 150 years and is nearly as old as the history of banking in the country. It goes back to 1853, when the Mercantile Bank of India, China and London, was established in Mumbai, with its headquarters in London. The following year saw the establishment of the Bank's first branch in the city. It has since then, steadily grown not only in size but also in terms of its reach. It currently has 31 operational branches spread across 14 cities in India. Over such a long period, it has seen many a transition, but broadly speaking, it needs to mention at least three major ones. First, the Pre-Independence period, during which period, foreign banks dominated the trade scenario in India. Their most important role then was to finance and facilitate the trade and industrialization process in the country. Unlike Indian banks, these banks were registered universally and therefore, enjoyed greater networking with so many branches at the global level.

The second phase associated with the post-independence period, saw the nationalization of major Indian banks in 1969 that led to Indian public sector

banks reaching 'commanding heights' in the country and, to some extent, stifled the growth of foreign banks. The concept of 'reciprocity' was very strong at that time. Opening branches in India implied not only going through rigorous licensing formalities with the RBI, but also improving provisions for creating corresponding opportunities for opening branches of Indian banks in respective foreign countries.

The third phase truly belongs to the post-liberalization reforms, unleashed since July 1991, marking a paradigm shift in the economic policies followed by India. Undoubtedly, this has unfolded a new era for the entire banking industry. The policy makers have realized the imperatives of liberalization, privatization and globalization. Also, the realization that India has to move further beyond, from manufacturing and production to service-oriented activities, continues to accelerate the process. Today's world is one without barriers, where technology is advanced enough to facilitate instant communication.

An urgent need was felt to encourage competitiveness in the banking industry and hence a series of reforms were initiated. For foreign banks, this has been the most opportune time thanks to the relaxation of stringent norms binding on their operations for so long. Fortunately, successive governments have been pursuing the process of liberalization, thereby building the confidence and commitment of foreign banks.

With better international linkages and efficient distribution channels, foreign banks offer better services to their customers. Since they operate in several countries, they have varied experiences of customer handling and product innovation in different environments in various parts of the world. Therefore, they can follow a policy of 'plug and play', which gives them a scope to quickly respond to market requirements by introducing new products and services tried and tested already in other markets.

After the set up foreign banks in India, the banking sector in India also become competitive and accurative. New rules announced by the Reserve Bank of India for the foreign banks in India in this budget has put up great hopes among foreign banks, which allows them to grow, unfettered. Now foreign banks in India are permitted to set up local subsidiaries. The policy conveys that foreign banks in India may not acquire Indian ones (except for weak banks identified by the RBI, on its terms) and their Indian subsidiaries will not be able to open branches freely.

#### **List of Foreign Banks in India** is as follows:

- 1 ABN-AMRO Bank
- 2 Abu Dhabi Commercial Bank
- 3 Bank of Ceylon
- 4 BNP Paribas Bank
- 5 Citi Bank
- 6 China Trust Commercial Bank
- 7 Deutsche Bank
- 8 HSBC
- 9 <u>JPMorgan Chase Bank</u>
- 10 Standard Chartered Bank
- 11 Scotia Bank
- 12 Taib Bank

By the year 2009, the list of foreign banks in India is going to become more quantitative as numbers of foreign banks are still waiting with baggage to start business in India.

Generally, liberalization has brought about a remarkable transformation in the banking industry in India. In the last few years, Indians have evolved as

discerning customers. Their aspirations and accordingly, their demands have changed dramatically. They are now more open to the acceptance of new financial products, and their changing requirements have encouraged banks to innovate their financial products and their ways of offering banking services. Indeed, the post-1991 period has been the most stimulating and by far, the best time for foreign banks in India.

It is strongly believed that while regulatory and legislative changes are very crucial, these per se would not be enough to facilitate the formation of a vibrant International Financial Center (in Mumbai). There are a number of other tangible and intangible factors responsible for its success, the most important being the physical infrastructure. Of all Asian countries, Hong Kong and Singapore are the only two cities, which have the configurations of mainline financial centres. These countries have the basic framework of rules and regulations, a suitable workforce, tax consultants, insurance companies, etc., underlying any financial centre. Besides, any financial centre should have more stability. The presence of good governance becomes very vital in this context, since it facilitates inflow of foreign capital through avenues like FIIs, etc. Prospective investors should feel confident about their investments. India has the advantage of a favourable climate to attract FDIs. But inadequacies of a physical infrastructure are one of the major drawbacks. In addition to focusing on regulatory aspects to accelerate opportunities of international financial transactions, it is equally important to concentrate on strengthening the physical infrastructure of the nation; we require a more investor-friendly procedural set-up; and so on.

#### 14.3 OBSTACLES BEFORE FOREIGN BANKS

Indian banks, particularly, private banks and the rapidly awakening public sector banks are vigorous in their operations, making the banking scenario really challenging. While evaluating the current situation, at the very outset, it must be complimented that the policy-making authorities, especially the RBI for responding proactively by introducing banking reforms. The present policy framework is conducive to foreign bank operations in India. There are as such no constraints on the expansion of foreign banks. It is emphasized that the 'regulatory environment is far more conducive in India compared to most other countries in South East Asia.' Foreign banks are now bestowed with greater scope to participate in the Indian banking business. However, there are a few aberrations and we are still subjected to some restrictions. For example, when foreign players want to participate in the securities market in India, it is imperative for them to do so in partnership with an Indian firm. Again, as far as the insurance sector is concerned, the 26 percent cap is definitely a limitation, especially because raising the limit will cause no harm. It appears that the regulators are still tentative about raising the upper limit of foreign ownership in Indian banks, since they fear that it may result in foreign players taking over the domestic market. This is not going to be true. Take for example, deposits; foreign banks control only 6 to 7 percent of the total bank deposits in India. The remaining is entirely with Indian banks. Even if there was complete freedom of operation, only three or four foreign banks may open additional branches.

Take the case of mergers and acquisitions, which is becoming a very common feature in today's corporate world. There are only 3 or 4 players like HSBC, Citibank, Standard & Chartered and ABN AMRO, who have the capacity to bid for the acquisition of some private or public sector banks. But most banks operating at a global level, whose strategy is more consumer-oriented, will not think of buying Indian banks. Even if foreign banks seek to buy out Indian banks, the country will benefit in terms of greater flow of foreign direct investment.

#### 14.4 PROSPECT OF FOREIGN BANKS IN INDIA

Looking at the future, it may be perceived that there are some major trends likely to emerge: First, at present, we have a fairly large presence of foreign banks in the country. However, effectively in terms of volume of business and operations, only a few of them dominate the scene. Second, there is a strong prospect of consolidation of banks through the route of M & A. This would indeed, stimulate not only the financial sector, but also the real sector of the economy. In the process of consolidation, it may be strongly recommended that the merger of a strong bank with another strong bank, rather than the commonly perceived need of encouraging the merger of a weak bank with a strong one. This is so, because the merger of a weak bank with a strong one often tends to jeopardize the health of the latter. Third, the introduction of stringent provisioning norms, Capital Adequacy Ratio (CAR) as well as better control over NPAs through ordinances dealing with the securitisation and reconstruction of financial assets will strengthen the banking system as a whole. Lastly, India's effort towards opening the financial sector in general and banking sector in particular will have to be compatible with expected changes in the framework of GATS and other related WTO provisions.

#### 14.5 NON-BANKING FINANCE COMPANIES (NBFCs)

NBFCs constitute an important segment of the financial system. NBFCs are financial intermediaries engaged primarily in the business of accepting deposits and delivering credit. They play an important role in channelising the scarce financial resources to capital formation. NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganised sector and to small local borrowers. NBFCs have a more flexible structure than banks. As compared to banks, they can take quick decisions; assume greater risks, and tailor-make their services and charges according to the needs of the clients. Their flexible structure helps in broadening the market by providing the saver and investor a bundle of services on a competitive basis.

Non-Banking Financial Company has been defined vide clause (b) of Section 45-I of Chapter III B of Reserve Bank of India Act, 1934, as (i) a financial institution, which is a company; (ii) a non-banking institution, which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner; and (iii) such other non-banking institutions or class of such institutions, as the bank may with the previous approval of the central government and by notification in the official gazette, specify.

NBFC has been defined under clause (xi) of paragraph 2(1) of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998, as: 'non-banking financial company' means only the non-banking institution which is a loan company or an investment company or a hire purchase finance company or an equipment leasing company or a mutual benefit finance company. NBFCs provide a range of services such as hire purchase finance, equipment lease finance, loans, and investments. Due to the rapid growth of NBFCs and a wide variety of services provided by them, there has been a gradual blurring of distinction between banks and NBFCs except that commercial banks have the exclusive privilege in the issuance of cheques. NBFCs have raised large amount of resources through deposits from public, shareholders, directors, and other companies and borrowings by issue of non-convertible debentures, and so on. In the year 1998, a new concept of public deposits meaning deposits received from public, including shareholders in the case of public limited companies and unsecured debentures/bonds other than those issued to companies, banks, and financial institutions, was introduced for the purpose of focused supervision of NBFCs accepting such deposits.

#### 14.6 **TYPES OF NBFCs**

NBFCs can be classified into different segments depending on the type of activities they undertake: (i) Hire Purchase Finance Company; (ii) Investment Company including primary dealers; (iii) Loan Company; (iv) Mutual Benefit Financial Company; (v) Equipment Leasing Company; (vi) Chit Fund Company; and (vii) Miscellaneous non-banking company

The Reserve Bank of India either partially or wholly regulates the abovementioned entities.

The principal business of NBFCs is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. The Residuary non-banking company (RNBC) Company receives deposits under any scheme or arrangements, by whatever name called, in one lump sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner.

**Residuary Non-Banking Companies:** RNBCs are a class of NBFCs that cannot be classified as equipment leasing, hire purchase, loan, investment, nidhi or chit fund companies, but which tap public savings by operating various deposit schemes, akin to recurring deposit schemes of banks. The deposit acceptance activities of these companies are governed by the provisions of Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. To safeguard the interest of depositors, the Reserve Bank has directed RNBCs to invest not less than 80 per cent of aggregate deposit liabilities as 'per the investment pattern prescribed by it and to entrust these securities to all public sector banks to be withdrawn only for repayment of deposits. Subject to compliance with the investment pattern, they can invest 20 per cent of aggregate liabilities or ten times its net owned fund; whichever is lower, in a manner decided by its Board of Directors. The RNBCs are the only class of NBFCs for which the floor rate of interest for deposits is specified by the Reserve Bank while there is no upper limit prescribed for them. The floor interest rate prescribed is 4 per cent per annum (to be compounded annually) on daily deposit schemes and 6 per cent per annum (to be compounded annually) on other deposit schemes of higher duration or term deposits. The Reserve Bank has also prescribed prudential norms for RNBCs. Compliance with prudential norms is mandatory and a prerequisite for acceptance of deposits. The Reserve Bank monitors and inspects these RNBCs from time to time. The Reserve Bank received 106 applications for Certificate of Registration (CoR) from NBFCs, which were functioning as RNBCs by accepting deposits under some scheme or arrangement. In 2000-01, 12 companies converted themselves to NBFCs and applications of 84 companies were rejected. Seven companies are still functioning as RNBCs with total public deposits of Rs 11,625 crore constituting about 64 per cent of the total deposits of all reporting companies.

Mutual Benefit Financial Companies: Mutual Benefit Financial Companies (Nidhis) are NBFCs notified under Section 620 A of the Companies Act, 1956, and primarily regulated by Department of Company Affairs (DCA) under the directions/guidelines issued by them under section 637 A of the Companies Act, 1956. These companies are exempt from the core provisions of the RBI Act and NBFC directions relating to acceptance of public deposits. However, the Reserve Bank is empowered to issue directions in matters relating to deposit acceptance activities and directions relating to ceiling on interest rate. They are also required to maintain register of deposits, furnish receipt to depositors and submit returns to the Reserve Bank. In order to facilitate healthy functioning of Nidhi companies and restore the confidence of the investing public, the Government of India constituted in March 2000, an Expert Committee under the Chairmanship of Shri P Sabanayagam to suggest an appropriate policy framework for overall improvement of these companies. The committee submitted its report to the Government on September 28, 2000 which included recommendations such as entry point barriers, minimum capital funds, liquid assets requirements, restrictions on dividend, ceiling on interest rates on deposit and loans, regulations of various managerial aspects, disclosure norms, prudential norms, adequate supervisory framework, role of auditors and other measures for protection of depositors' interest.

Miscellaneous **Non-Banking Companies:** Miscellaneous Non-Banking Companies (MNBCs) are companies engaged in the chit fund business. The term 'deposit' as defined under section 451(bb) of the Reserve Bank of India Act, 1934, does not include subscription to chit funds. The chit fund companies are exempted from all the core provisions of chapter III B of the RBI Act. The Reserve Bank regulates only the deposits accepted by these companies, but it does not regulate their chit fund business. The respective state governments through the offices of Registrars of Chits administer chit fund business. Chit fund companies, as per the Miscellaneous Non-Banking Companies (RBI) Directions, can accept deposits upto 25 per cent and 15 per cent of the net owned fund (NOF) from public and shareholders, respectively, for a period of 6 months to 36 months, but cannot accept deposits repayable on demand/notice. The RBI (Amendment) Act, 1997, provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits. The amended Act (1997) provides an entry point norm of Rs 25 lakh as the minimum net owned funds (NOF), which has been raised to Rs 2 Crore for new NBFCs seeking grant of Certificate of Registration (CoR) on or from April 21, 1999. The provisions relating to certificate of registration and minimum NOF were made mandatory (i) to ensure

that only financially sound companies carry on the business; (ii) to reduce the number of NBFCs to a manageable universe; and (iii) for effective regulation and supervision.

As on June 30, 2002, RBI received 36,269 applications of which 14,077 were approved and 19,111 were rejected. Of the total approvals, only 784 companies have been permitted to acceptlho1d public deposits. Certain types of financial companies, namely, insurance companies, housing finance companies, stock broking companies, chit fund companies, companies notified as 'nidhis' under section 620A of the Companies Act, 1956, and companies engaged in merchant banking activities (subject to certain conditions), however, have been exempted from the requirement of registration under the RBI Act, as they are regulated by other agencies.

#### 14.7 GROWTH OF NBFCs

NBFCs in India have existed since long. They came into limelight in the second half of the eighties and in the first half of the nineties. NBFCs flourished during the stock market boom of the early 1990s. In the initial years of liberalisation, they not only became prominent in a wide range of activities but they outpaced banks in deposit rising owing to their customised services. Total assets/liabilities of NBFCs grew at an average annual rate of 36.7 per cent during the nineties (1991-98) as compared to 20.9 per cent during the eighties (1981-91). The growing importance of this segment and the surfacing of some scams compelled the Reserve Bank to increase regulatory attention.

Income of reporting NBFCs continued to decline and the order of decline was much larger during 2000-01 resulting in a net loss of Rs 325 Crore. This decline was largely due to a drop in fund-based income, which contributed 91.4 per cent of the decline in income. The decline in income was much larger than the decline in operating expenses. NBFCs held public deposits of Rs 5,351 Crore, which accounted for 82.8 per cent of total public deposits held by all the reporting NBFCs, excluding RNBCs. A major portion of the assets of NBFCs (excluding RNBCs) constituted hire purchase and equipment leasing assets followed by loans

and inter-corporate deposits. The major sources of borrowings were corporates, banks, central/state government, convertible debentures and financial institutions. Capital adequacy norms were made applicable to NBFCs in 1998. Out of the 714 reporting NBFCs, 525 NBFCs had CRAR above 30 per cent as on March 31, 2001. However, the number of NBFCs having capital adequacy ratio of less than 10 per cent increased during the year 2000-01.

There is considerable diversity in the composition; structure and functioning of NBFCs. Deposits of NBFCs witnessed a substantial increase since 1970s in tandem with a manifold increase in the number of reporting companies from 2,242 in 1969 to 11,010 in 1993. Subsequent upon the introduction of the new regulatory frameworks in 1997-98, the deposits of NBFCs have witnessed a marked decline (Table 14.1).

**Table 14.1: Deposits with NBFCs** 

Period	As percent of Bank Deposits	As percent of GDP
1979-71 to 1974-75	0.71	6.12
1980-81 to 1984-85	9.49	6.14
1990-91 to 1992-63	1.18	0.45
1996-97	9.47	3.98
1997-98	3.70	1.57
1999-2600	2.16	1.10
2660-01	1.73	6.95

Note: Degesits of NBFCs, for the period 1978-71 to 1966-97 refer to regulated deposits.

#### 14.8 REGULATION OF NBFCs

In the 1960s, the Reserve Bank made an attempt to regulate NBFCs by issuing directions relating to the maximum amount of deposits, the period of deposits and rate of interest they could offer on the deposits accepted. Norms were laid down regarding maintenance of certain percentage of liquid assets, creation of reserve funds, and transfer thereto every year a certain percentage of profit, and so on. These directions and norms were revised and amended from time to time.

In 1977, the Reserve Bank issued two separate sets of guidelines, namely, (i) NBFC Acceptance of Deposits Directions, 1977, for NBFCs and (ii) MNBD Directions, 1977, for MNBCs. These directions were related to deposit-taking

activities of NBFCs. The Reserve Bank made an attempt to regulate the asset side of NBFCs in 1994 in pursuance of the Shah Committee recommendations. However, it was not empowered to regulate the asset side of NBFCs.

NBFCs became prominent in the first half of the 1990s. The growth in aggregate deposits of NBFCs outpaced that of banks. However, bank finance to NBFCs dried up in 1995 after the Reserve Bank cautioned banks against such lending. Therefore, NBFCs had to depend on fixed deposits often at rates upto 26 per cent. To service high-cost deposits, NBFCs invested in bought-out deals, shares, real estate and corporate financing-areas in which they had little experience. The slackness in the capital and real estate markets and general industrial activities resulted in sharp deterioration in NBFC's quality of assets.

Crores of rupees of small investors disappeared overnight as NBFCs like CRB Capital Markets, JVG Finance, and Prudential Capital Markets failed in 1997. This shook investor confidence, which resulted in a rush of withdrawals of public deposits. This is the only sector which had a number of committees trying to regulate its working. The first was the Shah Committee in 1992. The Shere Committee, Khanna Committee, and various committees of the Reserve Bank of India followed it. In 1997, the RBI Act was amended and the Reserve Bank was given comprehensive powers to regulate NBFCs. The amended Act made it mandatory for every NBFC to obtain a certificate of registration and have minimum net owned funds. Ceilings were prescribed for acceptance of deposits, capital adequacy, credit rating and net-owned funds. Net owned fund (NOF) of NBFCs is the aggregate of paid-up capital and free reserves, netted by (i) the

amount of accumulated balance of loss (ii) deferred revenue expenditure and other intangible assets, if any, and further reduced by investments in shares and loans and advances to (a) subsidiaries (b) companies in the same group and (c) other NBFCs, in excess of 10 per cent of owned fund. Norms relating to capital adequacy, credit rating exposure, asset classification, and so on were laid down. The Reserve Bank also developed a comprehensive system to supervise NBFCs accepting/holding public deposits. Directions were also issued to the statutory auditors to report non-compliance with the RBI Act and regulations to the RBI, Board of Directors and shareholders of the NBFCs.

The Task Force constituted by Government of India under the Chairmanship of Shri C M Vasudev submitted its report on October 28, 1998, after reviewing the existing regulatory framework for NBFCs. The Government of India framed the Financial Companies Regulation Bill, 2000; to implement the recommendations requiring statutory changes, as also consolidate the law, relating to NBFCs and unincorporated bodies with a view to ensuring depositor protection. According to this bill, all the NBFCs will be known as Financial Companies instead of NBFCs.

# 14.8.1 IMPORTANT STATUTORY PROVISIONS OF CHAPTER IIIB OF THE RBI ACT AS APPLICABLE TO NBFCS.

1. Certificate of registration: No company (nidhi and chit fund companies exempted), other than those exempted by the RBI, can commence or carry on the business of non-banking financial institution without obtaining a CoR from RBI. The pre-requisite for eligibility for such a CoR is that the NBFC should have a minimum

NOF of Rs 25 lakh (since raised to Rs 2 crore on and from April 21, 1999, for any new applicant BBFC). The RBI considers grant of the CoR after satisfying itself about the company's compliance with the criteria enumerated in section 45-IA of the RBI Act.

- 2. Maintenance of Liquid Assets: NBFCs (nidhi and chit fund companies exempted) have to invest in unencumbered approved securities, valued at a price not exceeding current market price, an amount which, at the close of business on any day, shall not be less than 5.0 per cent but not exceeding 25.0 per cent specified by RBI, of the deposits outstanding at the close of business on the last working day of the second preceding quarter.
- 3. Creation of Reserve Fund: All non-banking financial company shall create a reserve fund and transfer thereto a sum not less than 20.0 per cent of its net profit every year as disclosed in the profit and loss account and before any dividend is declared (nidhi and chit fund companies exempted). Such fund is to be created by every NBFC, irrespective of the fact whether it accepts public deposits or not. Further, no appropriation can be made from the fund for any purpose without prior written approval of RBI.

#### 14.8.2 Directions applicable to NBFCs

The RBI has issued comprehensive deposit acceptance and asset side regulations as under for the NBFCs. While all the prudential norms are

- applicable to public deposit accepting/holding NBFCs only, some of the regulations are applicable to non-deposit accepting companies.
- 1. Ceiling on quantum of public deposits: Loan and investment companies-1.56 times of NOF if the company has NOF of Rs 251akh, minimum investment grade (MIG) credit rating, complies with all the prudential norms and has CRAR of 15 per cent. Equipment leasing and hire purchase finance companies-if company has NOF of Rs 25 lakh and complies with all the prudential norms.(i) with MIG credit rating and 12 per cent CRAR times of NOP; (ii) without MIG credit rating but CRAR 15 per cent or above-1.5 times of NOF, or Rs 10 Crore, whichever is less.
- 2. Investment in Liquid Assets: NBFCs-15 percent of outstanding public deposit liabilities as at the close of business on the last working day of the second preceding quarter, of which (i) not less than 10 per cent in approved securities; and (ii) not more than 5 per cent in term deposits with scheduled commercial banks. RNBCs-10 percent of outstanding deposit liabilities as at close of business on last working day of second preceding quarter. These liquid asset securities are required to be lodged with one of the scheduled commercial banks or Stock Holding Corporation of India Ltd., or a depository or its participant (registered with SEBI). Effective October 1, 2002, government securities are to be necessarily held by NBFCs either in Constituent's Subsidiary General Ledger Account with a scheduled commercial bank or in a demat account with a depository participant registered with SEBI. These securities cannot be withdrawn or

otherwise dealt with for any purpose other than repayment of public deposits.

**3. Period of Deposits:** No demand deposits.

NBFCs-12 to 60 months

RNBCs-12 to 84 months

MNBCs (Chit Funds)-6 to 36 months

- 4. Ceiling on Deposit rate: NBFCs, MNBCs and Nidhis-12.5 percent per annum (effective November 1, 2001). RNBCs-Minimum interest of 4.0 per cent on daily deposits and 6.0 per cent on other than daily deposits. Interest may be paid or compounded at periods not shorter than monthly rests.
- **Advertisement and methodology for acceptance deposits/public deposits:** Every company which accepts deposits by advertisement has to comply with the advertisement rules prescribed in this regard, the deposit acceptance form should contain certain prescribed information, issue receipt for deposits, maintain a deposit register, and so on.
- **6. Submission of returns:** All NBFCs holding or accepting public deposits have to submit periodical returns to RBI at Quarterly, half yearly and annual intervals.

## 14.8.3 SUPERVISION

In order to ensure that NBFCs function on sound lines and avoid excessive risk taking, the RBI has developed a four pronged supervisory framework based on:

(i) On-site inspection structured on the basis of assessment and evaluation of

CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Systems) approach; (ii) Off-site monitoring supported by state-of-the-art technology. It is through periodic control reports from NBFCs. (iii) Use of Market Intelligence System; and (iv) Exception reports of statutory auditors of NBFCs.

The RBI supervises companies not holding public deposits in a limited manner. Companies with asset size of Rs 100 Crore and above are subject to annual inspection while other non-public deposit companies are supervised by rotation once in every five years.

## 14.8.4 Role of Board for Financial Supervision in Monitoring NBFCs

With a view to having an integrated approach to the entire financial sector, the supervision of NBFCs was brought under the jurisdiction of the Board for Financial Supervision (BFS) with effect from July 1, 1995. BFS directs, formulates, and oversees the implementation of policy as well as supervises NBFCs. BFS also serves as an important forum for deciding the course of action against problem companies and monitoring their status on an on-going basis. In addition, quarterly and half-yearly reports on the performance of NBFCs are discussed in BFS meetings.

# 14.8.5 Automatic Approval Route of RBI for NBFCs

Automatic approval for FDI / NRI investment allowed up to 100% in merchant banking, underwriting, portfolio management services, investment advisory services, financial consultancy, stock broking, asset management, venture capital, custodial services, factoring, credit reference agencies, credit rating agencies, leasing & finance, housing finance, forex broking, credit card business, money

changing business, micro credit and rural credit subject to compliance with RBI guidelines and minimum capitalization norms. Minimum capitalization norms for fund based NBFCs: For FDI up to 51% - US \$ 0.5 million to be brought upfront; for FDI above 51% and up to 75% - US \$ 5 million to be brought upfront; for FDI above 75% and up to 100% - US \$ 50 million out of which US \$ 7.5 million to be brought upfront and the balance in 24 months. Minimum capitalization norms for non-fund based activities of US \$ 0.5 million is applicable in respect of all permitted non- fund based NBFCs with foreign investment. Foreign investors can set up 100% operating subsidiaries without the condition to disinvest a minimum of 25% of its equity to Indian entities, subject to bringing in US \$ 50 million as given above, without any restriction on number of operating subsidiaries without bringing in additional capital. Joint venture operating NBFCs that have 75% or less than 75% foreign investment are also allowed to set up subsidiaries for undertaking other NBFC activities subject to the subsidiaries also complying with the applicable minimum capital inflow as given above.

# 14.9 **SUMMARY**

The impact of foreign banks on India's banking sector is limited at this stage although it contributed to improving domestic banks' management and balance sheets. While foreign banks are to be allowed to engage in the local-currency activities under the WTO framework, the Government should give in the next reform agenda the highest priority to more drastic measures for reforming public sector banks and liberalizing the whole commercial banking sector, through careful consideration of the various aspects indicated above. The existence of remaining barriers, such as administered interest rates on saving deposits and other saving schemes, may partly explain why financial deepening

has taken place at a relatively mild pace in India, compared with the earlier period. Household sector savings have remained at 20 percent of GDP, while physical savings account for only 9% of GDP. Given India's large population and relatively high-income growth, there is room for the country's banking sector to grow further through increased deposit mobilization.

NBFCs in India have become prominent in a wide range of activities like hire purchase finance, equipment lease finance, loans, investments, and so on. NBFCs have greater reach and flexibility in tapping resources. In desperate times, NBFCs could survive owing to their aggressive character and customised services. NBFCs are doing more fee-based business than fund-based. They are focusing now on retail sector-housing finance, personal loans, and marketing of insurance. Many of the NBFCs have ventured into the domain of mutual funds and insurance. NBFCs undertake life and general insurance, business as joint venture participants in insurance companies. The strong NBFCs have successfully emerged as 'Financial Institutions' in a short span of time and are in the process of converting themselves into Financial Super Market -a one stop financial shop. The NBFCs are taking initiatives to establish a self-regulatory organisation (SRO). At present, NBFCs are represented by the Association of Leasing and Financial Services (ALFS), Federation of Indian Hire Purchase Association (FIHPA) and Equipment Leasing Association of India (ELA). The Reserve Bank wants these three industry bodies to come together under one roof. The Reserve Bank has emphasised on formation of SRO particularly for the benefit of smaller NBFCs.

# 14.10 SELF-TEST QUESTIONS

- 1. What in your opinion has been the role and contribution of foreign banks since they began their operations in India and how have they been instrumental in shaping the economy of India?
- 2. What have been the salient features of the banking scenario in the post-liberalization period, with special reference to foreign banks?
- 3. What are the various financial products, services, and significant innovations that have been initiated by foreign banks in course of their operations in India?
- 4. What are the various obstacles faced by foreign banks in the expansion of their businesses in India?
- 5. How do you envision the future of foreign banks in India?
- 6. What do you mean by NBFCs? What is the role of them in the Indian Economy?
- 7. How can you say NBFCs are important to initialize to strengthen an economy of a nation?
- 8. What type of regulation and provisions are followed by NBFCs in India?

# 14.11 SUGGESTED READINGS

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**COURSE: BUSINESS ENVIRONMENT** 

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LESSON: 15 VETTER: Dr. V. K. BISHNOI

TECHNIQUES OF ENVIRONMENTAL ANALYSIS

**OBJECTIVE:** After reading the chapter, the students will be able to understand the techniques of environmental analysis.

**STRUCTURE** 

15.1 Introduction

15.2 Techniques for Environmental Analysis

15.3 Types of Forecasting

15.4 Techniques for Environmental Forecasting

15.5 Benefits/Importance of Environmental Analysis

15.6 Limitations of Environmental Forecasting

15.7 Summary

15.8 Self-Test Questions

15.9 Suggested Readings

15.1 INTRODUCTION

The strategic business decisions need a clear identification of the relevant variables and a detailed and in-depth analysis of them. A good amount of information is available about the past, recent, current, ensuing the future events and developments in respect of different manners. However, there are a number of things about which information is scanty. To generate adequate information in such areas, research, discussion and forecasting, including scenario building, may be necessary. There are many pieces of vital information available in respect of a

number of matters. Such information should be analysed to understand the impact on and implications for the organisation. In addition, a thorough analysis of the environment is necessary to identify the future threats and opportunities and for formulating strategic plans.

# 15.2 TECHNIQUES FOR ENVIRONMENTAL ANALYSIS

Techniques for environmental analysis refer to the methods of gathering the relevant information for appraising the environment. William Glueck mentions four techniques for environmental analysis: Verbal and Written Information; Search and Scanning; Spying; and Forecasting and formal studies.

#### 15.2.1 VERBAL AND WRITTEN INFORMATION

A lot of documented information, published or unpublished, is available on many matters. However, people may not like to put on record certain types of information which they may be prepared to divulge orally, some times on condition of anonymity or confidentiality. Tact and proper approach are required to obtain such information. Verbal information is significant in several other situations. The situation might have changed after the documentation of the information, necessitating personally contacting knowledgeable people to get the latest information. Personal contacts will be helpful in getting more details of the written information. Personal contacts will also be useful in obtaining diverse views of different people. There are indeed many matters on which written information is non-existent or scanty. All these highlight the importance of verbal information in environmental analysis. While using written information, several factors such as the purpose for which it was prepared, the methodology used for

collection of the information, reliability of the sources of information, the ideology/orientation of the individual/organisation that prepared the information etc. need to be evaluated. Such cautions should also be exercised while going in for verbal information. Sources of verbal information also include electronic media, seminars, and workshops etc.

### 15.2.2 SEARCH AND SCANNING.

Even when the required information exists somewhere, it may not become readily available. Search and scanning are, therefore, needed, many a times to identify the sources of information and to manage the timely availability of the required information. A number of organisations have clipping service which constantly scans newspapers, periodicals etc. and prepare clippings containing information required by different departments/executives of the organisation. Many organisations have Management Information System for systematic gathering, processing, storing and disseminating information. An MIS is generally regarded as very useful.

#### **15.2.3 SPYING**

Spying, albeit regarded unethical by many, is not very uncommon in business.

This has been used to a considerable extent to obtain secret information regarding defense and space research. There are many instances of industrial espionage also.

This is used mostly to gather competitive information.

#### 15.2.4 FORECASTING

The environmental forecasting is similar to formulating and executing a research project. The important steps in environmental forecasting are the following.

important step in environmental forecasting is identification of the environmental variables critical to the firm. All environmental variables do not have the same relevance to all the industries or firms. A variable that is relevant to one industry may not be relevant for another. Again, important developments in some market may not have any implications for some other markets. For example, the high level of penetration of

microwave ovens in some of the developed countries like USA is a critical variable as far as food processing industry in that market is concerned; but it is not relevant in markets where the microwave ovens have not penetrated, if micro-waveable packaging increases the cost of the product it could be a negative factor in such markets. Similarly, a factor relevant in one technological environment may not be relevant in a different environment. Diesel price is a critical factor for railways, which use that energy source, but not for those, which depend on electricity (assuming that there is no competition between those depending on these two different energy sources). Some demographic trends have implications for certain business. A falling birth rate is. a threat to several businesses (for example, for companies like Johnson & Johnson, which depends heavily on the baby segment of the market). The increase in the longevity and the resultant increase in the number of aged generate good demand for several goods and services. To envision the future environment it is essential to identify the critical environmental variables and to predict their future trends. Omission of any critical variable will affect the assessment of the future environment and strategies based on that premise. Similarly, inclusion of variables, which are not adequately relevant, could have misleading effects.

Pearce and Robinson point out that the list of key variables that will have make or break consequences for the firm can be kept to manageable size by limiting key variables in the following ways:

(i) Include all variables that would have a significant impact although their probability of occurrence is low. Delete others with little impact and low probability.

Disregard major disasters, such as nuclear war.

Aggregate when possible into gross variables (e.g., a bank loan is based more on the dependability of a company's cash flow than on the flow's component sources).

If the value of one variable is based on the value of the other, separate the dependent variable for future planning.

Collection of Information: The key environmental variables having been determined, the next important step is the collection of the needed information. This involves identification of the sources of information, determination of the types of information to be collected, selection of methods of data collection and collection of the information.

Selection of Forecasting Technique: The dependability and usefulness of the forecast depend a lot on the appropriateness of the forecasting technique-used. The choice of forecasting technique depends on such considerations as the nature of the forecast decision, the amount and accuracy of available information, the accuracy required, the time available. The importance of the forecast, the cost, and the competence and interpersonal relationships of the managers and forecaster involved. One issue often debated is the quantitative techniques versus qualitative techniques. The fact is that each has its own merits and limitations. Some people have a

wrong notion that quantitative techniques are highly dependable and qualitative techniques are often too subjective that they are not reliable. The dependability of the quantitative techniques is affected by the accuracy/reliability of the data used. It is pointed out that the difference in the predictions using each type of approach is often minimal. Additionally, subjective or judgement approaches may often be the only practical method of forecasting political, legal, social, and technological trends in the remote external environment. The same is true of several trends in the task environment, especially customer and competitive considerations.

**Monitoring:** The characteristics of the variables or their trends may undergo changes. Further, new variables may emerge as critical or the relevance of certain variables may decline. It is, therefore, necessary to monitor such changes. Sometimes the changes may be very significant so as to call for a re-forecasting.

# 15.3 TYPES OF FORECASTING

Forecasts of the important business environments, viz; economic environment, social environment, political environment etc. would be useful in formulating plans and strategies.

**15.3.1 Economic Forecast:** The fact that economic environment is a very critical determinant of business prospects underscores the importance of economic forecasts. Important economic factors often considered include general economic conditions, GDP growth rate, per capita income, distribution of income, structural changes in GDP, investment and output trends in.

different sectors and subsectors/industries, price trends, trade and BOP trends etc. The macro economic forecasts serve as a base for deriving industry and company forecasts. There are indeed a number of sources of short, medium and long-term forecasts. International organisations like World Bank, IMF, UNCTAD, UN, WTO etc. and regional organisations like Asian Development Bank have periodic and occasional publications, which provide, inter alia, economic forecasts. The Planning Commission and several other bodies like, for example, National Council of Applied Economic Research (NCAER) and Confederation of Indian Industry (Cll) make macro economic estimates and forecasts of the Indian economy. Sector specific organisations do such things for the concerned sectors. It becomes more useful when disaggregated details of the estimates/forecasts are available. When reliable forecasts are not available from the secondary source, a firm has to make it own forecasts. Reliable forecasts give very useful picture of the future scenario helpful to planning and strategy. For example, details of power development would indicate the scope of investment in the power sector itself and the prospects of related industries like generators, transformers, cables, switch gears, other electrical goods and materials used by power projects etc. Plans of rural electrification will give some indication of the additional demand for pump sets and certain categories of consumer durables and non-durables. Short-term economic forecasts are very useful for demand and sales forecasting and marketing strategy formulation. Both quantitative methods such as econometric

methods, and time series models and qualitative techniques like judgement models can be used for economic forecasts.

15.3.2 Social Forecasts: There are a number of social factors, which have profound impact on business. It is, therefore, very essential to forecast the possible changes in the relevant social variables. Important factors include population growth/decline, age structure of population, ethnic composition of population, occupational pattern, rural-urban distribution of population, migration, factors related to family, life style, income levels, expenditure pattern, social attitudes etc. As in the case of economic factors, there is a wealth of published and unpublished data of forecasts of social trends available. International organisations like the UN and its organs, World Bank etc., academic organisations and government organisations do considerable work in these areas. For example, a considerable amount of data is available regarding future trends in birth and death rates and population size, age structure, and ethnic composition etc. of different nations. Certain aspects of this are dealt with in the chapters Societal Environment and Demographic Environment. Social trends have significant implications for business strategy. Quantitative techniques like time series analysis and econometric methods and qualitative methods like Delphi method or a combination of both quantitative and qualitative techniques may be used for social forecasts. One of the most popular methods is scenario building, which involves drawing up alternative future scenarios, based on different assumptions or predictions of developments.

**15.3.3 Political Forecasts:** Political forecast has an important part in envisioning properly the future scenario of business. There are even chances of a country undergoing a drastic shift in the political system (Example: USSR and Eastern Europe in the late 1980's). Changes in the relative power of political parties, changes in the internal power structure of political parties (including changes in leadership and its implications), political alliances and political ideologies etc. may have implications for business. Some political factors may be embedded in social factors. Political forecasts also cover industrial policy, commercial policy and fiscal policy. Some political changes are sudden and unpredictable. There are, however, several changes, which are reasonably predictable. For example the sweeping political and economic changes in the erstwhile USSR and Eastern Europe and the general liberalisation trend in many other countries could be regarded as an indicator that liberalisation would set in India too. The liberalisation ushered in 1991 indicated that there would be privatisation (which even. at the end of 1990's has not assumed a serious intent and real earnest in India) and other liberalisation. The discussions on decentralisation and government pronouncement on this' enabled the prediction of administrative decentralisation in several States in India. With the decentralisation, decision-making process in the government has changed and this has important implications for business. Pre-election opinion polls may help certain political forecasts. There are several factors, which have international or global overtones. Sanctions, formal or informal, which have serious consequences for business are nor very rare. Increasing world interdependence makes it imperative for firms of all sizes to consider the international political implications of their strategies. In the early 1980s, while the price of a barrel of oil was hovering around \$30 and many were predicting an increase in the oil prices to around \$50 per barrel by 1990s, Royal Dutch shell mulled over the possibility of a break-down of the oil cartel's (OPEC) agreement to restrict the supply, an oil glut and a drop in the price to \$15 and instructed its operating managers to plan how they would respond to such a situation. As a result, when the oil price crashed from \$ 27 in January 1986 to \$10 in April, Shell was much better prepared than its rivals to effectively respond to this challenge. Companies, research organisations and consultants have developed a variety of approaches to international forecasts of which political factors are an important component. Harner's Business Environmental Risk Index, for instance, monitors a number of economic and political variables in many countries. The World Economic Forum brings out annually a Global Competitiveness Report based on eight set of factors including government, openness and institutions.

**15.3.4** Technological **Forecast:** Innovation and other technological developments drastically alter the business environment. can Technological forecasts, therefore, assumes great significance. Technological forecast encompass not only technological innovations but also the pace and extent of diffusion and penetration of technologies and their implications. For example., what will be the pace and extent of penetration of PCs and the internet and their implications for business? How far can and will the existing and new technologies be applied in diverse areas and what are their implications? It may be noted that one of the eight components of the world competitiveness index used in the World Competitiveness Report is technology, which measures computer usage, the spread of new technologies, the ability of the country to absorb new technologies and the level and quality of Research and Development. The Technology Information, Forecasting and Assessment Council (TIFAC) established in 1988 have done considerable work to draw up a Technology Vision 2020 for India. It is among the tasks of TIFAC to look ahead at the technologies emerging worldwide and pick those technology trajectories, which are relevant for India and should be promoted.

# 15.4 TECHNIQUES FOR ENVIRONMENTAL FORECASTING

As mentioned earlier, there are a number of quantitative and qualitative techniques used in environmental forecasting. Some important techniques are mentioned below.

# 15.4.1 ECONOMETRIC TECHNIQUES

Economic techniques involve casual models to predict major economic indicators. When there is a well-established relationship between two or more variables, that casual relationship can be used to forecast the future. For example, if demand is a function of consumer income, the impact of an increase in consumer income on demand can be predicted using the equation representing the relationship between

these two key variables. The econometric models may utilise complex simultaneous regression equations to relate economic occurrences to areas of corporate activity. They are especially useful when information is available on casual relationships and when large changes are anticipated. The most commonly used econometric environmental forecasting techniques are multiple regression analysis and time series regression models.

## 15.4.2 TREND EXTRAPOLATION

Time series models assume that the past is a prologue to the future and extrapolate the historical data to the future. The technique may use simple linear relationship or more complex non-linear relationships to forecast trends.

#### 15.4.3 SCENARIO DEVELOPMENT

A very popular and useful forecasting method is development of alternative scenarios. When it is not possible to accurately forecast the future, the alternative scenarios help managers to formulate strategies to cope with different possible future situations. As hinted earlier (under political forecasts), Royal Dutch Shell's anticipation of a possibility of a substantial crash in oil prices in future prompted it cut exploration costs .by pioneering advanced exploration technologies, massive investments in cost efficient refining facilities etc so that by 1989 its exploration costs at \$2 per barrel were less than half the industry average. "Scenario analysis is a technique used to forecast the occurrence of complex environmental events. It is particularly useful for forecasting events in which many variables playa role. Scenarios allow the integrated consideration of these multiple variables in explaining the emergence of future conditions. A scenario is a detailed description

of how certain events may occur in the future and their consequences for the organisation." Shrivastava suggests the following steps to develop scenarios.

- Identify strategic environmental issues that are likely to affect the industry/firm. Prioritize these issues in order of their importance to the firm.
- Select the most important issues as the focus for scenario development.
   List the organizational assumptions with respect to these issues and identify the possible variations in these assumptions.
- 3. Prepare a preliminary description of these issues and how they evolved.

  Include the key economic, social, political, and cultural influences that affect them. Do this with help of outside industry experts.
- 4. Draw out the implications of the issue for organizational performance. What has the organization done and what can it do to cope with the issues? Identify those variables shaping the issue that the management can control and partially control. Also, identify those variables over which management has no control.
- 5. Develop detailed descriptions of the future in the form of scenarios.

  Scenarios are constructed under a worst case, best case, and most likely case set of assumptions. Draw out the implications of these scenarios for future performance of the company.
- 6. Discuss the scenarios with top management and refine them.
- 7. Develop contingency action plans for each scenario.

Developing alternative scenarios is common in economic planning too. The

Planning Commission of India, for example, have drawn up alternative scenarios regarding growth rates of different sectors, poverty ratios etc. under different assumption. Many forecasts, which use the scenario method, draw up three alternative scenarios - a most likely scenario, a pessimistic scenario and an optimistic scenario. However, forecasts having more than three scenarios are not uncommon.

# 15.4.3.1 Methods of Scenario Building

- 1. **Premising Method:** In this method, a series of premises is drawn up from which projection of the future scenarios is made. The premises might consist of basic assumptions about certain important variables, current trends etc. Sometimes extreme projections may also be made focusing on a few tendencies and exaggerating their evolution. For example, the extreme possible outcome of some ethnic issues in a country.
- 2. Systems Diagram Method: The systems diagram method seeks to explore policy and strategic options based on the present system of the organisation's activities. For example, a newspaper firm may think of entering other media. Extending the publication business, starting information service business etc. using and developing its existing capabilities.
- 3. Critical Site Method: This method which bases the scenario projection on the policy making structure of an organisation identifies the key decision making points and dynamics of the system focuses on the critical site where the key decisions are taken, such as the meeting of the Board of

a company, the national convention or the meeting of the policy decision making body of the relevant political party, critical meetings of organisations like OPEC or WTO etc. Scenarios are drawn up based on the anticipation of the possible critical decisions made at such sites and their future implications.

- 4. The Newspaper Headline Method: In this method the scenario writer posits one or more hypothetical headlines for .some future date' such as:

  New Delhi, January 20. 2010: "The three surviving car manufactures in India intensify the battle for market share: The scenario writer then tries to map out the possible developments in the industry during the course and chart out a strategy for the company to successfully navigate through.
- **5. Logical Possibilities Method**: This method, which generates alternative scenarios based on those already developed, is used as a supplement to other methods.

## 15.4.4 JUDGEMENT MODELS

Judgement models involve the use of opinion of people who have intimate knowledge of relevant factors. For example, sales force: opinion of the sales potential, competitive challenges, customer behaviour etc. Another method is jury's executive opinion, which combines estimates made by executives from marketing, production, finance and purchasing and then averages their views.

#### 15.4.5 BRAIN STORMING

Brainstorming is a creative method of generating ideas and forecasts. Under this method, a group of knowledgeable people is encouraged to generate ideas, discuss

them and to make forecasts on the basis of that. With a view to encouraging throwing up new ideas without any reservation, the discussion and evaluation of the ideas generated is often done only after the idea generation process is over. Brain storming is a popular technique of technological forecasting.

#### 15.4.6 DELPHI METHOD

The Delphi method, which is also a common technique of technological forecasting, is a more systematic technique than brain storming. This method uses a panel of experts on the subject from whom opinions are gathered, may be by using a semi-structured questionnaire and/or interview. The opinions of the experts are documented and consolidated and circulated among the panel members, preferably anonymously, for their evaluation and comments. The experts are requested to review their opinion in the light of the feedback. This process may be continued until a consensus view is arrived at. The RAND Corporation which pioneered the use of this technique used it to predict the impact of the formation of the OPEC on oil supplies and oil prices. Other applications of this technique included assessing trends in terrorist activities and their influence on international businesses and prioritising domestic social programmes.

#### 15.4.7 STRATEGIC ISSUES ANALYSIS

Strategic issue analysis is a qualitative technique that can be used for assessing emerging strategic environmental issues. It consists of systematically monitoring of social, regulatory and political changes that can affect corporate performance and identifying their impact on the company. For example, companies, which

were doing business in South Africa, used this technique to assess the impact of racial tensions there on their worldwide business. Similarly, chemical companies, such as Du Pont, Monsanto, and Stauffer Chemicals have used this technique for assessing the impact of environmental movement on the cost of doing business.

# 15.5 BENEFITS/IMPORTANCE OF ENVIRONMENTAL

# **ANALYSIS**

Environmental analysis has several benefits like those mentioned below.

- 1. The very idea of environmental analysis makes one aware of the environment- organisation linkage.
- **2.** A corollary of the above is that (environmental analysis helps) an organisation to identify the present and future threats and opportunities.
- **3.** Environmental analysis will provide a necessary and very useful picture of the important factors, which influence the business.
- **4.** Environmental analysis helps to understand the transformation of the industry environment.
- **5.** Technological forecasting will indicate some of the future opportunities and challenges.
- **6.** A very important benefit of environmental analysis is its contribution to identification of risks.
- 7. Environmental analysis is a prerequisite for formulation of right strategies
- corporate, business and functional.
- **8.** Environmental monitoring helps suitable modifications of the strategies as and when required.

**9.** Environmental analysis keeps the managers informed, alert, and often dynamic.

# 15.6 LIMITATIONS OF ENVIRONMENTAL FORECASTING

Environmental forecasting has several limitations. Some of the limitations arise from the forecasting techniques used. Further there are also chances of certain errors affecting the reliability of the forecasts. Errors may occur.

- 1. The selection of the variables included in the predictive model.
- 2. The selection of the functional form for linking these predictor variables to the variable(s) being predicted and
- 3. The estimation of the 'correct' values for the predictor variables.

Several techniques use opinions of people and they may be affected by subjectivity.

## 15.7 SUMMARY

Adequate and reliable information is a prerequisite for managerial decision-making. That strategic management is establishing the right 'firm-environment' fit and further that strategic decisions involve committing resources today for tomorrow make clear the importance of environmental analysis, including environmental forecasting, to strategic management.

# 15.8 SELF-TEST QUESTIONS

- 5. What do you mean by environmental analysis?
- 6. How can you evaluate the techniques of environmental analysis in Indian industries?
- 7. What do you mean by environmental forecasting?
- 8. Explain the benefits and limitations of environmental analysis?

# 15.9 SUGGESTED READINGS

- Cherrunilam, Francis (2003), Business Environment, New Delhi: Vikas Publishing House Private Limited.
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- 3. Paul, Srivastava, *Strategic Management*, Cinicinnati:South-Western Publishing Conmpany.
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**COURSE: BUSINESS ENVIRONMENT** 

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## TECHNIQUES OF COMPETITION ANALYSIS

**OBJECTIVE:** After reading the chapter, the students will be able to understand the concept of competition and techniques of analysing the competition.

# **STRUCTURE**

- 16.1 Introduction
- 16.2 Competition and Competitors
- 16.3 Competitive Structure of Industries
- 16.4 Strategic Groups
- 16.5 Implications of Strategic Groups
- 16.6 Limitations of Porterian Models
- 16.7 Competitor Analysis
- 16.8 Environmental Analysis and Strategic Management
- 16.9 Summary
- 16.10 Self-Test Questions
- 16.11 Suggested Readings

# 16.1 INTRODUCTION

The microenvironment consists of the actors in the company's immediate environment that affects the performance of the company. These include the suppliers, marketing intermediaries, competitors, customers and the publics. The macro environment consists larger societal forces that affect all the actors in the company's microenvironment namely, the demographic, economic, and natural, technical, political and cultural forces. It is quite obvious that the micro environmental factors are more intimately linked with the company than that of

the macro factors. The micro forces need not necessarily affect all the firms in a particular industry in the same way. Some of the micro factors may be particular to a firm. For example, a firm, which depends on a supplier, may have a supplier environment, which is entirely different from that of a firm whose supply source is different. When competing firms in an industry have the same microelements, the relative success of the firms depends, inter alia, on their relative effectiveness in dealing with these elements.

In addition to above the macro forces are, generally, more uncontrollable than the micro forces. When the macro environment is uncontrollable, the success of a company depends on its adaptability to the environment e.g., if the cost of the imported components increases substantially because of the depreciation of the domestic currency, a solution may be their domestic manufacture. The macro environment factors include economic environment, demographic environment, technological environment, natural environment, and global environment.

# 16.2 COMPETITION AND COMPETITORS

A firm's competitors include not only the other firms, which market the same or similar products, but also all those who compete for the discretionary income of the consumers. For example, the competition for a company's televisions may come not only from other T.V. manufacturers but also from two-wheelers, refrigerators, cooking ranges, stereo sets and so on and from firms offering savings and investment schemes like banks, Unit Trust of India, companies accepting public deposits or issuing shares or debentures etc. This competition among these products may be described as desire competition as the primary task

here is to influence the basic desire of the consumer. Such desire competition is generally very high in countries characterised by limited disposable incomes and many unsatisfied desires (and, of course, with many alternatives for spending/investing the disposable income). If the consumer decides to spend his discretionary income on recreation (or recreation cum education) he will still be confronted with a number of alternatives to choose from like T.V., stereo, two-inone, three-in-one etc. The competition among such alternatives, which satisfy a particular category of desire, is called generic competition. If the consumer decides to go in for a T.V., the next question is which form of the T.V. black and white or colour with remote control or without it etc. In other words, there is a product form competition. Finally, the consumer encounters the brand competition i.e., the competition between the different brands of the same product form. An implication of these different demands is that a marketer should strive to create primary and selective demand for his products. Consequent to the liberalisation, the competitive environment in India has been undergoing a sea change. Many companies restructured their business portfolio and strategies. In many industries where a seller's market existed a buyer's market has emerged.

# 16.3 COMPETITIVE STRUCTURE OF INDUSTRIES

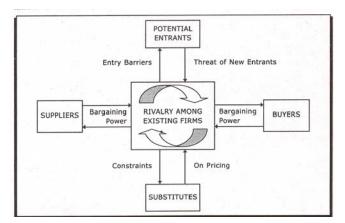
The competitive structure of industries is a very important business environment. Identification of forces affecting the competitive dynamics of an industry will be very useful in formulating strategies. According to Michael Porter's well known model of structural analysis of industries, the state of competition in an industry depends on five basic competitive forces, viz., (i) Rivalry among existing firms;

(ii) Threat of new entrants; (iii) Threat of substitutes; (iv) Bargaining power of suppliers; and (v) Bargaining power of buyers. The Graphics depicts the five forces competitive structure of industry.

# 16.3.1 THREAT OF ENTRY

A growing industry often faces threat of new entrants that can alter the

competitive environment. There may, however, be a number of barriers to entry. Potential competition tends to be high if the industry is profitable or critical, entry barriers are low and expected



retaliation from the existing firms is not serious. The following are some of the important common entry barriers

- important entry barriers. For example, prior to the economic liberalisation in India, government-dictated entry barriers were rampant, like reservation of industries / products for public sector and small scale sector, industrial licensing, regulations under MRTP Act, import restrictions, restrictions on foreign capital and technology etc.
- **2. Economies of Scale**: Economies of scale can deter entry in two ways: it keeps out small players and discourages even potentially large players because of the risk of large stakes.

- 3. Cost Disadvantages Independent of Scale: Entry barrier may also arise from the cost advantages, besides that of economies of scale, enjoyed by the established firms which cannot be replicated by new firms, such as proprietary product technology, learning or experience curve, favourable access to raw materials, favourable location, government subsides etc.
- 4. **Product Differentiation:** Product differentiation characterised by brand image, customer royalty, product attributes etc. may form an entry barrier forcing new entrants to spend heavily to overcome this barrier.
- **Monopoly Elements:** Proprietary product / technology, monopolisation/ effective control over raw material supplies, distribution channels etc. are entry barriers which are insurmountable or difficult to overcome.
- **6. Capital Requirements:** High capital-intensive nature of the industry is an entry barrier to small firms. Further, the risk of huge investment could be a discouraging factor even for other firms.

## 16.3.2 RIVALRY AMONG EXISTING COMPETITORS

Rivalry among existing competitors is often the most conspicuous of the competitions. Firms in an industry are "mutually dependent" - competitive moves of a firm usually affects others and may be retaliated. Common competitive actions include price changes, promotional measures, customer service, warranties, product improvements, new product introductions, channel promotion etc.

There are a number of factors, which influence the intensity of rivalry. These include:

- 1. Number of Firms and their Relative Market Share, Strengths etc:

  Rivalry is likely to be affected by the number of firms, their relative market shares, and competitive strengths, etc.
- 2. State of Growth of Industry: In stagnant, declining and, to some extent, slow growth industries a firm is able to increase its sales only by increasing its market share, i.e., at the expense of others.
- **3. Fixed or Storage Costs:** When the fixed or storage costs are very high, firms are provoked to take measures to increase sales for improving capacity utilisation or reducing storage costs.
- 4. Indivisibility of Capacity Augmentation: Where there are economies of scale, capacity increases would be in large blocks necessitating, in many cases, efforts to increase sales to achieve capacity utilisation norms.
- 5. Product Standardisation and Switching Costs: When the product of different firms are standardised, price, distribution, after-sales service, credit etc. become important strategic variables of competition. Absence of switching costs makes firms more vulnerable.
- 6. Strategic Stake: Rivalry in an industry becomes more volatile if a number of firms have high stakes in achieving success there. For example, a firm, which regards a particular industry as its core business, will give great importance to success in that industry.
- 7. **Exit Barrier:** High exist barriers (for example, compensation for labour, emotional attachment to the industry etc.) tend to keep firms competing in an industry even though the industry is not very attractive.

- **8. Diverse Competitors:** Rivalry becomes more complex and unpredictable when competitors are very diverse in their strategies, origins, personalities, relationships to their parents etc.
- 9. Switching Costs: In some cases a barrier to entry is created key switching costs (i.e., one time costs facing the buyer of switching from one supplier's product to another's) such as cost of retraining the employees, cost of new ancillary equipment etc.
- **10. Expected Retaliation:** The potential entrants' expectations about the reactions of the existing competitors may also sometimes deter entry.

#### 16.3.3 THREAT OF SUBSTITUTES

An important force of competition is the power of substitutes. "Substitutes limit the potential returns in an industry by placing a ceiling on the price firms in the industry can profitability charge. Firms in many industries face competition from those marketing close or distant substitutes. Porter points out that substitute products that deserve the most attention are those that (1) are subject to trends improving their price-performance trade off with the industry's product, or (2) are produced by industries earning high profits.

#### 16.3.4 BARGAINING POWER OF BUYERS

For several industries, buyers are potential competitors - they may integrate backward. Besides, they have different degrees of bargaining power. Buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other - all at the expense

of industry profitability. Important determinants of the buyer power, explained by Porter, are the following:

- 1. The volume of purchase relative to the total sale of the seller.
- 2. The importance of the product to the buyer in terms of the total cost.
- 3. The extent of standardisation or differentiation of the product.
- 4. Switching costs.
- 5. Profitability of the buyer (low profitability tends to pressure costs down).
- 6. Potential for backward integration by buyer. .
- 7. Importance of the industry's product with respect to the quality of the buyer's product or services.
- 8. Extent of buyers' information.

#### 16.3.5 BARGAINING POWER OF SUPPLIERS

The important determinants of supplier power are the following:

- 1. Extent of concentration and domination in the supplier industry.
- 2. Importance of the product to the buyer.
- 3. Importance of the buyer to the supplier.
- 4. Extent of substitutability of the product.
- 5. Switching costs.
- 6. Extent of differentiation or standardisation of the product.
- 7. Potential for forward integration by suppliers.

Porter's analysis, thus, shows that competition in an industry goes well beyond the established players. Knowledge of these underlying sources of competitive pressure highlights the critical strengths and weaknesses of the company, animates its positioning in its industry, clarifies the areas where strategic changes may yield the greatest payoff, and highlights the areas where industry trends promise to hold the greatest significance as either opportunities or threats. Understanding these sources will also prove to be useful in considering areas for diversification, though the primary focus here is on strategy in individual industries. Structural analysis is the fundamental underpinning for formulating competitive strategy.

# 16.4 STRATEGIC GROUPS

The analysis of an industry within the framework of the five forces model will give a general picture of the competitive forces. Useful as this analysis is, it is not sufficient enough for formulating competitive strategies. More in-depth knowledge of the competitive situation is needed because the competitive environment and competitive strategies of different firms within an industry may not be the same. The size, resources and strengths of the firms etc. may differ between firms. Again, firms differ with respect to portfolio strategy, product mix in each business, market segments targeted, marketing mix strategy, backward or forward integration, extent of outsourcing, intra-corporate linkages, parentsubsidiary relationships etc. The strategic dimensions for a particular firm usually form an internally consistent set. An industry normally has firms with a number of different, though internally consistent, combinations of dimensions. Analysis of the strategic dimensions of the homogeneous sets of firms in a heterogeneous industry is an important step in structural analysis of industry. In other words, it is necessary to identify the various strategic groups within an industry. According to Porter: "a strategic group is the group of firms in an industry following the same or similar strategy along the strategic dimensions". Normally, a small number of strategic groups capture the essential strategic differences among firms in the industry although one may even think of the extreme cases of an industry having only one strategic group (i.e., all the firms are similar vis-a-vis the strategic dimensions) on the one end and each firm in an industry amounting to a strategic group on the other end. For example, in advanced countries like USA, there are two significant strategic groups in the pharmaceutical industry, namely, the proprietary group (i.e., firms that concentrate on patented drugs and who expend enormous resources on R&D), and the generic group (i.e., firms depending on off patent drugs). In India, in many industries there are, at a very broad level, firms in the organised sector and firms in the unorganised sector. Competitive strategies of the unorganised sector firms are often different from those in the organised sector (it is possible that there are more than one strategic group in each of these sectors). Organised sector firms are normally national or at least regional players whereas the unorganised sector firms, by and large, are local or at best regional player. The direct and major competitors and market/target customers of these groups would be different and, therefore, the marketing strategies would be different. In the furniture industry, for example, Godrej and Allwyn are national players and their important customers are corporate and other quality conscious customers - organisations and individuals who are not very price sensitive. The numerous firms in the unorganised sector in this industry are largely local players and they cater mostly to price sensitive customers. In the hotel and restaurant industry, the competitors of a five star hotel are mostly other five star hotels and they have many common strategic dimensions. The five star hotels, therefore, form one strategic group. Similarly, three star hotels constitute another strategic group. There may be barriers to shifting strategic position from one strategic group to another. Such barriers are referred to as mobility barrier. For example, an assembler of personal computers may encounter several barriers to shift to the position of a fully integrated computer manufacturer, such as barriers of technology, capital investment human resources and organisation, brand image and market standing of established firms etc. Similarly, there are several barriers to entering the proprietary group by generic drug firms, such as capital investment, research facilities, human resources, high risks of investment on R&D etc. In contrast, it is easier for a proprietary drug firm to enter the generic group.

### 16.5 IMPLICATIONS OF STRATEGIC GROUPS

The concept of strategic groups has implications for industry analysis and identification of opportunities and threats. A company's immediate competitors are firms within the same strategic group. Second, the nature and intensity of competition and business prospects vary from strategic group to strategic group. The choice of strategic group is, therefore, very important. Third, high mobility barriers normally help insulate the group from new entrants and facilitate high profitability. The firms in strategic groups with high mobility barriers will have greater profit potential than those in groups with lower mobility barriers. These barriers also provide a rationale for why firms continue to compete with different strategies despite the fact that all strategies are not quickly successful. Fourth, just

like entry barriers, mobility barriers can change; and as they do (such as if the manufacturing process becomes more capital intensive) firms often abandon some strategic groups and jump into new ones, changing the pattern of strategic group. Mobility barriers can also be influenced by firm's choices of strategy. A company in an undifferentiated product industry, for example, can attempt to create a new strategic group (with higher mobility barriers) by investing heavily in advertising to develop brand identification or it can try to introduce a new manufacturing process with greater economies of scale. Fifth, the competitive standing of the different strategic groups would be different with respect to each of the five competitive forces. For example, the threat of new entrants is less in respect of the proprietary group compared to the generic drug group. The bargaining power of the buyers is also weak for patented drugs because of no or limited alternative. Such is the case with competition from substitutes. Players in the strategic group of fully integrated firms may not be subject to as much supplier power as other firms because of their lesser dependence on the outside suppliers. It is, of course, true that in a number of cases outsourcing firms have advantages over integrated ones.

## 16.6 LIMITATIONS OF PORTERIAN MODELS

The five forces and strategic group models provide very useful frameworks for analysing the nature of competition in an industry. These models, however, suffer from some important shortcomings mentioned below:

In many industries competition is a process driven by innovation and industry structures are very significantly changed by innovation. In a later work, Porter has

recognized the role of innovation in revolutionizing industry structure. Innovations, according to him, can unfreeze and reshape industry structure. He holds, that after a period of turbulence triggered by innovation, the structure of an industry once more settles down to a stable pattern. Once the industry stabilises in its new configuration, the five forces and strategic group concepts can once more be applied. This view of the evolution of industry structure is often referred to as punctuated equilibrium. The punctuated equilibrium view holds that long periods of equilibrium, when industry's structure is stable, are punctuated by periods of rapid changes when industry structure is revolutionized by innovation. Thus, there is an unfreezing and refreezing process.

### 16.7 COMPETITOR ANALYSIS

Competitor analysis is necessary for formulating right strategies and determining the right positioning for the firm in the industry. Competitor analysis seeks to find answers to certain basic questions such as: (i) Who are the competitors of the firm? (ii) What are the current strategies of the competitors? (iii) What are their future goals and likely strategies? (iv) What drives the competitor? (v) Where is the competitor vulnerable? (vi) How are the competitors likely to respond to the strategies of others?

Porter has suggested a framework for competitor analysis, consisting of four diagnostic components, viz., future goals, current strategy, assumptions and capabilities. As Porter observes, its goals, assumptions, and current strategy will influence the likelihood, timing, nature, and intensity of competitor's reactions. Its

strengths and weaknesses will determine its ability to initiate or react to strategic moves and to deal with environmental or industry events that occur.

### 16.7.1 COMPETITOR RESPONSE PROFILE

An analysis of these components will help to formulate what Porter calls competitor's response profile, i.e., answers to critical questions such as: What moves or developments will provoke the competitor and how is the competitor likely to respond or retaliate? The competitor response profile seeks to predict the competitor's offensive moves and defensive capabilities.

1. Future Goals: Analysis of future goals would be helpful to identify the attitude and behaviour of the competitor and likely strategies. As Porter observes, a knowledge of goals will allow predictions about whether or not each competitor is satisfied with its present position and financial results and; thereby, how likely that competitor is to change strategy and the vigour with which it will react to outside events or to moves by other firms? Knowledge of competitor's goals may help to predict its reactions to strategic changes. Goals of both the business unit and corporate parent need to be examined. Assumptions: The competitor's assumptions about itself and the competitor's assumptions about the industry and the other companies in it.

A firm may perceive itself as a socially conscious organisation, the industry leader, quality conscious firm, highly ethical etc. Such assumptions will, obviously, guide the way the firm behaves, including reactions to competitors' moves. A firm would also have assumptions

about the industry and competitors, like the industry prospects; competitors' goals, capabilities and weaknesses; competitors' possible behaviours and reactions etc. The strategies and moves of a firm will be influenced by the above two assumptions. The assumptions may or may not be correct.

- 2. Current Strategy: Identification of the current strategies of the competitors is a -very important component of competitor analysis. A competitor's strategy is most usefully thought of as its key operating policies in each functional area of the business and how it seeks to interrelate the functions.
- **3. Capabilities:** The ability of a firm to accomplish its goals and to respond to competitor's moves depends on its strengths and weaknesses. Analysis of the strengths and weaknesses of the competitors is, therefore, very important.

### 16.7.2 VALUE CHAIN

Porter points out that a firm's value chain is an important determinant of competitive advantage. Value is the amount which buyers are willing to pay for what a firm provides them. The total revenue reflects the value. Creating value for buyers that exceeds the cost of activities are the physically and technologically distinct activities a firm performs. There are, broadly, two types of value activities, namely, primary activities and support activities. Primary activities include: (i) inbound logistics (activities associated with receiving, storing and

disseminating inputs to products); (ii) operations (processing activities); (iii) marketing and sales; and (iv) services.

Support activities include: (i) procurement (purchasing of inputs); (ii) technology development; (iii) human resource management; (iv) firm infrastructure (includes general management, planning, finance, accounting, legal and government affairs and quality management). Each of these activities may be subdivided in to several activities. For example, Marketing and sales include activities such as advertising, sales promotion, sales force management, marketing research etc. A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its rivals. A firm should strive to understand not only its own value chain activities but also of the competitors', distributors' and suppliers'. This has important implications for the business marketers.

### 16.7.3 BENEFITS OF STRUCTURAL ANALYSIS

The purpose of the structural analysis is to diagnose the competitive forces and to identify the strengths and weakness of the firm vis-à-vis the industry, to help formulate an effective competitive strategy that "takes offensive or defensive action in order to create a defendable position against the five competitive forces". Structural analysis would enable a firm to answer such questions as:

- 1. How vulnerable is the firm against potential entrants? In other words, are there or how insurmountable are the entry barriers? Or, what measures can it take to ward off new entrants?
- 2. How serious is the threat of substitutes? What strategies should the firm employee against them?

- 3. What is the nature of supplier power? How to combat it?
- 4. How powerful are the buyers? How to deal with their bargaining power?
- 5. What are the strengths and weaknesses and strategies of the establish competitors and how to cope with them?

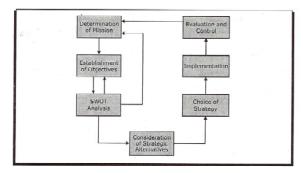
### 16.8 ENVIRONMENTAL ANALYSIS AND STRATEGIC MANAGEMENT

An analysis of SWOT (i.e. strengths and weaknesses of the company and the opportunities and threats in the environment) plays a very important role in the strategic management or business policy. A look at the strategic management process would make the importance of the external internal factors nexus more clear. Glueck defines strategy as a "unified, comprehensive and integrated plan relating the strategic advantages of the firm to the challenges of the environment. It is designed to ensure that the basic objectives of the-enterprise are achieved. Strategic management is defined as "that set of decisions and actions which leads to the development of an effective strategy or strategies to help achieve corporate objectives. Chandler describes strategic management as the determination of the basic long-term goals and objectives of

an enterprise and the adoption of courses of action and allocation of resources necessary to carry out these goals.

According to Paine and Naumes,

"Strategic management involves the



decision-making and the activities in an organisation which (1) have wider ramifications, (2) have a long time perspective, and (3) use critical resources

towards perceived opportunities or threats in a changing environment". Strategic management or business policy is, thus, the means to achieve the organisational purpose. Strategic management process involves determining the mission and objectives, analysis of the environmental opportunities and threats and evaluating the strengths and weaknesses of the firm to tap the opportunities or to combat the threats, formulating strategies to achieve the objectives on the basis of the SWOT analysis, choosing the most appropriate strategy, implementation of the strategy and reformulation of the objectives or strategy, if needed. The strategic management process is schematically presented in Graphics. A very brief account of the steps in the strategic management process is given below. A detailed discussion of strategic management is, obviously, beyond the scope of this book; what is given below is only a sketch. As the objective of this chapter is to the highlight the importance of the environmental analysis to managerial decision-making, more space is devoted to the description of this step than the other steps.

### 16.8.1 FORMULATION OF MISSION AND OBJECTIVES

Determining the mission and objectives of the company is the first step in the strategic management process. A strategy is, in fact, a means to achieve the ends or objectives. It should, however, be noted that objectives should not be static they should be dynamic. That is changes in the environment and/ or changes in the organisational strengths and weaknesses may call for modifications to the objectives. A company should, therefore, appraise how well its objectives tap the firm's opportunities and resources. Dynamic companies conduct audit of their objectives and reformulate or reorient the objectives, if desirable, to ensure that

the company's objectives are the most appropriate, given the environment and the company's resources. It is such appraisal and the resultant reorientation of the business, which have enabled many companies to achieve remarkable successes. To formulate clear objectives, it is essential to get definite answers to certain questions, viz.. "what business the company is in?" "What should the company's business be?" "What will the company's business be?" As Gluek aptly remarks, "objectives help define the organisation in its environment." Environmental analysis will help find answer to the question what should the company's business be? If 'what should be the business' is different from 'what is the business', there is certainly a need for redefining the business, matching the company resources to the environment. The question 'what will the company's business be?' exposes another dimension of business objectives, namely, the long term perspective. As Drucker succinctly puts it, 'what will the business' is related to 'what changes in the environment are already discernible that is likely to have high impact on the characteristics, mission, and purpose of our business? and how do we now build these anticipations into our theory of business, into its objectives, strategies and work assignments?"

### 16.8.2 SWOT ANALYSIS

Identification of the threats and opportunities in the environment and the strengths arid weaknesses of the firm is the cornerstone of business policy formulation; it is these factors, which determine the course/courses of action to ensure the survival and/or growth of the firm. The environment might present many opportunities, but a company might not have the strengths to exploit all the opportunities.

Similarly, sometimes a firm will not have the strength to meet the environmental threats. If a company, thus, finds that it will not have the competence to survive in a particular line of business, it will be prudent to give it up and concentrate on such business/ businesses for which the firm is most competent. The economic liberalisation is ushered in India in 1991 drastically changed the business environment. Many companies have exited several of their businesses and have been concentrating on their core businesses. For example, the Ceat exited four non-tyre businesses (glass-fibre, electronics, photocopiers and nylon code) and decided to concentrate on its core business - tyre. Funds obtained by the divestment have been used, in many cases, to consolidate or further develop the businesses they have decided to focus on. Indeed, strategic management has come to assume great\ importance as a result of the liberalisation. The liberalisation, by substantially expanding the scope of private enterprise and removing the entry and growth restrictions, has given a substantial leeway to private enterprise to decide the portfolio strategy. A number of companies have changed their business portfolios (i.e., the businesses they are in). Many have entered new businesses (Reliance, for example) and exited some of their businesses, while many have done both (like the Tata group and RPG group). A number of companies have been growing organically as well as by acquisitions (e.g., Gujarat Ambuja). Changes in the business environment across the world may change the industrial scenario of nations. Wells, for example, has pointed out in his well known International Product Life Cycle model 30 that certain products which were exported in the early stages of the product life cycle by high income countries like

the U.S.A. were later imported by them. Other countries, which acquired the technology, would be able to produce them cheaper because of low labour cost or would sometimes improve the technology. Thus, although the U.S. had a very dominant position in electronic products and had been exporting them in the beginning, later countries like Japan started exporting them to the U.S. and replacing the U.S. in other markets too. An analysis of products traded by countries like Japan, Korea, Taiwan etc. would show the changes in the comparative advantages. The environmental opportunities and threats should be evaluated in the light of the strengths and weaknesses of the internal factors comprising finance, technology and skill, production facilities, personnel and marketing capabilities. The capability of a company to exploit the environmental opportunities or to meet the challenges depends on the strength of these factors. Procter and Gamble (P&G), Unilever's arch rival globally, had a tough time in India because Hindustan Lever sitting entrenched with its long standing familiarity of the Indian market and marketing prowess was a formidable force in India. Japanese companies saw an opportunity in the US market segments for compact fuel efficient cars, small screen T.V's, low horse power tractors etc., which were rather neglected by the American firms. As the Japanese firms were marketing these products in the home market, they were, unlike the American counterparts, comfortable with these products. The conjecture of the market opportunity and the strategic strength enabled the Japanese companies to penetrate the American market. After having consolidated their position in these segments, they have moved up to other segments with the strength of the reputation they established. The general success of the Japanese in the world market is attributed to the right choice of the products and markets, based on a proper understanding of the environment and the internal strengths. Kotler and Fahey point out that "the Japanese government and companies work hard to identify attractive global markets. They favour industries that require high skills, high labour intensity and only small quantities of natural resources: candidates include consumer electronics, cameras, watches, motorcycles and pharmaceuticals. They prefer product markets that are in a state of technological evolution. They like product markets where consumers around the world would be willing to buy the same product designs. They look for industries where the market leaders are complacent or under financed".

### 16.8.3 STRATEGIC ALTERNATIVES AND CHOICE OF STRATEGY

After the identification of the environmental opportunities and threats and the organisational strengths add weaknesses (and the reformulation of the mission and objectives, if needed) the next tasks in the strategic management process are the consideration of strategic alternatives and the choice of the most appropriate strategy/strategies. A company may be confronted with several alternatives such as:

- ➤ Should the company continue in the same business or get out of it?
- ➤ If it should continue in the same business, should it grow by expanding the existing units, establishing new units or by acquiring other units in the industry?

- ➤ If it should diversify, should it diversify into related areas or unrelated areas?
- > Should it grow by vertical integration?

A company, which plans to market its products in foreign markets, may have the following alternatives:

- ➤ Manufacture the product completely in the home country and export it to the foreign market.
- ➤ Establish manufacturing facility in free areas such as export processing zones and make exports from there.
- ➤ Establish manufacturing facility in the foreign country and undertake the complete manufacturing of the product there.
- Manufacture the components at home and assemble the product in the foreign market. Contract some foreign firm for manufacturing the product and do only the marketing of it. Enter into licensing / franchising agreement with a firm in the foreign market.
- Establish a joint venture abroad for manufacturing and marketing the product.

The choice of the strategy should invariably be based on the evaluation of the various alternatives.

**1. Implementation:** A good strategy is not a sufficient condition for success; Its effective implementation is equally important. Many good strategies fail to achieve the results because of poor implementation. It is necessary to formulate a detailed plan to achieve the objectives by means of the chosen

strategy. The term implementation is used in a broad sense so that it encompasses also the formulation of the plan to implement the strategy. In a multi-unit business, formulation of different levels of strategies is an essential and important aspect of implementation. There are three levels of strategies applicable to such a business.

- 2. Corporate Level Strategy: This is the master strategy to achieve the overall corporate objectives. The other levels of strategies are designed to implement the corporate strategy and they are, therefore, formulated with reference to the corporate strategy.
- 3. SBU Level Strategy: It is the strategy to achieve the specific objectives of the strategic business unit (SBU) so as to help achieve the overall corporate objectives. A SBU is "an operating division of a firm which serves a distinct product/market segment or a well-defined set of customers or a geographic area. The SBU is given the authority to make its own strategic decisions within corporate guidelines as long as it meets corporate objectives." The SBU is also known as 'operating division'.
- 4. Functional Level Strategy: The ultimate success of the SBU level strategy will depend, among other things, on the effectiveness with which it is translated to management functions like marketing, finance, production, Rand D etc. For example, if some of the SBU level objectives are to be achieved by introducing a new product, the Rand D, production. Finance and marketing departments will have to be geared up to this task. In a single unit business there are, obviously only two levels of strategies, namely, the corporate level

and the functional level. The task of implementation involves mobilisation and deployment of resources, including personnel, needed for implementation, organizing and assigning tasks to the various elements of the organisation. For effective implementation of the strategy it is essential to formulate an implementation strategy. Motivation and high morale of people from top to bottom of the organisation are essential for successful implementation of the strategy, besides their potential capability.

- **5. Evaluation:** Evaluation of strategy is that phase of the strategic management process in which the top managers determine whether their strategic choice as implemented is meeting the objectives of enterprise. Failure to achieve the results may arise from any one or more of the following:
- 1. Improper implementation of the strategy.
- 2. Environmental changes which were not anticipated while formulating the strategy.
- 3. Inappropriate strategy.

Improper implementation of the strategy may be due to (a) inappropriateness of the implementation strategy; (b) inefficiency and/or lack of commitment of the personnel in charge of implementation; (c) wrong assignment of the tasks; or (d) inadequacy of resources. Environmental changes such as increase in competition, changes in consumer preferences or attitudes, technological changes which could not be anticipated while formulating the strategy etc. may come in the way of achieving the results. Sometimes environmental changes will make the achievement of the objectives easier. Such favourable changes in the

environment, which help achieve the objectives easily, may sometimes even conceal the drawbacks of the strategy or its implementation. The chances of environmental changes affecting the effectiveness or achievements of the strategy indicate the need for constant monitoring of the environment and modification or reformulation of the strategy, as and when necessary. An inappropriate strategy may be the result of a wrong diagnosis (of the environmental threats and opportunities or the internal strengths and weaknesses) or of a wrong strategic choice resulting from the faulty evaluation of the alternatives.

### **16.8 SUMMARY**

The key to business success is the most effective utilisation of the company's resources (resources here mean not only the existing resources but also the additional resources it can mobilise and augment for any specific task). This involves the evaluation of the company's strengths and weaknesses in the light of the environmental threats and opportunities and taking appropriate measures to harness the opportunities or to combat the threats and formulation of strategies accordingly. Companies, which fail to do, so are often doomed to failure. Constant monitoring of the environment and timely and appropriate steps to tap the opportunities and to meet the challenges are essential for success. Environmental analysis will indicate the potential and prospective businesses.

# 16.10 SELF-TEST QUESTIONS

- 9. What do you mean by competition in the business world?
- 10. How can you evaluate the strategic analysis in Indian industries?
- 11. What steps may be taken by the companies to cope up the challenges?

12. Explain the competitive structure of industries?

# **16.11 SUGGESTED READINGS**

- Cherrunilam, Francis (2003), Business Environment, New Delhi: Vikas Publishing House Private Limited.
- 2. Glueck, William (1980), *Business Policy and Strategic Management*, Auckland: McGraw-Hill International Book Company.
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**COURSE: BUSINESS ENVIRONMENT** 

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### RASICS OF INTELLECTUAL PROPERTY LAWS

**OBJECTIVE:** After reading the chapter, the students will be able to understand that what are the intellectual properties and how these may be protected? In addition, they will be able to know the laws concerning the protection of IPRs.

### STRUCTURE:

- 17.1 Introduction
- 17.2 Basics/Origins of Intellectual Property Rights and their Laws
- 17.3 Enforcement of IPR Laws
- 17.4 Summary
- 17.5 Self-Test Questions
- 17.6 Suggested Readings

### 17.1 INTRODUCTION

Intellectual property consists of items that have been created, that are unique and that provide you with an economic benefit. It includes inventions, designs,

you protect your intellectual property depends on what types of intellectual property you have.

original works of authorship and trade secrets. How

The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), negotiated



in the 1986-1994 Uruguay Round, introduced intellectual property rules into the multilateral trading system for the first time.

# 17.2 ORIGINS OF INTELLECTUAL PROPERTY RIGHTS AND THEIR LAWS

Ideas and knowledge are an increasingly important part of trade. Most of the value of new medicines and other high technology products lies in the amount of invention, innovation, research, design and testing involved. Films, music recordings, books, computer software and on-line services are bought and sold because of the information and creativity they contain, not usually because of the plastic, metal or paper used to make them. Many products that used to be traded as low-technology goods or commodities now contain a higher proportion of invention and design in their value - for example brand-named clothing or new varieties of plants. Creators can be given the right to prevent others from using their inventions, designs or other creations - and to use that right to negotiate payment in return for others using them. These are "intellectual property **rights**". They take a number of forms. For example books, paintings and films come under copyright; inventions can be patented; brand names and product logos can be registered as trademarks; and so on. Governments and parliaments have given creators these rights as an incentive to produce ideas that will benefit society as a whole. The extent of protection and enforcement of these rights varied widely around the world; and as intellectual property became more important in trade, these differences became a source of tension in international economic relations. New internationally agreed trade rules for intellectual property rights were seen as a way to introduce more order and predictability, and for disputes to be settled more systematically. The Uruguay Round achieved that. The WTO's TRIPS Agreement is an attempt to narrow the gaps in the way these rights are protected around the world, and to bring them under common international rules. It establishes minimum levels of protection that each government has to give to the intellectual property of fellow WTO members. In doing so, it strikes a balance between the long-term benefits and possible short-term costs to society. Society benefits in the long-term when intellectual property protection encourages creation and invention, especially when the period of protection expires and the creations and inventions enter the public domain. Governments are allowed to reduce any short-term costs through various exceptions, for example to tackle public health problems. And, when there are trade disputes over intellectual property rights, the WTO's dispute settlement system is now available.

## TYPES OF INTELLECTUAL PROPERTY

The areas covered by the TRIPS Agreement

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

The agreement covers five broad issues:

- How basic **principles** of the trading system and other international intellectual property agreements should be applied;
- How to give adequate **protection** to intellectual property rights;
- How countries should enforce those rights adequately in their own territories;
- How to settle disputes on intellectual property between members of the WTO;
- Special transitional arrangements during the period when the new system is being introduced.

# 17.2.1 BASIC PRINCIPLES: NATIONAL TREATMENT, MFN, BALANCED PROTECTION

As in GATT and GATS, the starting point of the intellectual property agreement is basic principles. And as in the two other agreements, non-discrimination features prominently: national treatment (treating one's own nationals and foreigners equally), and most-favoured-nation treatment (equal treatment for nationals of all trading partners in the WTO). National treatment is also a key principle in other intellectual property agreements outside the WTO. The TRIPS Agreement has an additional important principle: intellectual property protection should contribute to technical innovation and the transfer of technology. Both producers and users should benefit, and economic and social welfare should be enhanced, the agreement says.

# 17.2.2 HOW TO PROTECT INTELLECTUAL PROPERTY: COMMON GROUND-RULES

The second part of the TRIPS agreement looks at different kinds of intellectual property rights and how to protect them. The purpose is to ensure that adequate standards of protection exist in all member countries. Here the starting point is the obligations of the main international agreements of the World Intellectual Property Organization (WIPO) that already existed before the WTO was created:

- The Paris Convention for the Protection of Industrial Property (patents, industrial designs, etc)
- The Berne Convention for the Protection of Literary and Artistic
   Works (copyright). Some areas are not covered by these conventions.

In some cases, the standards of protection prescribed were thought inadequate. So the TRIPS agreement adds a significant number of new or higher standards.

➤ COPYRIGHT: A copyright provides protection for original works of authorship, fixed in a tangible medium of expression including literary, musical, and dramatic works, as well as photographs, audio and visual recordings, software, and other intellectual works. Copyright protection begins as soon as the work is fixed in a tangible medium. The author should begin using the copyright symbol immediately as a method of informing others

that he intends to exercise control over the production, distribution, display, and or performance of the work. While it is not necessary to file for copyright protection, doing so will make it easier to seek court enforcement of your copyright. You should consult an attorney about the advantages and disadvantages of filing.

The TRIPS agreement ensures that computer programs will be protected as literary works under the Berne Convention and outlines how databases should be protected. It also expands international copyright rules to cover rental rights. Authors of computer programs and producers of sound recordings must have the right to prohibit the commercial rental of their works to the public. A similar exclusive right applies to films where commercial rental has led to widespread copying, affecting copyright owners' potential earnings from their films. The agreement says performers must also have the right to prevent unauthorized recording, reproduction and broadcast of live performances (bootlegging) for no less than 50 years. Producers of sound recordings must have the right to prevent the unauthorized reproduction of recordings for a period of 50 years.

> TRADEMARK: A trademark protects the name of your product by preventing other business from selling a product under the same name. Having a unique and identifiable name for your product is an advantage for your business. Trademark law seeks to protect

consumers from confusion or deception by preventing other

businesses from using the same or a confusingly similar name for their products. A service mark is used when what your business sells is a service rather than a product. Being the first to use the name is important to protect the continuing right to use the name, but filing is important for enforcement purposes.

### What's the difference?

Copyrights, patents, trademarks, etc apply to different types of creations or inventions. They are also treated differently.

Patents, industrial designs, integrated circuit designs, geographical indications and trademarks have to be registered in order to receive protection. The registration includes a description of what is being protected — the invention, design, brandname, logo, etc — and this description is public information.

Copyright and trade secrets are protected automatically according to specified conditions. They do not have to be registered, and therefore there is no need to disclose, for example, how copyrighted computer software is constructed.

Other conditions may also differ, for example the length of time that each type of protection remains in force.

The first step in filing for trademark registration is performing a trademark search. This step is extremely important because it could prevent you from investing a lot in the promotion of a product under a trademark that is already in use. An attorney who practices in the area of intellectual property can help you with a trademark search and application.

The TRIPS agreement defines what types of signs must be eligible for protection as trademarks, and what the minimum rights conferred on their owners must be. It says that service marks must be protected in the same way as trademarks used for goods. Marks

that have become well known in a particular country enjoy additional protection.

**GEOGRAPHICAL INDICATIONS:** A place name is sometimes used to identify a product. This "geographical indication" does not only say where the product was made. More importantly it identifies the products special characteristics, which are the result the product's origins. Well-known examples "Champagne", "Scotch", "Tequila", and "Roquefort" cheese. Wine and spirits makers are particularly concerned about the use of place names to identify products, and the TRIPS Agreement contains special provisions for these products. But the issue is also important for other types of goods. Using the place name when the product was made elsewhere or when it does not have the usual characteristics can mislead consumers, and it can lead to unfair competition. The TRIPS Agreement says countries have to prevent this misuse of place names. For wines and spirits, the agreement provides higher levels of protection, i.e. even where there is no danger of the public being misled. Some exceptions are allowed, for example if the name is already protected as a trademark or if it has become a generic term. For example, "cheddar" now refers to a particular type of cheese not necessarily made in Cheddar, in the UK. But any country wanting to make an exception for these reasons must be willing to negotiate with the country, which wants to protect the geographical indication in question. The agreement provides for further negotiations in the WTO to establish a multilateral system of notification and registration of geographical indications for wines. These are now part of the Doha Development Agenda and they include spirits. Also debated in WTO, is whether to negotiate extending this higher level of protection beyond wines and spirits.

- ➤ INDUSTRIAL DESIGNS: Under the TRIPS Agreement, industrial designs must be protected for at least 10 years. Owners of protected designs must be able to prevent the manufacture, sale or importation of articles bearing or embodying a design, which is a copy of the protected design.
- ➤ PATENTS: Inventions are crucial to the success of many businesses. If your business has developed a new and better product or process that is unique, useful, and non-obvious you will want to protect the competitive advantage this gives you by obtaining a patent. The holder of a patent can stop third parties from making, using or selling his invention for a period of years depending on the type of invention. Obtaining a patent can be complicated, so you may want to hire an attorney with experience in patent law to help you. If your business is one in which inventions are created on a continuing basis, it is very important that you have a clear understanding about who owns the

inventions. Does your business own the inventions or do the employees who create the inventions own them? This can depend on the type of work arrangement you have. You will want to make sure workers sign an agreement that any inventions created by them while working for your business belong to the business.

The TRIPs agreement says patent protection must be available for inventions for at least 20 years. Patent protection must be available for both products and processes, in almost all fields of technology. Governments can refuse to issue a patent for an invention if its commercial exploitation is prohibited for reasons of public order or morality. They can also exclude diagnostic, therapeutic and surgical methods, plants and animals (other than microorganisms), and biological processes for the production of plants or animals (other than microbiological processes). Plant varieties, however, must be protectable by patents or by a special system (such as the breeder's rights provided in the conventions of UPOV — the International Union for the Protection of New Varieties of Plants). The agreement describes the minimum rights that a patent owner must enjoy. But it also allows certain exceptions. A patent owner could abuse his rights, for example by failing to supply the product on the market. To deal with that possibility, the agreement says governments can issue "compulsory licenses", allowing a competitor to produce the product or use the process under license.

But this can only be done under certain conditions aimed at safeguarding the legitimate interests of the patent-holder. If a patent is issued for a production process, then the rights must extend to the product directly obtained from the process. Under certain conditions alleged infringers may be ordered by a court to prove that they have not used the patented process. An issue that has arisen recently is how to ensure patent protection for pharmaceutical products does not prevent people in poor countries from having access to medicines — while at the same time maintaining the patent system's role in providing incentives for research and development into new medicines. Flexibilities such as compulsory licensing are written into the TRIPS Agreement, but some governments were unsure of how these would be interpreted, and how far their right to use them would be respected. A large part of this was settled when WTO ministers issued a special declaration at the Doha Ministerial Conference in November 2001. They agreed that the TRIPS Agreement does not and should not prevent members from taking measures to protect public health. They underscored countries' ability to use the flexibilities that are built into the TRIPS Agreement. And they agreed to extend exemptions on pharmaceutical patent protection for leastdeveloped countries until 2016. On one remaining question, they assigned further work to the TRIPS Council - to sort out how to provide extra flexibility, so that countries unable to produce pharmaceuticals domestically can import patented drugs made under compulsory licensing. A waiver providing this flexibility was agreed on 30 August 2003.

> INTEGRATED CIRCUITS LAYOUT DESIGNS: The basis for protecting integrated circuit designs ("topographies") in the TRIPS agreement is the Washington Treaty on Intellectual Property in Respect of Integrated Circuits, which comes under the World Intellectual Property Organization. This was adopted in 1989 but has not yet entered into force. The TRIPS agreement adds a number of provisions: for example, protection must be available for at least 10 years.

### > UNDISCLOSED INFORMATION AND TRADE SECRETS:

Trade secrets and other types of "undisclosed information" which have commercial value must be protected against breach of confidence and other acts contrary to honest commercial practices. But reasonable steps must have been taken to keep the information secret. Test data submitted to governments in order to obtain marketing approval for new pharmaceutical or agricultural chemicals must also be protected against unfair commercial use.

CURBING ANTI-COMPETITIVE LICENSING

CONTRACTS: The owner of a copyright, patent or other form of intellectual property right can issue a license for someone else to

produce or copy the protected trademark, work, invention, design, etc. The agreement recognizes that the terms of a licensing contract could restrict competition or impede technology transfer. It says that under certain conditions, governments have the right to take action to prevent anti-competitive licensing that abuses intellectual property rights. It also says governments must be prepared to consult each other on controlling anti-competitive licensing.

### 17.3 ENFORCEMENT OF IPR LAWS

Having intellectual property laws is not enough. They have to be enforced. The governments have to ensure that intellectual property rights can be enforced under their laws, and that the penalties for infringement are tough enough to deter further violations. The procedures must be fair and equitable, and not unnecessarily complicated or costly. They should not entail unreasonable time limits or unwarranted delays. People involved should be able to ask a court to review an administrative decision or to appeal a lower court's ruling. The agreement describes in some detail how enforcement should be handled, including rules for obtaining evidence, provisional measures, injunctions, damages and other penalties. It says courts should have the right, under certain conditions, to order the disposal or destruction of pirated or counterfeit goods. Willful trademark counterfeiting or copyright piracy on a commercial scale should be criminal offences. Governments should make sure that intellectual property rights owners could receive the assistance of customs authorities to prevent imports of counterfeit and pirated goods.

### 17.3.1 TECHNOLOGY TRANSFER

Developing countries in particular, see technology transfer as part of the bargain in which they have agreed to protect intellectual property rights. The TRIPS Agreement includes a number of provisions on this. For example, it requires developed-country governments to provide incentives for their companies to transfer technology to least-developed countries.

### 17.3.2 TRANSITION ARRANGEMENTS

When the WTO agreements took effect on 1 January 1995, developed countries were given one year to ensure that their laws and practices conform with the TRIPS agreement. Developing countries and (under certain conditions) transition economies were given five years, until 2000. Least-developed countries have 11 years, until 2006 - now extended to 2016 for pharmaceutical patents. If a developing country did not provide product patent protection in a particular area of technology when the TRIPS Agreement came into force (1 January 1995), it has up to 10 years to introduce the protection. But for pharmaceutical and agricultural chemical products, the country must accept the filing of patent applications from the beginning of the transitional period, though the patent need not be granted until the end of this period. If the government allows the relevant pharmaceutical or agricultural chemical to be marketed during the transition period, it must - subject to certain conditions - provide an exclusive marketing right for the product for five years, or until a product patent is granted, whichever is shorter. Subject to certain exceptions, the general rule is that obligations in the agreement apply to intellectual property rights that existed at the end of a country's transition period as well as to new ones.

### 17.4 SUMMARY

Protecting your intellectual property is important to the success of a business. You have to know about your intellectual property and the laws and procedure for the protection of such properties. Intellectual property consists of items that you have created that are unique and that provide you with an economic benefit. It includes inventions, designs, original works of authorship and trade secrets. The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), negotiated in the 1986-1994 Uruguay Round, introduced intellectual property rules into the multilateral trading system for the first time.

### 17.5 SELF-TEST QUESTIONS

- 1. Explain the Intellectual Property Rights regarding Trade.
- 2. How can you protect your intellectual property?
- 3. What types of obstacles may be faced in the implementation of IPRs?
- 4. What are the basics of IPR Laws?

### 17.6 SUGGESTED READINGS

- 1. Cherrunilam, Francis, (2003), *Business Environment*, New Delhi: Vikas Publishing House Private Limited.
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**COURSE: BUSINESS ENVIRONMENT** 

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LESSON: 18 VETTER: Sh. SANJEEV KUMAR

CONTROL OF THE TAXABLE AND THE PROPERTY OF THE

Objective: The present lesson explains the burning issues in business environment,

nationally or internationally.

### LESSON STRUCTURE

18.1 Introduction

18.2 India - A Growing Economy

18.3 Issues and Priorities for India

18.4 Foreign Direct Investment Policy in India

18.5 Value Added Tax

18.6 Summary

18.7 Self-Test Questions

18.8 Suggested Readings

### 18.1 INTRODUCTION

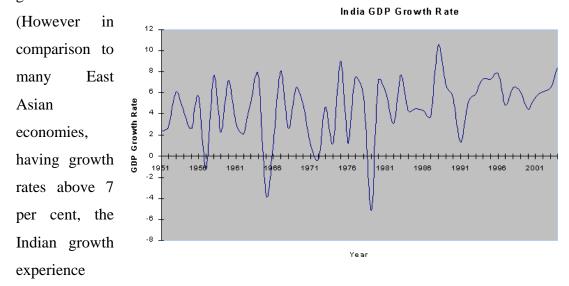
Economics experts and various studies conducted across the globe envisage India and China to rule the world in the 21st century. For over a century the United States has been the largest economy in the world but major developments have taken place in the world economy since then, leading to the shift of focus from the US and the rich countries of Europe to the two Asian giants- India and China. The rich countries of Europe have seen the greatest decline in global GDP share by 4.9 percentage points, followed by the US and Japan with a decline of about 1 percentage point each. Within Asia, the rising share of China and India has more than made up the declining global share of Japan since 1990. During the seventies and the eighties, ASEAN countries and during the eighties South Korea, along with China and India, contributed to the

rising share of Asia in world GDP.

According to some experts, the share of the US in world GDP is expected to fall (from 21 per cent to 18 per cent) and that of India to rise (from 6 per cent to 11 per cent in 2025), and hence the latter will emerge as the third pole in the global economy after the US and China. By 2025 the Indian economy is projected to be about 60 per cent the size of the US economy. The transformation into a tri-polar economy will be complete by 2035, with the Indian economy only a little smaller than the US economy but larger than that of Western Europe. By 2035, India is likely to be a larger growth driver than the six largest countries in the EU, though its impact will be a little over half that of the US. India is slated to become the third largest economy with a share of 14.3 per cent of global economy by 2015 and graduate to become the "third pole" and growth driver by 2035. As the share of USA in World GDP falls from 21 to 18 percent and that of India rises from 6 to 11 per cent in 2025, the latter emerges as third pole in the global economy, according to ADB India Economic Bulletin. India, which is now the fourth largest economy in terms of purchasing power parity, will overtake Japan and become third major economic power within 10 years.

# 18.2 INDIA - A GROWING ECONOMY

A growth rate of above 8 per cent was achieved by the Indian economy during the year 2003-04 and in the advanced estimates for 2004-05, Indian economy has been predicted to grow at a level of 6.9 per cent. Growth in the Indian economy has steadily increased since 1979, averaging 5.7 per cent per year in the 23-year growth record.



lags behind.) The tenth five-year plan aims at achieving a growth rate of 8 per cent for the coming 2-3 years. Though, the growth rate for 2004-05 is less than that of 2003-04, it is still eligible for counting it among the high growth rates seen in India since independence. Many factors are behind this robust performance of the Indian economy in 2004-05. High growth rates in Industry & service sector and a benign world economic environment provided a backdrop conducive to the Indian economy. Another positive feature was that the growth was accompanied by continued maintenance of relative stability of prices. However, agriculture fell sharply from its 2003-04 level of 9 per cent to 1.1 per cent in the current year primarily because of a bad monsoon. Thus, there is a paramount need to move Indian agriculture beyond its centuries old dependency on monsoon. This can be achieved by bringing more area under irrigation and by better water management. Because of the weakening of the US dollar for the last two years, (caused mainly by widening US deficits), Indian Rupee has steadily appreciated vis-à-vis US

dollar. Though, this trend saw a brief reversal during may-august 2004. The latest Re/\$ Exchange rate (March 2005) stood close to 44. Despite strengthening nominally against US \$, Rupee depreciated against other major non-dollar currencies. Thus, the Real Effective Exchange rate of the Rupee depreciated and this trend continued until end 2004.

A strong BOP position in recent years has resulted in a steady accumulation of foreign exchange reserves. The level of foreign exchange reserves crossed the US \$100 billion mark on Dec 19, 2003 and was \$142.13 billion on March 18, 2005. The capital inflows, current account surplus and the valuation gains arising from appreciation of the major non-US dollar global currencies against US dollar contributed to such a rise in Forex reserves.

The current account of BOP having been in surplus since 2001-02 turned into deficit in the first half of the current year (April-September 2004-05). Such a reversal was observed on the back of rise in POL and non-POL imports, which overwhelmed the growth of exports in US dollar terms at over 23 per cent. Growth momentum in exports was maintained; India's exports during Apr-Nov registered a growth of 24 per cent from the last period but India's position was down from 30th to 31st rank in the top exporting countries of the world.

The main contributors to capital account surplus were the banking capital inflows, foreign institutional investments and other capital inflows. Alike current account, capital account too witnessed decline

## 18.3 ISSUES AND PRIORTIES FOR INDIA

As India prepares for becoming an economic superpower, it must expedite socioeconomic reforms and take steps for overcoming institutional and infrastructure bottlenecks inherent in the system. Availability of both physical and social infrastructure is central to sustainable economic growth. Since independence Indian economy has thrived hard for improving its pace of development. Notably in the past few years the cities in India have undergone tremendous infrastructure up gradation but the situation in not similar in most part of rural India. Similarly in the realm of health and education and other human development indicators India's performance has been far from satisfactory, showing a wide range of regional inequalities with urban areas getting most of the benefits. In order to attain the status that currently only a few countries in the world enjoy and to provide a more egalitarian society to its mounting population, appropriate measures need to be taken. Currently Indian economy is facing these challenges:

- Sustaining the growth momentum and achieving an annual average growth of 7-8 per cent in the next five years.
- > Simplifying procedures and relaxing entry barriers for business activities.
- ➤ Checking the growth of population; India is the second highest populated country in the world after China. However in terms of density India exceeds China, as India's land area is almost half of China's total land. Due to a high population growth, GNI per capita remains very poor. It was only \$ 2880 in 2003 (World Bank figures).
- ➤ Boosting agricultural growth through diversification and development of agro processing.
- Expanding industry fast, by at least 10 per cent per year to integrate not only the surplus labour in agriculture but also the unprecedented number of women and teenagers joining the labour force every year.
- ➤ Developing world-class infrastructure for sustaining growth in all the sectors of the economy.
- ➤ Attracting foreign investment in more areas
- Effecting fiscal consolidation and eliminating the revenue deficit through revenue enhancement and expenditure management.
- Empowering the population through universal education and health care. India needs to improve its HDI rank, as at 127 it is way below many other developing countries' performance.

#### 18.3.1 LEGAL SYSTEM AND MAJOR LAWS

India is a common law country with a written constitution, which guarantees individual and property rights. There is a single hierarchy of courts. Indian courts provide adequate safeguards for the enforcement of property and contractual rights. However, case backlogs often result in procedural delays. Most of the laws are codified. Regulations and policies fill in the details. Major bodies of law in

India affecting foreign investment are the Foreign Exchange Regulation Act of 1973 ("FERA"), the Industries Act of 1951, the Companies Act of 1956, the Monopolies and Restrictive Trade Practices Act of 1969 and the New Industrial Policy of 1991. The Foreign Exchange Regulation Act of 1973 regulates foreign collaboration and equity participation in India. The Industries (Development Regulation) Act of 1951 governs industrial regulation. The Companies Act of 1956 regulates corporations and their management in India. The Monopolies and Restrictive Trade Practices Act of 1969 ("MRTP") governs restrictive and fair trade practices. The New Industrial Policy of 1991 ("NIP") that lays down the policy and procedure for foreign investment has liberalized and simplified the investment procedures. The major changes introduced by NIP are as follow:

- (i) NIP brings about a streamlining of procedures, deregulation, de-licensing, a vastly expanded role for the private sector and an open policy towards foreign investment and technology.
- (ii) Foreign investors are allowed to hold more than 50 per cent equity ownership in most of the sectors, and 100 per cent percent equity ownership in some sectors.
- (iii) Foreign Institutional Investors ("FII's) from reputable institutions (like pension funds, mutual funds) may participate in the Indian capital markets.
- (iv) Joint ventures with trading companies and imports of secondhand plants and machinery are allowed.
- (v) Monopoly and restrictive trade practice restraints (i.e., antitrust laws) have been eased.
- (vi) Customs duties have been slashed considerably; duty-free imports are allowed in some cases.
- (vii) The rupee is completely convertible; 100 per cent of foreign exchange earnings can be converted at free market rates.
- (viii) Export policies have been liberalized.
- (ix) The Foreign Exchange Regulation Act has been amended to encourage foreign investments in India.

- (x) A tax holiday is available for a period of 5 continuous years in the first 8 years of establishing exporting units.
- (xi) A tax holiday for up to 5 to 8 years is available and 100 per cent equity participation is allowed for the power projects in India.
- (xii) Concessions in tax regime are available for foreign investors in high-tech areas.

#### 18.3.2 JOINT VENTURES IN INDIA

Joint Venture companies are the most preferred form of corporate entities for investment in India. There are no separate laws for joint ventures in India. The companies incorporated in India, even with up to 100 per cent foreign equity, are treated the same as domestic companies. Foreign companies are also free to open branch offices in India. However, a branch of a foreign company attracts a higher rate of tax than a subsidiary or a joint venture company. The liability of the parent company is also greater in case of a branch office.

The Government has outlined 37 high priority areas covering most of the industrial sectors. Investment proposals involving up to 74 per cent foreign equity in these areas receive automatic approval within two weeks. An application to the Reserve Bank of India in the form FC (RBI) is required. The application can be made either by the Indian party or the foreign party. Existing companies having foreign equity holding and desiring to increase it to 74 per cent can also obtain automatic approval if they are in priority areas. Besides the 37 high priority areas, automatic approval is available for 74 per cent foreign equity holdings setting up international trading companies engaged primarily in export activities.

Approval of foreign equity is not limited to 74 per cent and to high priority industries. Greater than 74 per cent of equity and areas outside the high priority list are open to investment, but government approval is required. For these greater equity investments or for areas of investment outside of high priority an application in the form FC (SIA) has to be filed with the Secretariat for Industrial Approvals. A response is given within 6 weeks. Full foreign ownership (100 per cent equity) is readily allowed in power generation, coal washeries, electronics,

Export Oriented Unit (EOU) or a unit in one of the Export Processing Zones ("EPZ's").

For major investment proposals or for those that do not fit within the existing policy parameters, there is the high-powered Foreign Investment Promotion Board ("FIPB"). The FIPB is located in the office of the Prime Minister and can provide single-window clearance to proposals in their totality without being restricted by any predetermined parameters.

Foreign investment is also welcomed in many of infrastructure areas such as power, steel, coal washeries, luxury railways, and telecommunications. The entire hydrocarbon sector, including exploration, producing, refining and marketing of petroleum products has now been opened to foreign participation. The Government had recently allowed foreign investment up to 51 per cent in mining for commercial purposes and up to 49 per cent in telecommunication sector. The government is also examining a proposal to do away with the stipulation that foreign equity should cover the foreign exchange needs for import of capital goods. In view of the country's improved balance of payments position, this requirement may be eliminated.

#### 18.3.3 CORPORATE INCOME TAX RATES

Revenue accruing to foreign companies (including royalty and technical services fees) from providing services concerning the exploration or production of petroleum or natural gas is subject to a maximum tax on a deemed profit of 10 per cent of gross revenue. Foreign companies engaged in the execution of turnkey power project contracts approved by the government and financed by international programs are subject to a maximum tax on a deemed profit of 10 per cent of gross revenue. The corporate income tax effective rate for domestic companies is 35 per cent while the profits of branches in India of foreign companies are taxed at 45 per cent. Companies incorporated in India even with 100 per cent foreign ownership, are considered domestic companies under the Indian laws.

#### 18.3.3.1 NON-EXPORT INCENTIVES

India offers a wide range of concessions to investors to provide incentives for economic and industrial growth and development. India's tax rates may not be one of the lowest in the world, but a careful tax planning keeping in mind the tax holidays and the following general tax incentives reduce the taxes considerably:

- ➤ No corporate taxes are levied for a period of five years for projects set up for domestic power generation and transmission and also for projects in Electric Hardware Technology Park Schemes.
- Deduction of preliminary and preoperative expenses incurred in setting up a project.
- ➤ Complete tax exemption on profits from exports of goods.
- Full or partial exemption of foreign exchange earnings on construction projects, hotel and tourism related services, royalties, commission, etc.
- ➤ Liberal depreciation allowances.
- ➤ Deduction of capital research and development expenditures.
- New industrial undertakings may deduct 25 per cent of their gross total income for eight years.

# 18.3.3.2 TAX INCENTIVES FOR EXPORTERS

The New Export-Import Policy of 1992 provides substantial tax incentives for investments in Export Oriented Units ("EOU's") and industries located in the Export Processing Zones ("EPZ's"). Automatic approvals are given by the Secretariat for Industrial Approval for setting up 100 per cent Export Oriented Units ("EOU"). Incentives and facilities available under the EOU scheme include concessional rent for lease of industrial plots, preferential power allocation and supply, exemption from import duty for capital goods and raw materials for power sector industries as well as for trading companies primarily engaged in export activity.

There are six EPZ's or free trade zones located in different parts of the country. These zones are designed to provide internationally competitive infrastructure facilities and duty-free and low cost environment. Various monetary and non-

monetary incentives are granted which include import duty exemption, complete tax holiday, decentralized "single window clearance," etc.

Twenty-five percent of goods manufactured in EPZ's are permitted to be sold in the domestic market. No excise duty is payable on such items and customs duties on imported components is 50 per cent of normal rates. Major exporters are allowed to operate bank accounts abroad to facilitate trade. Companies that sell in the domestic market as well as international markets may deduct export earnings from their tax liabilities.

Exporters and other foreign exchange earners have been permitted to retain 25 per cent of their foreign exchange earnings in foreign currency. For 100 per cent Export Oriented Units and units in Export Processing Zones, Electronic Hardware Technology Parks, retention up to 50 per cent is allowed.

#### Other incentives include:

- > Duty-free imports of raw materials and components.
- Tax holiday for a period of 5 continuous years in the first 8 years from the year of commencement of production.
- Exemption from taxes on exports earnings even after the period of tax holiday.
- Exemption from central and state taxes on production and sale.
- Permission to install machinery on lease.
- > Freedom to borrow self-liquidating foreign currency loans at the prime rate of interest.
- Inter-unit transfers of finished goods among exporting units.
- Decentralized single-window clearance of proposals concerning units in Export Processing Zones.
- ➤ EOU/EPZ units may export through Export Houses, Trading Houses and Star Trading houses.

## **18.3.3.3 DOUBLE TAXATION TREATIES**

India has entered into tax treaties with a number of countries including, Australia, Belgium, Canada, Denmark, France, Germany, Indonesia, Japan, Korea, Mauritius, Singapore, the United Kingdom and the United States. These treaties

endeavor to avoid double taxation and attract know- how and technology. In many treaties the withholding tax on royalties and fees for technical services emanating from India is lower than the general tax rate. A careful planning and corporate structuring can reduce the tax obligations considerably. The international investors to reduce their tax obligations in India and in their home countries have successfully used the treaties such as Indo-U.S. Treaty, Indo-Mauritius Treaty,

# 18.3.4 Transfer of Technology Approvals

The Reserve Bank of India ("RBI") accords automatic permission for foreign technology agreements in high priority industries up to 5 per cent royalty for domestic sales and 8 per cent for exports, subject to total payment of 8 per cent of sales over 10 year period from date of agreement or 7 years from commencement of production. In addition, lump-sum technology payments up to Rs. 1 crore, i.e., (Rs. 10 million) are permitted under the automatic approval system. The prescribed royalty rates are net of taxes and are calculated according to standard procedures. Subject to the aforesaid guidelines, automatic approval is available in non-high priority industries, if no foreign exchange is required for any payment.

#### 18.3.5 REPATRIATION

One of the biggest concerns for foreign investors is how to get dollars out of India? Historically, it is not a problem to repatriate investments and profits from India. The Overseas Private Investment Corporation ("OPIC"), a U.S. government backed insurer of foreign commercial dealings, has never had to pay a claim due to India's failure to provide foreign exchange. Dividends, capital gains, royalties and fees can be repatriated easily with the permission of the Reserve Bank of India. In a short, specified list of consumer goods industries, dividend balancing is required against export earnings. In case of an exit decision, the overseas promoter can repatriate his share after discharging tax and other obligations. He can also disinvest his share either to his Indian partner, to another company, or to the public. Even during the so-called worst period no foreign company left India without proper and due compensation. Problems do arise when people and

businesses try to go around the rules or from inexperience. Rupee, the Indian currency, is convertible for the current account.

# 18.3.6 PRIVATIZATION AND PRIVATE SECTOR

Almost all the agriculture sector in India is in private hands. Most of the industrial sector is open to private participation. The number of industries reserved for the public sector has been reduced to 2: atomic energy and railway transport. All other areas are open to the private sector and private sector participation on a selective basis even in the still restricted areas is being considered. In practice railways, post and telegraph, shipbuilding, oil exploration and mineral industries are mostly government owned. A process of disinvestment of government holdings in selected public enterprises has been initiated. The government plans to form a new corporation, Indian Railways Catering Tourism Corporation (IRCTC). IRCTC will take over catering work and enter into tourism projects and trains in collaboration with private sector.

#### 18.3.7 ARBITRATION AND INTERNATIONAL ARBITRATION

Recently India enacted the Arbitration and Conciliation Act, 1996 ("New Law"). The New Law is based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration ("Model Law"). Among others, the objectives of the New Law are to harmonize the Indian arbitration law with the Model Law and establish an internationally recognized legal framework for arbitration, consolidate the laws on domestic and international arbitration and conciliation, and enforcement of foreign awards. Another important purpose of the New Law is to encourage arbitration as an alternate dispute resolution process and avoid prolonged judicial process.

#### 18.4 FOREIGN DIRECT INVESTMENT POLICY IN INDIA

Foreign Direct Investment (FDI) (discussed in para 2, MANUAL ON FOREIGN DIRECT INVESTMENT IN INDIA – POLICY AND PROCEDURE, MAY-2003) is now recognized as an important driver of growth in the country.

Government is, therefore, making all efforts to attract and facilitate FDI and investment from Non Resident (NRIs) including Overseas Corporate Bodies (OCBs) that are predominantly owned by them, to complement and supplement domestic investment. To make the investment in India attractive, investment and returns on them are freely repatriable, except where the approval is subject to specific conditions such as lock -in period on original investment, dividend cap, foreign exchange neutrality, etc. as per the notified sectoral policy. The condition of dividend balancing that was applicable to FDI in 22 specified consumer goods industries stands withdrawn for dividends declared after 14th July 2000, the date on which Press Note No. 7 of 2000 series was issued.

2.1 Foreign direct investment is freely allowed in all sectors including the services sector, except a few sectors where the existing and notified sectoral policy does not permit FDI beyond a ceiling. FDI for virtually all items/activities can be brought in through the Automatic Route under powers delegated to the Reserve Bank of India (RBI), and for the remaining items/activities through Government approval. Government approvals are accorded on the recommendation of the Foreign Investment Promotion Board (FIPB).

#### **Automatic Route**

#### (a) New Ventures

2.2 All items/activities for FDI/NRI/OCB investment up to 100 per cent fall under the Automatic Route except those covered under (i) to (iv) of para 2.9. Whenever any investor chooses to make an application to the FIPB and not to avail of the automatic route, he or she may do so. Investment in public sector units as also for EOU/EPZ/EHTP/STP units would also qualify for the Automatic Route. Investment under the Automatic Route shall continue to be governed by the notified sectoral policy and equity caps and RBI will ensure compliance of the same. The National Industrial Classification (NIC) 1987 shall remain applicable for description of activities and classification for all matters relating to FDI/NRI/OCB investment: Areas/sectors/activities hitherto not open to FDI/NRI/OCB

investment shall continue to be so unless otherwise decided and notified by Government. Any change in sectoral policy/sectoral equity cap shall be notified by the Secretariat for Industrial Assistance (SIA) in the Department of Industrial Policy & Promotion.

## (b) Existing Companies

- 2.3 Besides new companies, automatic route for FDI/NRI/OCB investment is also available to the existing companies proposing to induct foreign equity. For existing companies with an expansion programme, the additional requirements are that (i) the increase in equity level must result from the expansion of the equity base of the existing company without the acquisition of existing shares by NRI/OCB/foreign investors, (ii) the money to be remitted should be in foreign currency and (iii) proposed expansion programme should be in the sector(s) under automatic route. Otherwise, the proposal would need Government approval through the FIPB. For this a Board Resolution of the existing Indian company must support the proposal
- 2.4 For existing companies without an expansion programme, the additional requirements for eligibility for automatic approval are (i) that they are engaged in the industries under automatic route, (ii) the increase in equity level must be from expansion of the equity base and (iii) the foreign equity must be in foreign currency.
- 2.5 The earlier SEBI requirement, applicable to public limited companies, that shares allotted on preferential basis shall not be transferable in any manner for a period of 5 years from the date of their allotment has now been modified to the extent that not more than 20 per cent of the entire contribution brought in by promoter cumulatively in public or preferential issue shall be locked-in.
- 2.6 The automatic route for FDI and/or technology collaboration would not be available to those who have or had any previous joint venture or technology transfer/trade mark agreement in the same or allied field in India.

- 2.7 Equity participation by international financial institutions such as ADB, IFC, CDC, DEG, etc. in domestic companies is permitted through automatic route subject to SEBI/RBI regulations and sector specific cap on FDI.
- In a major drive to simplify procedures for foreign direct investment under the "automatic route", RBI has given permission to Indian Companies to accept investment under this route without obtaining prior approval from RBI. Investors are required to notify the Regional Office concerned of the RBI of receipt of inward remittances within 30 days of such receipt and file required documentation within 30 days of issue of shares to Foreign Investors. This facility is available to NRI/OCB investment also. [For procedure relating to automatic approval, refer to para 8.1 in the MANUAL ON FOREIGN DIRECT INVESTMENT IN INDIA POLICY AND PROCEDURE, MAY- 2003].

# **Government Approval**

2.9 For the following categories, Government approval for FDI/NRI/OCB through the FIPB shall be necessary: - (i) All proposals that require an Industrial Licence which includes (1) the item requiring an Industrial Licence under the Industries (Development & Regulation) Act, 1951; (2) foreign investment being more than 24 per cent in the equity capital of units manufacturing items reserved for small scale industries; and (3) all items which require an Industrial Licence in terms of the locational policy notified by Government under the New Industrial Policy of 1991. (ii) All proposals in which the foreign collaborator has a previous venture/tie up in India. The modalities prescribed in Press Note No. 18 dated 14.12.1998 of 1998 Series of Proceedings, shall apply to such cases. However, this shall not apply to investment made by multilateral financial institutions such as ADB, IFC, CDC, DEG, etc. as also investment made in IT sector. (iii) All proposals relating to acquisition of shares in an existing Indian company in favour of a foreign/NRI/OCB investor. (iv) All proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted. Areas/sectors/activities hitherto not open to FDI/NRI/OCB investment shall continue to be so unless otherwise decided and notified by Government. Any change in sectoral policy/sectoral equity cap shall be notified by the Secretariat for Industrial Assistance (SIA) in the Department of Industrial Policy & Promotion.

# Foreign Investment in the Small Scale Sector

2.10 Under the small-scale policy, equity holding by other units including foreign equity in a small-scale undertaking is permissible up to 24 per cent. However there is no bar on higher equity holding for foreign investment if the unit is willing to give up its small-scale status. In case of foreign investment beyond 24 per cent in a small-scale unit, which manufactures small scale, reserved item(s), an industrial license carrying a mandatory export obligation of 50 per cent would need to be obtained.

#### **Foreign Investment Policy for Trading Activities**

2.11 Foreign investment for trading can be approved through the automatic route up to 51 per cent foreign equity, and beyond this by the Government through FIPB. For approval through the automatic route, the requirement would be that it is primarily export activities and the undertaking concerned is an export house/trading house/ super trading house/star trading house registered under the provisions of the Export and Import policy in force. The sectoral policy of trading activities is elaborated at Sr. No. 8 viz. Trading of Annexure IV (Sector Specific Guidelines for Foreign Direct Investment) of this Manual.

# **Other Modes of Foreign Direct Investments**

2.12 Global Depository Receipts (GDR)/American Deposit Receipts (ADR)/Foreign Currency Convertible Bonds (FCCB): Foreign Investment through GDRs/ADRs, Foreign Currency 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 GDR/ADRs/FCCBs. These are not subject to any ceilings on investment. An applicant company seeking Government's approval in this regard

- should have a consistent track record for good performance (financial or otherwise) for a minimum period of 3 years. This condition can be relaxed for infrastructure projects such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.
- 2.13 There is no restriction on the number of GDRs/ADRs/FCCBs to be floated by a company or a group of companies in a financial year. A company engaged in the manufacture of items covered under Automatic Route, whose direct foreign investment after a proposed GDR/ADR/FCCBs issue is likely to exceed the percentage limits under the automatic route, or which is implementing a project falling under Government approval route, would need to obtain prior Government clearance through FIPB before seeking final approval from the Ministry of Finance.
- 2.14 There are no end-use restrictions on GDR/ADR issue proceeds, except for an express ban on investment in real estate and stock markets. The FCCB issue proceeds need to conform to external commercial borrowing end use requirements; in addition, 25 per cent of the FCCB proceeds can be used for general corporate restructuring.

#### **Preference Shares**

2.18 Foreign investment through preference shares is treated as foreign direct investment. Proposals are processed either through the automatic route or FIPB as the case may be. The following guidelines apply to issue of such shares: (i) Foreign investment in preference share are considered as part of share capital and fall outside the External Commercial Borrowing (ECB) guidelines/cap. (ii) Preference shares to be treated as foreign direct equity for purpose of sectoral caps on foreign equity, where such caps are prescribed, provided they carry a conversion option. If the preference shares are structured without such conversion option, they would fall outside the foreign direct equity cap. (iii) Duration for conversion shall be as per the maximum limit prescribed under the Companies Act or what has been agreed to in the shareholders agreement whichever is less. (iv) The dividend rate would not exceed the limit prescribed by the Ministry of

Finance. (v) Issue of Preference Shares should conform to guidelines prescribed by the SEBI and RBI and other statutory requirements.

## 18.5 VALUE-ADDED TAX

Value-Added Tax, one of the most radical reforms to be proposed for the Indian economy, could finally become a reality after four years of political and economic debate. So far 21 States have given their nod for the April 1 2005 deadline for switching over to VAT. The decision to introduce VAT was publicly discussed first at a conference of state chief ministers and finance ministers in November 1999. At that time, the deadline of April 2002 was agreed upon to bring in VAT but it couldn't be implemented due to political instability and a lack of initiatives. Now, despite a backlash from the trading community and some political circles, there appears to be a realistic scope for VAT to be introduced. VAT is a sales tax collected by the government (of the state in which the final consumer is located) which is the government of destination state on consumer expenditure. Over 120 countries worldwide have introduced VAT over the past three decades and India is amongst the last few to introduce it. India already has a system of sales tax collection wherein the tax is collected at one point (first/last) from the transactions involving the sale of goods. VAT would, however, be collected in stages (instalments) from one stage to another. The mechanism of VAT is such that, for goods that are imported and consumed in a particular state, the first seller pays the first point tax, and the next seller pays tax only on the value-addition done - leading to a total tax burden exactly equal to the last point tax. VAT is necessary, as it will close avenues for traders and businessmen to evade paying taxes. They will also be compelled to keep proper records of their sales and purchases. Many sections hold the view that the trading community has been amongst the biggest offenders when it comes to evading taxes. Under the VAT system, no exemptions will be given and a tax will be levied at each stage of manufacture of a product. At each stage of value-addition, the tax levied on the inputs can be claimed back from the tax authorities. At a macro level, there are two issues, which make the introduction of VAT critical for India. First, Industry watchers say that the VAT system, if enforced properly, forms part of the fiscal

consolidation strategy for the country. It could, in fact, help address the fiscal deficit problem and the revenues estimated to be collected could actually mean lowering of the fiscal deficit burden for the government. Second, any globally accepted tax administrative system would only help India integrate better in the World Trade Organisation regime.

# 18.6 SUMMARY

India is emerging as a major market and investment destination. In the continuation of that the share of the India in world GDP has been rise (from 6 per cent to 11 per cent in 2025). By 2025 the Indian economy is projected to be about 60 per cent the size of the US economy. The transformation into a tri-polar economy will be complete by 2035, with the Indian economy only a little smaller than the US economy but larger than that of Western Europe. By 2035, India is likely to be a larger growth driver than the six largest countries in the EU, though its impact will be a little over half that of the US. India is slated to become the third largest economy with a share of 14.3 per cent of global economy by 2015 and graduate to become the "third pole" and growth driver by 2035.

# 18.7 SELF-TEST QUESTIONS

- 13. Explain the policy regarding FDI in India.
- 14. How can you evaluate the status of Joint Ventures in India?
- 15. Explain the legal system in India.
- 16. What kinds of incentives are given by Indian Government to boost the exports?
- **17.** What steps may be taken by the India to cope up the challenges in the international business?

## 18.8 SUGGESTED READINGS

- 1. Cherrunilam, Francis (2003), *Business Environment*, New Delhi: Vikas Publishing House Private Limited.
- 2. Glueck, William (1980), *Business Policy and Strategic Management*, Auckland: McGraw-Hill International Book Company.

- 3. Paul, Srivastava, *Strategic Management*, Cinicinnati:South-Western Publishing Company.
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# FDI UPTO 74 per cent IN TELECOM SERVICES ALLOWED

Hutchison, Idea, Bharti, BPL and Spice have emerged winners from the government's decision to increase the FDI limit in telecom service providers from 49 per cent to 74 per cent.

Estimates have shown that an investment of about Rs 50,000 crore is required in the sector in the next three years to keep pace with the growing demand. Since such funds are not available in the domestic market, telecom operators had demanded the FDI limit be raised beyond 49 per cent. Moreover, raising money from the domestic market is more expensive than internationally.

"This was a long-pending measure. Attracting foreign investment will help boost growth and increase telecom penetration in the country," said Rajan B Mittal, joint MD of Bharti Tele-Ventures. Bharti will be the main beneficiary.

Bharti Enterprises chairman and group managing director Sunil Mittal said the hike in FDI cap would give a major boost to the sector. "Telecom is a highly capital intensive sector and this decision removes a large hurdle in the expansion of the Indian telecom companies. Companies can now access foreign capital markets to serve the hinterland and bringing affordable telecom services."

He also welcomed the exemption of excise duty on capital goods for the manufacture of and the exemption of customs duty on telecom grade optical fibres and mobile switching centres.

Tata Industries managing director Kishore Chaukar said the hike would channelise more funds into telecom, apart from increasing the flexibility of the operators. "These are welcome and are also needed," he pointed out. BPL Communications chairman Rajeev Chandrasekhar explained that the FDI hike would not materially affect his company. "However, the industry will be enthused by the fact that the government is looking at issues relating to investment in the telecommunications sector," he added.

Cellular Operators Association of India (COAI) chairman Dilip Modi maintained that the decision was a positive sign and would allow telecom players to raise fresh capital for the growth and development of telecom infrastructure. "Reduction in input costs is another welcome move and will enable the industry to extend affordable telecom solutions to the end consumers," he said.

The Indian telecommunications industry, particularly the cellular space, has been in the midst of some hectic activity on the mergers and acquisitions (M&A) front. Industry players have been of the view that the pace of this activity could be increased if the FDI limit were increased. Investment bankers said this decision would now result in large-scale funds coming into the Indian market.

"This will change the dynamics of the industry. It is positive for M&A consolidation and also for the capital markets," said NM Rothschild & Sons' (India) managing director Munesh Khanna.

Gartner India's principal analyst (Telecom) Kobita Desai said the hike in the FDI limit to 74 per cent was progressive. "India's telecommunications sector has shown high growth rates and the funds that will come in will facilitate the process of network expansion," she explained.

Association of Unified Telecom Service Providers of India (AUSPI) secretary general SC Khanna expressed concern that the telecom sector has not been excluded from the service tax net. "The sector is already paying 6-10 per cent revenue share and 2-6 per cent spectrum fee to the government," he said.

According to Ashish Chowdhary, country head - India & South Asia, Nokia Networks, the initiatives to raise the FDI limit and exempt MSCs from import duty are a welcome move and will help mobilise much-needed investments and drive down the cost of telecom equipment, further accelerating overall growth in the sector. These initiatives will supplement the operators' efforts to build telecom infrastructure across the country.

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**COURSE: BUSINESS ENVIRONMENT** 

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**OBJECTIVE** The present chapter explains the role of foreign technology and MNCs in global and competitive environment of a nation.

# **STRUCTURE**

- 19.1 Introduction
- 19.2 Role of Foreign Technology and MNCs in Global Environment
- 19.3 FDI And MNCs
- 19.4 Investment Potential in India For MNCs
- 19.5 Summary
- 19.6 Self-Test Questions
- 19.7 Suggested Readings

# 19.1 INTRODUCTION

All developing countries are dependent on foreign technology. In this sense, many analysts have regarded MNCs as one of the main vehicles, or even the main vehicle, for allowing developing countries to begin to close the gap with the world leaders in technology or at least to be able to keep up in a more open and competitive economic environment. In many sectors, especially in the most dynamic and knowledge-intensive ones, MNCs have important technological assets. Besides, MNCs are often at the cutting edge in terms of their process and organizational technologies. Hence, the way in which, and the extent to which developing countries may benefit from the technological advantages of MNCs to

foster their social and economic development and enhance their competitiveness are key questions. Even if most technological inputs can be imported, developing countries have to foster what has been termed a "social" or "absorptive" capability. In other words, developing countries must create a basic endogenous capability to be able to assimilate and take advantage of foreign technology inputs.

# 19.2 ROLE OF FOREIGN TECHNOLOGY IN GLOBAL ENVIRONMENT

This endogenous capability is a crucial element in what has been termed "structural competitiveness". It is based on the idea that the competitiveness of firms is not only a reflection of successful management and technological practices, but also stems from the strength and efficiency of a national economy's productive structure, the collective learning process associated with innovation and the proper use of human capital. Those developing countries which have reached a relatively high level of industrialization and of structural competitiveness have done so by building domestic technological capabilities which go beyond those required for choosing, adapting and efficiently using foreign technological inputs. The experience of the most advanced developing economies, and specially those of the Republic of Korea, Taiwan Province of China, Singapore and Hong Kong (China) indicates that major improvements are possible. Local firms in developing countries can also develop new technologies while they progress through their learning process. In this way, firms can progressively become "genuine innovators"

There are four ways in which developing countries can obtain technology from MNCs: through FDI; through joint ventures between domestic firms and MNCs (including what has been termed "strategic partnerships"); by purchasing technology in contractual form (patents, licensing, turnkey contracts, etc.); and through reverse engineering, imitation, copying, etc. (in this case, without the consent of MNCs). The choice between these four ways, when there is a choice<sup>1</sup>, depends mainly on the type of sector involved, the technological infrastructure of the host country, the availability of skilled domestic human resources and the existence (or absence) of native firms with endogenous innovative capabilities. The technological impact of the presence of MNCs should be assessed not only in terms of their direct contribution (i.e., the technologies they introduce in the host country, the innovative activities which they eventually accomplish, etc.), but should be mainly related to the following key question: To what extent does the presence of MNCs fosters or inhibits, the creation and upgrading of domestic absorption capabilities of host countries?

Through FDI, MNCs may bring to the host country their best technological and organizational practices or, at least, they may introduce technologies and practices which are more up-to-date (though not necessarily more attuned to local conditions or domestic factor prices) than those applied by local firms. Furthermore, MNCs may generate technological spillovers from which indigenous institutions and domestic entrepreneurs can benefit. In this case, the

<sup>&</sup>lt;sup>1</sup>. MNCs may be reluctant to engage in arm's-length technology transfer, or to associate with domestic firms. As for reverse engineering or copying, the international legal framework seems to have been moving for many years towards a more stringent enforcement of intellectual and industrial property rights.

social benefits of MNCs activities are enhanced, since MNCs are not the only ones to enjoy the economic benefits arising from their technological assets.

MNCs may be an important source of spillovers. First, their entry may lead to increasing competition in domestic markets, forcing local firms to enhance their productivity by being more efficient in using existing technologies and, eventually, by adopting new and more efficient technologies. Second, local firms may take advantage of the superior technologies and organizational and management practices of MNCs by initiating them, hiring workers trained by MNCs, or establishing forward and backward linkages with their affiliates. Finally, if MNCs develop innovative activities in the host country, they could generate significant externalities (through human capital upgrading). It has been suggested also that MNCs may help developing countries, and especially the least developed countries, to foster an entrepreneurial culture. At the same time, cultural barriers, and especially the lack of a "scientific outlook" in host countries, may help to explain why spillovers from MNCs' operations are often so limited. The available evidence on the actual magnitude of this kind of spillover is inconclusive. Even if "many analyses of the linkages between MNCs and their local suppliers and subcontractors have documented learning and technology transfers that may make up a basis for productivity spillovers. The MNCs are able to extract all the benefits that the new technologies or information generate among their supplier firms, so there is no clear proof of spillovers", though they readily argue that it "is reasonable to assume that spillovers are positively related to the extent of linkages".

Regarding spillovers through the training of workers, it seems to be a definite accumulation of human capital skills among the MNCs' employees, but the extent to which these skills can be appropriated by local firms when these employees move to new jobs is an open question. Though empirical evidence is scattered, most studies suggest that management skills are less firm specific than technical skills, and can more easily be used in other contexts.

It is well known that MNCs undertake only a small proportion of their research and development (R&D) activities outside their home countries. Although information technology may facilitate greater decentralization of R&D activities, it may also lead to a concentration of such activities in a few developed countries. Whereas in some cases affiliates in developing countries undertake some R&D work, it may well happen that the total expenditure on R&D in the host country may be reduced with the entry of MNCs. For example, an MNC which takes over an existing local firm that used to make significant investments in R&D activities may decide to discontinue these activities since it centralizes them in its home base or in affiliates in developed countries. Even without takeovers, the presence of MNCs may discourage innovative activity in domestic enterprises and induce them to substitute licensing agreements for such activity.

At the same time, MNCs may not necessarily bring their latest technologies to the host countries. This depends, amongst other things, on the relative price factors, the intensity of competition in the host country market, the requirements of industrial and final customers, and the global strategy followed by MNCs.

Nonetheless, FDI is generally regarded as being more conducive to the transfer of modern technologies than other ways of technology transfer such as licensing.

The relationship between FDI and the technological performance of host countries cannot be easily assessed with conventional indicators. If the technological performance through R&D expenditures relative to GDP or through number of patents granted in the United States of America is measured, the two outstanding cases amongst developing countries are the Republic of Korea and Taiwan Province of China, which have relied intensively on foreign technology and have generally not controlled FDI by MNCs. They have mostly used contractual arrangements, joint ventures and reverse engineering. At the same time, there are cases with a high influence of FDI and good technological performance (Singapore), as well as other cases with relatively low presence of MNCs and poor technological performance (India).

## 19.3 FDI AND MNCs

Almost by definition, FDI should help to reduce the gap with the world leaders in process and product technologies. However, it cannot be expected that MNCs' affiliates will be undertaking significant innovation activities in these countries, and their linkages with domestic firms and local S&T institutions will be generally very weak (especially when MNCs are located in EPZs). Domestic competitors, if there are any, will find it hard to learn from MNCs technologies, which are likely to be well beyond their endogenous capabilities. The technology indicators often employed in developed countries must be adapted if they are to have a meaningful use in developing countries. It is evident that they are totally

inappropriate for LIDCs and there are very few studies concerned with the development of S&T indicators suitable for this kind of countries. This fact complicates even further the analysis of the technological impact of FDI.

In this context, it is important to distinguish LIDCs (Low Income Developing Countries) from other developing countries. LIDCs have weak or almost inexistent national systems of innovation; there are few, if any, enterprises with technological capabilities; their S&T institutions are poorly endowed; there is a dearth of skilled human resources, and their manufacturing sector and domestic markets are small. In short, they have not even begun to build the abovementioned social or absorptive capability that is needed if they are to take advantage of foreign sources of technology. How, then, are we to evaluate this issue? First, it would be advisable to learn about the existence of clusters or networks build around MNCs' activities. At the same time, the impact of MNCs on existing clusters should also be studied. The main objective of this analysis should be to determine whether the presence of MNCs presence fosters entrepreneurial and innovative attitudes in their suppliers and customers. Second, the employment of native human resources in jobs, which require significant skills, and of local engineers and scientists in the labor force of MNCs should be examined. It would also be interesting to learn whether MNCs have any specific policies for training, qualifying and upgrading the skills of local human resources. The mobility of skilled workers is, as mentioned above, one of the possible spillovers from FDI. Since it is plausible to assume that few local existing firms could employ these workers in LIDCs, it would be interesting to know any cases

in which workers trained by MNCs have created new enterprises in which they could take advantage of the skills learned in the MNC. Third, it is important to find out whether the presence of MNCs fosters, or inhibits, the ability of LIDCs to gain expertise in identifying the technologies, which are most suitable to their needs, including "hard" as well as "soft" technologies. Finally, the possible existence of differences in the technological performance and in the generation of spillovers for host countries between "conventional" MNCs and so-called "Third World" MNCs -a growing phenomenon, especially in some East Asian and Latin American countries should also be verified.

A different approach is required to analyze the technological impact of FDI in more advanced developing countries. Even if these countries are, in general, far from having mature national system innovation, they have generally built an S&T system and have at least some local base of skilled human resources. The technological modernization of the infrastructure inherited by new owners has nurtured a number of locally owned firms specialized in systems engineering, computer software, etc. On the other hand, privatization has meant a contraction, and even the disappearance, of the domestic R&D infrastructure developed by former State enterprises.

MNCs in developing countries, as part of the globalization of their production strategies, have often discontinued local engineering activities in order to adapt and improve product and process technologies provided by their parent companies. Moreover, the increasing use of imported components may have a negative impact on local firms, which were suppliers of MNCs (of course, the

same arguments apply when new MNCs take over local existing firms). Thus, we seem to be witnessing a process of "creative destruction". The society's pre-existing human, engineering and technological capabilities are devalued. The new innovation systems seem to rely more on external sources of technology and to be more responsive to the influence of global technological trends. Whether one considers this transition as a good or bad development depends chiefly on the assessment of the quality of the previous technological base, on the extent on which it has been eroded, preserved or transformed, and on the new linkages or spillovers arising from the new productive and innovative strategies by MNCs' affiliates.

In this case, several sectors where the presence of MNCs is widespread should be selected for studies in different countries. It would be advisable to choose sectors with different characteristics - consumer durables (e.g. automobiles), a scale-intensive sector (e.g. petrochemicals) and a high-tech sector (e.g. electronics or biotechnology) and countries with different structural features, economic policy regimes and levels of development. The study of some activities, which have been privatized and are now under foreign control, could be relevant as well.

In recent years, restrictions on FDI have been substantially reduced in the majority of countries. As said before, many Governments have also implemented incentive regimes designed to attract FDI. Since Governments can more easily manipulate incentives than other factors, which influence investment decisions, the "incentives-led" competition for FDI makes some sense. This competition for FDI is not necessarily bad in itself. The problem is the form that it assumes in

many cases. Host Governments are often only interested in the quantity of FDI, paying little if any attention to the externalities, which it generates, or to its impact on income distribution or the environment, for example. Furthermore, there has been criticism of the use of incentives as the predominant tool for attracting FDI.

Even if "rules-based competition" may appear as a better alternative for attracting FDI -since it gives less room for bribery and corruption-, this kind of competition includes a broad and heterogeneous groups of government actions, which could include the lowering of standards regarding worker's right or environment protection -with obvious negative effects in terms of SHD-, but also the signing of regional integration treaties or the strengthening of judicial systems.

Different surveys on this issue suggest that there are more influential determinants of FDI attraction – namely, host market size and rate of growth, physical and communications infrastructure, and the quality of human resources - than fiscal or financial incentives. These other determinants of FDI are especially important when Governments are trying to attract high-quality FDI, from which substantial externalities could be obtained in terms of employment, human resources upgrading, value-added exports, technology, and enhancement of environmental performance. It is acknowledged, however, that incentives can be important in the margin, when MNCs are choosing amongst a short-list of fairly similar alternative locations in a given country.

Nonetheless, there seem to be some successful examples of a promotional policy for FDI based on fiscal and financial incentives. The first step in designing policies to attract and enhance the contribution of FDI in developing countries is to study the preconditions for this success, and the modalities and objectives of the instruments implemented. The example of Ireland is useful in this respect. From the 1980's onwards, Ireland's FDI policy was based on: (i) selecting leading, high value-added industries (electronics, software, medical instruments, financial services, etc.); (ii) creating specialized industrial clusters in designated locations; and (iii) promoting links with domestic firms. The FDI policy included, amongst other things, grants for establishing R&D facilities. At the same time, fiscal and financial incentives were not the only factors in attracting FDI; education and training efforts were fostered by the Irish Government to upgrade the qualifications of the labor force.

## 19.4 INVESTMENT POTENTIAL IN INDIA FOR MNCs

A new report from the World Bank rated India as the best among South Asian Nation in improving investment climate, India also figurers among the top 10 reformers in the world as per the latest annual survey of executives from the world's largest companies, India is third most attractive FDI location after China & USA. China's FDI Flow is larger and primarily capital-intensive, while India FDI flows are smaller and skill-intensive. Its growth rates are between the second and third fastest in the world, particularly in the fields of IT, Telecommunications and Business Process Outsourcing.

India's economic strategies have been very good: there are surpluses in both food and industrial production, and it has not seen hyperinflation, as many other economies have seen in the past years. Moreover, there is still steady growth despite 9/11 and a global recession. It has been a good, steady race for the Indians, even if it has been a slow one for the first forty years of Indian independence.

Now a day, India is becoming an attractive investment location due to:

- ✓ Indian economy is certainly playing a role, an important one, in the global economy. It has a large market and moreover an immense source of resources- both in terms of wealth and in human resources. Thus, in order to compete in this global, linked, "Communications rich" environment, companies large and small are spurred to make their presence in India.
- ✓ India is a very trustworthy power; the fact recognized worldwide by countries.
- ✓ A well-established legal system with an independent judiciary.
- ✓ Skilled manpower and professional mangers available at reasonable cost.
- ✓ Well developed capital markets, Banking, Insurance and financial services sectors.
- ✓ The tremendous reports of overseas companies, which have invested in India.
- ✓ The increasing role played by private and foreign investment in the Indian economy.
- ✓ Full convertibility of the Rupee on current account, and the expected full convertibility on capital account.
- ✓ A vast middle class consumer population of 300 million estimated to be growing at 8% per annum.

- ✓ Government's proven commitment to the deregulation process Excellent, well developed accounting, legal, actuarial and consulting professions
- ✓ Many MNCs have established a presence in India and many medium sized foreign companies are setting up joint ventures, trading and manufacturing facilities in India.

# **19.5 SUMMARY**

In common sense, the "system of innovation" framework seems to be a promising way to analyze the impact of FDI on the technological performance of host countries. This relatively recent framework has some weaknesses - it is conceptually diffuse, and it is hard to operationalize. However, it has several interesting features: it is holistic and interdisciplinary, it emphasizes the role of history and institutions, it stresses the interactions and interdependence between agents. It allows the use of different approaches, (sectoral, regional or national, even multinational or transnational). Furthermore, it is similar to the notion of "structural competitiveness". In sum, it is a promising research framework for the more systematic and holistic analysis of the interactions between technological and innovative capabilities and economic and social development.

# 19.6 SELF-TEST QUESTIONS

1. What kind of product and process technologies do MNCs' affiliates employ in host countries, both in tradable and non-tradable sectors? How much of a gap is there between those technologies and those employed in MNCs' home countries or in their affiliates in developed countries? Has the gap been

- reduced after trade and FDI liberalization measures? To what extent is the gap due to the relative prices of capital and labor or to non-price factors?
- 2. Do MNCs' affiliates engage in innovative activities in host countries? If so, what are the characteristics of those activities and the main motivating factors?
- 3. In what way do MNCs' affiliates interact with different host country science and technology (S&T) institutions?
- 4. Are there technological partnerships between MNCs and local firms? If so, what are the features and prospects of these kind of alliances?
- 5. What kind of technical assistance do MNCs' affiliates provide to their suppliers and customers in the host country?
- 6. To what extent do MNCs' train and upgrade the technical skills of their labor force? Are there any spillovers from these activities through workers' mobility?
- 7. Does the presence of MNCs' in LIDCs help to foster the development of an entrepreneurial and innovative culture in local firms and institutions?

### 19.7 SUGGESTED READINGS

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