THIRD EDITION

BUSINESS Environment

TEXT AND CASES

JUSTIN PAUL

The McGraw-Hill Companies

BUSINESS Environment

TEXT AND CASES

Third Edition

About the Author

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He is the author/co-author of several books—*International Marketing*, *International Business*, *Export-Import Management* and *Management of Banking and Financial Services*. A consistent rank holder, he has two masters degrees, two PG diplomas, a Faculty Development Programme–Summer School (FDP-SS), Germany and a doctorate from the Indian Institute of Technology (IIT) Bombay. He has also received international awards for research papers and case studies instituted by the American Society for Competitiveness, Emerald Publishers, Indian Banks Association and Association of Indian Management Scholars. He has hands-on experience of working with two commercial banks before joining academic world. He has published over 20 papers in international journals and presented papers at the conferences organised/hosted by the University of San Francisco, Fudan University-Shanghai, Indiana University of Pennsylvania, University of Stirling-UK, Asian Academy of Management, Waseda University-Tokyo in the recent past. He has also undergone a case writing training program organised by London Business School. He has also served as a Reviewer of research papers for Academy of International Business-USA, International Journal of Commerce and Business, International Journal of Bank Marketing and Management Review.

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and
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Preface

The end of the first decade in the 21st century saw the global economic crisis hampering commerce around the world, particularly in the developed countries. Economic reforms, implemented in the form of liberalisation, privatisation and globalisation, have brought about a wide range of challenges and opportunities in most of the countries during the last decade. Understanding the implications of structural adjustment programmes on business, economy and society becomes all the more significant in this competitive era.

The economic growth of China and India has been remarkable over the last decade and the former is expected to overtake the position of United States as the largest economy in the world. Organisations will have to formulate new growth strategies for success, expansion and increasing gains based on day-to-day developments and the fast-moving world. The need of the hour is to learn all the new policies, structures, measures, steps and the implications with reference to legal framework, foreign investment, exports and imports, privatisation, taxation, budget, competition, monetary policy, technology, capital market, foreign exchange transactions, corporate governance and social responsibility. Gaining knowledge about all these spectra of business would help one to be a successful manager in the era of ever-increasing competition.

It is because of the importance of these topics and the changing environment that universities and institutes have made Business Environment/Economic Environment and Policies as a core subject in management and commerce streams. In some institutes this course has been covered under titles like *Economic and Social Environment, Business in Asia, Indian Economy, Developments in Indian and Global Economy, Asian Business Environment* and so on.

The idea of this book originated when I was teaching 'Economic Environment of Business' for Mumbai University's Master of Management Studies course and 'Business Environment' for Executive MBA during 2001-03. Later, I got the opportunity to teach this course at the Indian Institute of Management, Indore, Nagoya University, Japan, University of Washington, Great Lake Institute etc., as a visiting professor, which helped me to include updated topics into this textbook. The changes made in the second edition have been widely accepted by professors and students, and they helped the book in becoming one of the best-selling titles on the subject.

This book has been written in accordance with the courses outlined in the University Grants Commission curriculum and will cater to the requirements of students as well as teachers. Candidates aspiring to update their knowledge about current affairs to prepare for interviews will find this book a valuable resource. The book can also serve the purpose of practicing managers who need to understand the permutations and combinations of new business rules and opportunities to take wise corporate decisions.

Many textbooks fail to discuss the implications of the various topics for the real world of business. This textbook takes this into consideration. So more than 75 company/industry based case studies as well as many country cases have been included. They will be very useful for students who will soon be practicing managers.

New and expanded topics in this edition

Many new and expanded topics in this third edition cover issues in global financial crisis and consequences, multinational corporations, foreign direct investment, business environment in East Asian countries, industry trends and market structure. The new chapters included in this book are:

Chapter 1 – Nature and Dynamics of Business Environment
Chapter 15 – Global Recession and New Business Environment
Chapter 20 – Multinational Companies and Foreign Direct Investment
Chapter 25 – Economic and Business Environment in East & South East Asian Countries

Other highlights of this new edition are:

- Class/Field Exercises including web links
- Practical Problems based on numerical calculations in important chapters
- Real life cases to provide insights on the recent developments
- Statistical updates in all chapters

Companion Website

Additional resources for students as well as instructors will be available on *http://mhhe.com/justinpaul*. Additionally, a blog on this subject will also be available on *www.drjustinpaul.com*, where the students and teachers can exchange their views with the author.

Acknowledgements

I am thankful to Prof. Hiroshi Kurimoto (President, Nagoya University of Commerce and Business, Japan), K. T. Chacko (Director, Indian Institute of Foreign Trade, New Delhi), Prof. Prasant N. Bharadwaj (Indiana University of Pennsylvania), Prof. A. Ramanathan and Prof. L. M. Bhole (IIT Bombay), Prof. C. Laxman (BEM, France), and V. J. Sebastian (IMT Ghaziabad) for their support and encouragement which helped me to enrich my knowledge on this subject.

At a time when the environment concerning business and economy is undergoing paradigm shift and many institutes are still searching for a good textbook covering the current issues of the subject, the publishers at McGraw-Hill deserve appreciation for nudging me to undertake the work for the Third Edition and for helping me to make it a worthy one. I am thankful to Vibha Mahajan, Tapas Maji, Hemant K. Jha, Shalini Negi, Anubha Srivastava, Sneha Kumari, Manohar Lal and Atul Gupta for this. I am deeply grateful to the reviewers of this book as well, some of whom are: A K Upadhyay, Apeejay Institute of Technology, Noida; Faisal Ahmed, Asia-Pacific Institute of Management, New Delhi; Sankalp Srivastava, Kali Charan Nigam Institute of Technology, Banda (UP); Debabrata Mandal, Presidency College, Kolkata; Sunita Malhotra, ITM Universe, Gwalior; Suresh Bedi, Institute of Management Studies and Research, Maharishi Dayanand University, Rohtak.

T. K. Pradeep (IIM Indore) contributed significantly for preparing the manuscript. He deserves my whole-hearted gratitude. And lastly, my thanks to family members Dr Festi, P. V. Paulose, Annie Paulose and Santhosh for their help in many ways in completing this work.

I appreciate the help of all the students and professors who have shared their opinions of past editions and welcome their comments and suggestions on this and future editions of this book.

Justin Paul

Visual Walkthrough

Visual

PART One

Political Economy, Development Economics, Government and Society

Part-Opening Pages

The book has been divided into several parts which club together chapters of the same nature for the reader's convenience.

Chapter 1

Nature and Dynamics of Business Environment

Learning Objectives

- to understand the changing nature of business environment
- to learn about the role of firms and governments in developing countries
- To study the dynamics of economic framework in which firms operate

Chapter Structure

Section 1: **History of Global Capitalism**
Section 2: **Pros and Cons of Capital Account Convertibility**
Section 3: **Lessons from US Prime Crisis and Global Recession**
Section 4: **Global Capitalism—Free Market Model**
Section 5: **Role of Developing Countries**

Learning Objectives

These outline what each chapter aims at achieving and what its reader should know on its completion. After these, the chapter structure tells the reader how that content has been designed.

142 *Business Environment: Text and Cases*

According to SWOT Analysis, Indian pharmaceutical industry is characterised by efficiency throug cost structure and good manufacturing base. However, R& D efforts are yet to become comparable t international levels. It has good export potential, which is, however, complicated with patent regim imposed by WTO.

Case 1: Cipla

Cipla is one of the biggest manufacturers of bulk drugs and formulations.

The company has introduced several formulations and active pharmaceutical ingredients (APIs). It commissioned the second phase of its manufacturing operations in Goa and has entered into a research alliance for biopharmaceutical products with a Bangalore-based biotech company.

Cipla exports a wide range of APIs and formulations to over 150 countries. Cipla has entered into new arrangements with leading US generic companies for the supply of a wide range of finished dosage formulations. They have obtained approvals from USFDA, MHRA of UK, PIC of Germany and WHO, for most of their drugs. Its overall profitability was due to the optimisation of resources and implementation of rigorous cost control measures.

Cipla focuses on technological excellence and innovation to improve its performance both in domestic and international markets. The company has already accepted the growing importance of strategic alliances for research, manufacture and marketing, in the changing business environment.

Question

Discuss the rationale for Cipla's focus on exports and strategic alliances?

Case 2: Nicholas Piramal

Nicholas Piramal India is a giant in the Indian pharmaceutical market.

Nicholas Piramal had a different growth strategy as it started as a small player with big dreams. The strategy was organic growth coupled with acquisitions. Piramal acquired nine entities and integrated them quickly into the parent company to deliver higher growth from the acquired portfolio.

Nicholas Piramal is also focusing on exports market. It has decided to partner with innovator companies in global markets, rather than compete or patent litigate against them. Building on this base, the company has built an export model that delivers the 'India advantage' to the global firms. It plans to provide end-to-end outsourcing solutions across the pharmaceutical life cycle, from custom-made synthesis and bulk intermediates to formulations. It has established four process development groups at multiple locations in India and has also set up a 100% subsidiary in the US for closer customer reach. Nicholas Piramal believes that the future growth driver will be exports, ably supported by a strong domestic market.

Case Studies

In order to understand the real world issues in the business environment, Case Studies have been provided liberally in the text. These cases centre on live examples observed by the author personally, or narrated to him by people having first-hand experiences.

Walkthrough

Chapter-end Appendices

These provide a wealth of information for the interested reader. They have been culled from various sources to help the reader add to his knowledge base.

Exhibits: Exhibits, within the Appendices, give useful and indepth details of the business environment.

Appendix

Exhibit 6.1

Organisations for Support of SSIs

- Technology Upgradation
  - National Small Industries Corporation (NSIC)
  - Small Industries Development Organisation (SIDO)
  - Small Industries Service Institutes (SISIs)
  - Regional Testing Centres (RTCs)
  - Process & Product Development Centres (PPDCs)
- Technical Training
  - Small Industries Development Organisation (SIDO)
  - Small Industries Service Institutes (SISIs)
  - Technical Consultancy Organisations (TCOs)
  - Process & Product Development Centres (PPDCs)
  - District Industries Centres (DICs)
  - Regional Testing Centres (RTCs)
  - Central Footwear Training Institutes CFTIs
  - Tool Rooms
- Industrial Infrastructure
  - Industrial State Infrastructure Development Corporations (ISIDCs)
  - Small Industries Development Corporations (SIDCs)
  - Housing Urban Development Corporation (HUDCO)
- Entrepreneurship Development
  - Small Industries Development Organisation (SIDO)
  - Specialised Institutes
  - National Institute for Entrepreneurship and Small Business Development (NIESBUD)
  - Small Industries Service Institutes (SISIs)
  - Entrepreneur Development Institutes (EDIs)
- Marketing
  - Small Industries Development Organisation (SIDO)
  - National Small Industries Corporation (NSIC)
  - State Small Industrial Development Corporations (SSIDCs)
  - Small Industries Service Institutes (SISIs)

Chapter Summary

The points discussed in this chapter can be summarised as follows:

(i) As a result of liberalisation in trade relations with other countries, the units in the electronics and textiles industries are going through a phase of compulsory modernisation and reforms. The changes are inducing some units to innovation processes, but the units, which are not economically strong, are facing the problem of sickness.

(ii) There are 3 major challenges faced by industries in India, namely:
  (a) Growing pressure from the import liberalisation programme;
  (b) Growing competition due to increased foreign direct investment; and
  (c) Growing complexity of issues.

(iii) Some of the changes made in the government policies have also affected industries. For example, the policy framework governing inward FDI was substantially liberalised under the automatic route.

(iv) Unless industrial units continuously upgrade their technologies, it will be difficult for them to withstand international competition arising from trade liberalisation and openness of the economy.

(v) The textiles exports from India is likely to be benefited due to the removal of restrictions as per the implementation of the Agreement on Textiles and Clothing, by many member countries of WTO that has taken place in 2005.

Review Questions

1. Discuss the competitive business environment that arises as an outcome of the implementation of globalisation and liberalisation policies.
2. Briefly analyse the structure and profile of electronics industry in India.
3. Elucidate the salient features of liberalisation policies pertaining to automobile sector.

Class/Field Exercise

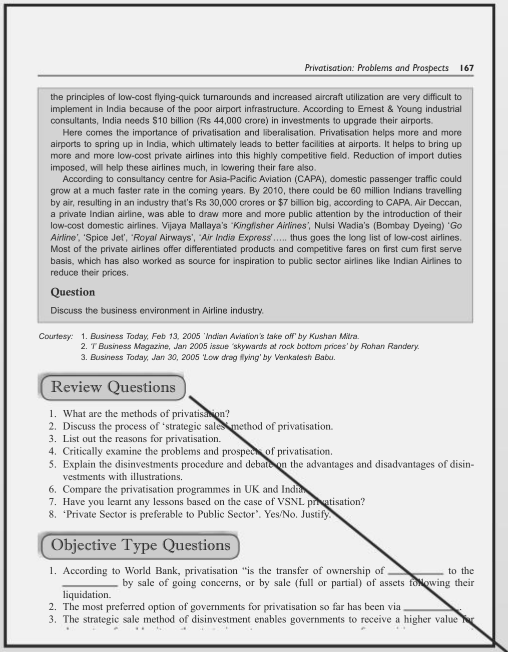
Do an analysis of the Market Structure based on factors affecting the market structure. Students can use statistical tools such as Herfendile Index, Concentration Ratio etc., that they have already studied in other courses if required.

1. Market Structure of IT Industry with reference to computer hardware industry – Analysis based on the developments in Indian and in the world economy.
2. Industry Analysis – Mobile Handset Industry in selected countries – Companies, Market Share – Past, Present and Future, New Product Innovations etc.
3. Passenger Car Industry in India US and China – Companies, Market Structure: Past, Present and Future Brands, Innovations and Recent Developments, detailed study on a selected company.
4. Textile Industry in Bangladesh, India and China – Companies, Market Structure and Market Shares in India, Leading Textiles Exporters from India. Study and prepare a business plan and to face challenges. Study on a selected brand – Demand Analysis (factors affecting domestic demand etc.).

Chapter Summary

This incapsulates the topcs discussed in the chapter. It will be of real help to the reader during examinations.

Visual



the principles of low-cost flying-quick turnarounds and increased aircraft utilization are very difficult to implement in India because of the poor airport infrastructure. According to Ernest & Young industrial consultants, India needs $10 billion (Rs 44,000 crore) in investments to upgrade their airports.

Here comes the importance of privatisation and liberalisation. Privatisation helps more and more airports to spring up in India, which ultimately leads to better facilities at airports. It helps to bring up more and more low-cost private airlines into this highly competitive field. Reduction of import duties imposed, will help these airlines much, in lowering their fare also.

According to consultancy centre for Asia-Pacific Aviation (CAPA), domestic passenger traffic could grow at a much faster rate in the coming years. By 2010, there could be 60 million Indians travelling by air, resulting in an industry that's Rs 30,000 crores or $7 billion big, according to CAPA. Air Deccan, a private Indian airline, was able to draw more and more public attention by the introduction of their low-cost domestic airlines. Vijaya Mallaya's '*Kingfisher Airlines*', Nulsi Wadia's (Bombay Dyeing) '*Go Airline*', 'Spice Jet', '*Royal* Airways', '*Air India Express*'..... thus goes the long list of low-cost airlines. Most of the private airlines offer differentiated products and competitive fares on first cum first serve basis, which has also worked as source for inspiration to public sector airlines like Indian Airlines to reduce their prices.

Question

Discuss the business environment in Airline industry.

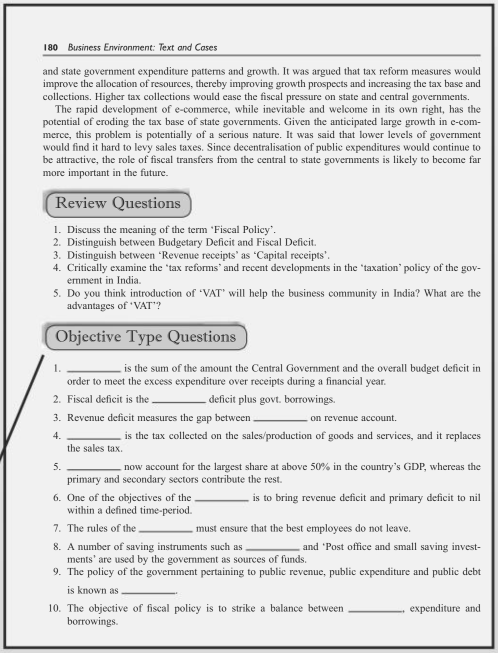
Courtesy: 1. *Business Today, Feb 13, 2005 'Indian Aviation's take off' by Kushan Mitra.*
2. *'I' Business Magazine, Jan 2005 issue 'skywards at rock bottom prices' by Rohan Randery.*
3. *Business Today, Jan 30, 2005 'Low drag flying' by Venkatesh Babu.*

Review Questions

1. What are the methods of privatisation?
2. Discuss the process of 'strategic sales' method of privatisation.
3. List out the reasons for privatisation.
4. Critically examine the problems and prospects of privatisation.
5. Explain the disinvestments procedure and debate on the advantages and disadvantages of disinvestments with illustrations.
6. Compare the privatisation programmes in UK and India.
7. Have you learnt any lessons based on the case of VSNL privatisation?
8. 'Private Sector is preferable to Public Sector'. Yes/No. Justify.

Objective Type Questions

1. According to World Bank, privatisation "is the transfer of ownership of ________ to the ________ by sale of going concerns, or by sale (full or partial) of assets following their liquidation.
2. The most preferred option of governments for privatisation so far has been via ________.
3. The strategic sale method of disinvestment enables governments to receive a higher value for



and state government expenditure patterns and growth. It was argued that tax reform measures would improve the allocation of resources, thereby improving growth prospects and increasing the tax base and collections. Higher tax collections would ease the fiscal pressure on state and central governments.

The rapid development of e-commerce, while inevitable and welcome in its own right, has the potential of eroding the tax base of state governments. Given the anticipated large growth in e-commerce, this problem is potentially of a serious nature. It was said that lower levels of government would find it hard to levy sales taxes. Since decentralisation of public expenditures would continue to be attractive, the role of fiscal transfers from the central to state governments is likely to become far more important in the future.

Review Questions

1. Discuss the meaning of the term 'Fiscal Policy'.
2. Distinguish between Budgetary Deficit and Fiscal Deficit.
3. Distinguish between 'Revenue receipts' as 'Capital receipts'.
4. Critically examine the 'tax reforms' and recent developments in the 'taxation' policy of the government in India.
5. Do you think introduction of 'VAT' will help the business community in India? What are the advantages of 'VAT'?

Objective Type Questions

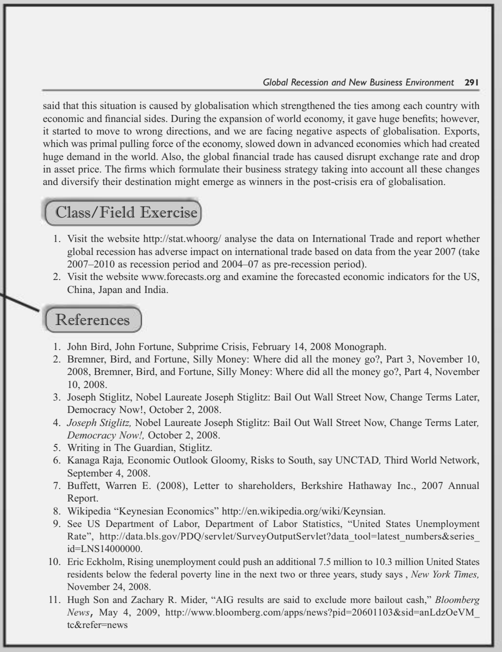
1. ________ is the sum of the amount the Central Government and the overall budget deficit in order to meet the excess expenditure over receipts during a financial year.
2. Fiscal deficit is the ________ deficit plus govt. borrowings.
3. Revenue deficit measures the gap between ________ on revenue account.
4. ________ is the tax collected on the sales/production of goods and services, and it replaces the sales tax.
5. ________ now account for the largest share at above 50% in the country's GDP, whereas the primary and secondary sectors contribute the rest.
6. One of the objectives of the ________ is to bring revenue deficit and primary deficit to nil within a defined time-period.
7. The rules of the ________ must ensure that the best employees do not leave.
8. A number of saving instruments such as ________ and 'Post office and small saving investments' are used by the government as sources of funds.
9. The policy of the government pertaining to public revenue, public expenditure and public debt is known as ________.
10. The objective of fiscal policy is to strike a balance between ________, expenditure and borrowings.

Review Questions and Objective Type Questions

These questions given at the end of the chapter would help the reader in gauging the depth of understanding of the subject.

References

The reader has been provided a comprehensive list of material for further reading, which will help him upgrade his knowledge.



said that this situation is caused by globalisation which strengthened the ties among each country with economic and financial sides. During the expansion of world economy, it gave huge benefits; however, it started to move to wrong directions, and we are facing negative aspects of globalisation. Exports, which was primal pulling force of the economy, slowed down in advanced economies which had created huge demand in the world. Also, the global financial trade has caused disrupt exchange rate and drop in asset price. The firms which formulate their business strategy taking into account all these changes and diversify their destination might emerge as winners in the post-crisis era of globalisation.

Class/Field Exercise

1. Visit the website http://stat.whoorg/ analyse the data on International Trade and report whether global recession has adverse impact on international trade based on data from the year 2007 (take 2007–2010 as recession period and 2004–07 as pre-recession period).
2. Visit the website www.forecasts.org and examine the forecasted economic indicators for the US, China, Japan and India.

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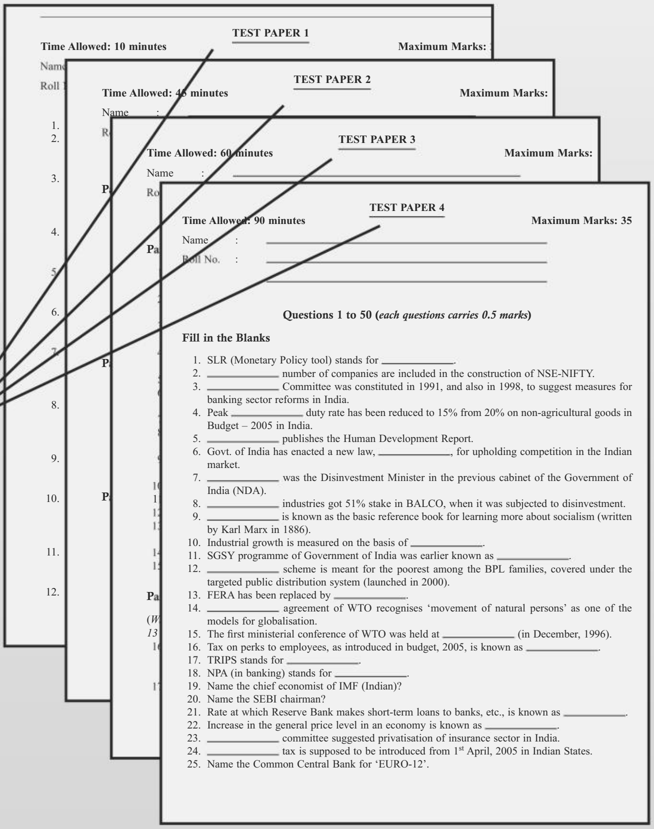
Walkthrough


TEST PAPER 1

Time Allowed: 10 minutes

TEST PAPER 2

Time Allowed: 45 minutes

TEST PAPER 3

Time Allowed: 60 minutes

Name :

TEST PAPER 4

Time Allowed: 90 minutes Maximum Marks: 35

Name :

Roll No. :

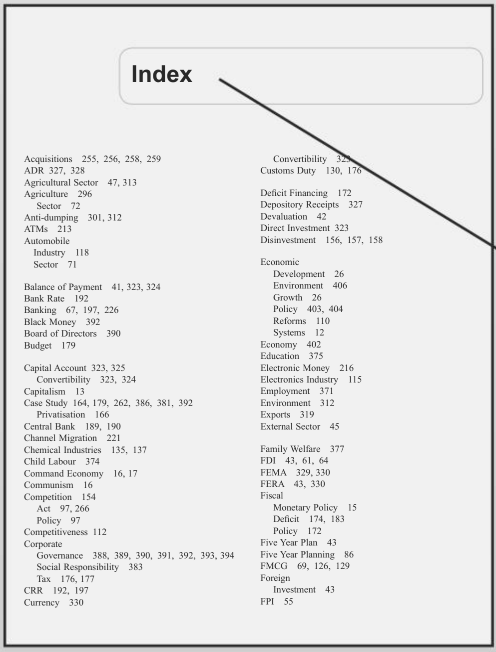
Questions 1 to 50 (*each questions carries 0.5 marks*)

Fill in the Blanks

1. SLR (Monetary Policy tool) stands for ________.
2. ________ number of companies are included in the construction of NSE-NIFTY.
3. ________ Committee was constituted in 1991, and also in 1998, to suggest measures for banking sector reforms in India.
4. Peak ________ duty rate has been reduced to 15% from 20% on non-agricultural goods in Budget – 2005 in India.
5. ________ publishes the Human Development Report.
6. Govt. of India has enacted a new law, ________, for upholding competition in the Indian market.
7. ________ was the Disinvestment Minister in the previous cabinet of the Government of India (NDA).
8. ________ industries got 51% stake in BALCO, when it was subjected to disinvestment.
9. ________ is known as the basic reference book for learning more about socialism (written by Karl Marx in 1886).
10. Industrial growth is measured on the basis of ________.
11. SGSY programme of Government of India was earlier known as ________.
12. ________ scheme is meant for the poorest among the BPL families, covered under the targeted public distribution system (launched in 2000).
13. FERA has been replaced by ________.
14. ________ agreement of WTO recognises 'movement of natural persons' as one of the models for globalisation.
15. The first ministerial conference of WTO was held at ________ (in December, 1996).
16. Tax on perks to employees, as introduced in budget, 2005, is known as ________.
17. TRIPS stands for ________.
18. NPA (in banking) stands for ________.
19. Name the chief economist of IMF (Indian)?
20. Name the SEBI chairman?
21. Rate at which Reserve Bank makes short-term loans to banks, etc., is known as ________.
22. Increase in the general price level in an economy is known as ________.
23. ________ committee suggested privatisation of insurance sector in India.
24. ________ tax is supposed to be introduced from 1st April, 2005 in Indian States.
25. Name the Common Central Bank for 'EURO-12'.

Test Papers

Four test papers at the end of the book will be of great help to students for polishing up the knowledge gained from the text. These will be an asset during last moment preparation for examinations.


Index

Index

A comprehensive index would aid the readers in locating the entries in the right context in an accurate manner.

Online Supplement

The book has an accompanying web supplement (http://www.mhhe.com/justinpaul).

Contents

PART NINE
Global Economy and Business Environment

The McGraw·Hill Companies

PART One

Political Economy, Development Economics, Government and Society

Chapter 1

Nature and Dynamics of Business Environment

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- to understand the changing nature of business environment
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Introduction

Capitalism is often characterised by free market forces, profit and private property. This economic system manifests itself in two broad directions. First, it leads to the development of large-scale multinational organisations. Second, it rationalises values, attitudes and behaviours with corporate goals and objectives to make abnormal profit. A critical debate for our times is whether the expansion of capitalism and its inherent rationality to the global stage will be a positive or negative factor in an economy. This chapter aims at explaining the new business environment in the 21st century, particularly in the context of changes over the last decade. The objective is to facilitate business educators to provide themselves and their students with opportunities to engage in the debate and, in the same context, to consider their responsibilities as educators and as functioning corporate managers in the global economy.

SECTION 1: HISTORY OF GLOBAL CAPITALISM

Modern capitalism emerged in the early 19th century in Western Europe and the European offshoots of the Americas. Recognising the dynamism of this socio-economic system, by the end of the 20th century, capitalism had indeed become global. This chapter provides a brief account of the changing nature of business environment in the context of emergence of global capitalism, and discusses some of the reasons why the diffusion of capitalism has been so conflictual and contested.

The socialist detour, which carried along roughly one-third of humanity as of the mid-1980s, had nearly vanished by the end of the 20th century—the result of de-communisation in Eastern Europe, the collapse of the Soviet Union in 1991, and China's adoption of market reforms after 1978.

By the end of the 20th century, almost all of the world nations—even the very poorest countries—had adopted the basic framework of modern capitalism, though few societies have done so without controversy. The 21st century opened with an international system that can be fairly characterised as global capitalism, though it is a system with social conflict and political contestation at the national and international levels. As has been true for much of the past two centuries, capitalism continues to be viewed in many countries, especially the poorer countries, as a system of exploitation rather than as a reliable path to economic prosperity. On the other hand, many people have argued that free market forces facilitate business expansion and growth opportunities.

The Age of Global Capitalism (Free Enterprise System)

By the 1980s, however, these alternative models had failed, typically leading to profound macroeconomic instability and state insolvency. In Latin America, the turn towards market reforms began in Chile in 1973, in the aftermath of a brutal coup that overturned left-wing government intent on establishing socialism. Other countries began to follow suit in the 1980s, following the onset of the debt crisis. India began very gradual market reforms in the 1980s, and these picked up speed in 1991, when India too came to the edge of the collapse of the economy mainly because of shortage of foreign exchange reserves. In the impoverished countries of Sub-Saharan Africa, market reforms came in the context of the IMF—World Bank structural adjustment programmes of the 1980s and 1990s.

By the 1990s, then, almost the entire world had adopted the fundamental elements of a market economy, including private ownership at the core of the economy, a currency convertible for international trade, standards for commercial transactions (for example the World Trade Organisation), and market-based transactions for the bulk of the productive sectors of the economy.

Prior to the second half of the 20th century, the economy of the United States was distinguished by cyclical instability and low growth; however, since the end of WWII, business cycles had moderated, coupled with relatively higher economic growth.

While business cycles such as boom or recession are explained by economists, they reflect equally the concerns of the informed public and, especially, of the businessmen, investors and consumers who are harmed by economic downturns and declines. Any knowledge of what passes as important news on the economic front will confirm the implications of a slowdown between a slowdown and a recovery phase.

Globalisation and Financial Integration

The symbiotic forces of trade liberalisation, adoption of information technology and financial deregulation have delivered visible economic growth benefits to some developing economies, particularly China and India. These economies have been forecasted to be emerged as important economic powerhouses by early 2040s, next to the US.

SECTION 2: THE PROS AND CONS OF CAPITAL ACCOUNT CONVERTIBILITY

The case for free cross-border capital flows (portfolio equity, debt instruments and real asset transactions) where there are no restrictions on the capital account convertibility presents a free market. Therefore, capital account convertibility or removal of all controls on cross-border capital flows entail costs.

The Asian currency crisis (1997) and the Mexican peso crisis (1994) amply demonstrate that free capital mobility or an open capital account could be a double-edged sword. Thus, capital account convertibility or free capital flows offers impressive economic benefits to economies where free markets function efficiently. Such markets operate in the advanced countries. However, in developing countries, the case for rapid liberalisation of capital account may be a recipe for a speculative attack on the country's currency. In such markets there is a case for sequencing capital account liberalisation after market distortions are eliminated.

The specific benefits of an open capital account are:

1. The efficient allocation of the world savings leading to high investment and growth rates worldwide. Savings-constrained Developing Countries (DCs) would supplement their meagre domestic savings from the global pool of saving.
2. Financial institutions could borrow from the global capital market during times of economic downturn and repay the loans during periods of economic upturn.
3. The liberalised trade and capital accounts are cited as evidence in support of the success of export-oriented industrialisation strategies pursued by the miracle growth economies of East Asia prior to the currency crisis in mid-1997.
4. Foreign direct investment (FDI) by multi-national corporations (MNCs).

The distortions can be classified as:

1. **Policy ineffectiveness**. For example, in an economy with perfect capital mobility, monetary policy becomes ineffective.
2. **Capital Flight**. For example, the absence of well-defined property rights can result in capital flight and cause adverse welfare effects on the domestic economy.

3. **Distortions resulting from financial fragility**. For example, excessive short-term borrowing in unhedged foreign currency by unregulated banks and lending to financial intermediaries ignoring guidelines of prudential supervision. This exposes the entire financial system to vulnerability to the problems in other countries.

SECTION 3: LESSONS FROM THE US SUB-PRIME CRISIS AND GREAT RECESSION

The US sub-prime mortgage crisis, which was clearly visible to the public in 2007 and aggrevated in 2008, illustrates how fast it de-railed US economy and other countries which were vulnerable to the US, like Japan. We have also seen the extent of inadequate financial regulation associated with the increasingly liberalised and globalised financial system in most countries. Few would deny that the source of the crisis in the sub-prime housing loan market in the US—consisting of loans to borrowers with a poor credit record—is the way in which the preceding housing market and consumption booms were triggered and sustained. Housing demand grew rapidly because of easy access to credit, with credit extended to borrowers considered less than creditworthy.

USA Sub-Prime Crisis in Nutshell

The root cause of global recession 2008–09 was the sub-prime mortgage crisis in the US triggered by falling real estate prices. The three reasons for the sub-prime mortgage crisis were: (i) loans were lent to people who were not creditworthy, which led to failure/default of repayment. They invested money in real estate expecting higher returns from the real estate; (ii) complex nature of loan products concealed the risk included, and easily transferred the risk to investors; (iii) over enthusiasm and lack of self-discipline of those who were involved.

In this case, the interest rates of loans to the low-income households increased because of floating nature of interest rates. At the same time, the real estate prices dropped. Hence, products that included sub-prime mortgage loans were downgraded. This led to shortage of money (liquidity crunch) in the US banking system. As more and more banks turned out to be highly affected, the crisis became more and severe.

The increase in this type of credit flow occurred because the money was lent without proper credit appraisal. Mortgage brokers sought out and found willing borrowers for a fee, taking on excessive risk while in search of volume of credit. The Wall Street banks bought these mortgages because they could bundle assets with varying returns.

The problem was not restricted to the Wall Street banks only. For example, in early August 2007, the French bank BNP Paribas suspended withdrawals from three of its funds exposed to the mortgage-backed securities market. The bank reportedly attributed its decision to "the complete evaporation of liquidity in certain market segments", which constrained it from meeting withdrawal demands that could have turned into a run on the fund. In sum, the effects of the sub-prime crisis weakened even distant segments of the global financial system, as a result of financial entanglement.

There are many lessons being driven home by the global financial crisis originated as an outcome of sub-prime mortgage crisis of USA. The most important lesson is that, easy liquidity in a loosely controlled financial system, which encourages the flow of capital, facilitates speculative and unsound financial practices that increase fragility.

To conclude, the evidence is strong that the surge in capital flows to developing countries in recent years is supply-driven and not warranted by the financing needs in these countries. This supply-side driven surge of capital has the following effects:

(i) Outcome of the actions of international firms (Foreign institutional investors and multi-national corporations) seeking profit by investing in emerging markets.
(ii) It increases financial vulnerability in these countries.
(iii) It leads to macroeconomic adjustments that reduce the fiscal and monetary autonomy of the governments and the central banks in these countries.

SECTION 4: THE GLOBAL CAPITALISM—FREE MARKET MODEL

For the past two decades, through both Republican and Democratic administrations, the US government has promoted a model of free-market global capitalism which claimed that it would benefit the great majority of people both at home and abroad. This model has not been so successful, particularly when we look at global recession as an off-shoot of American-free market system.

We have another crisis to cite as example to critically examine the global capitalism—South East asian currency crisis that was also originated as a result of de-regulated financial markets in South East Asian countries in second half of 1990s. The countries that were the showcases for globalisation's success in the first half of 1990s collapsed in 1997 because of economic crisis. South Korea's economy shrank by 45% and Thailand's by 50%. Indonesia's shrank by nearly 80%, and gross domestic product per capita had fallen from $3,500 to $750.

Over and over, it has been repeated that "there is no alternative" to this de-regulated global capitalism. But, from debates over forums like WTO and the IMF, and from scholars and activists around the world, progressive alternatives have been emerging. Their aim is to build a new global economy that benefits poor and working people with a new business environment where there is better corporate governance with social responsibility. Following the lead of G-20 group of countries, there have been calls for tighter controls on financial institutions and better international cooperation.

Problems With Global Capitalism

The unregulated global economy promoted by the US has the following consequences.

Volatility: Global financial de-regulation has reduced barriers to the international flow of capital. More than $1.5 trillion now flow across international borders every day in the foreign currency market alone. This excess volume contributes to financial instability and is too large for each nation to be able to intervene to restore monetary stability.

Race to the bottom: Globalisation promotes a destructive competition in which workers, communities, and entire countries are forced to cut labour, social and environmental costs in order to attract mobile capital.

Inequality: Globalisation has contributed to an enormous increase in the concentration of wealth and the growth of poverty both within countries and worldwide. It is said that the total wealth of the world's three richest individuals is greater than the combined gross domestic product of the 38 poorest countries—a quarter of all the world's states.

Degradation of Democracy: Globalisation has reduced the power of individuals and peoples in some countries to shape their destinies through participation in democratic processes. Governmental authority has been undermined by trade agreements, such as World Trade Organisation (WTO), regional economic groups like European Union and North American Free Trade Agreement and by international financial institutions, such as the IMF and World Bank, which restrict the power of national, state and local governments to govern their own economies.

Of the 100 largest economies in the world, 51 are corporations, not countries. Globalisation has greatly increased the power of global corporations relative to local, state and national governments. The ability of governments to pursue development, full employment, or other national economic goals has been undermined by the growing power of capital to relocate to other jurisdictions.

The disadvantages of globalisation can be summarised as

- Many people are being hurt by globalisation without being supported by a social safety net;
- Markets are good at creating wealth but are not designed to take care of social needs;
- Global financial markets are crisis-prone and vulnerable to each other.

SECTION 5: ROLE OF DEVELOPING COUNTRIES

The process of globalisation has become an irreversible phenomenon, even though great recession that arose out of sub-prime crisis in the US (2007 to 2009) has prompted us to think about the evils of the free enterprise system, particularly freedom given to the banks.

Countries like India, China, Russia etc. can work towards strategies to overcome the challenges and pitfalls of globalisation by way of undertaking the following **action plan:**

(i) Adopt sound macroeconomic policies.
(ii) Engage in better disclosure of information.
(iii) Pursue sound banking practices such as Bank Supervision by central bank.
(iv) Engage in good corporate governance.
(v) Institute capital controls if necessary.

Developing countries can play an important role to correct the global capitalism. The steps to be taken are:

(a) Create a new, inclusive international dialogue worldwide on the future of the global economy.
(b) Develop a new international financial strategy that supports sustainable development through coordinated economic policies.
(c) Redesign existing institutions of the global economy to make sustainable development rather than unlimited mobility of capital their goal.

Brazil, Russia, India and China (BRIC) countries would be in a position to lead other countries in the next three decades with the purpose of:

- reducing the threat of financial volatility and meltdown;
- democracy at every level from the local to the global;
- environmental sustainability worldwide;
- economic advancement.

Chapter Summary

The need of the hour is to develop the broadest possible dialogue by the people on the future of global economy, taking into account the dynamic nature of changing business environment. It is important for the managers to recognise the role of political institutions such as legislature, executive and judiciary.

It is high time that the firms and regulatory organisations in developing countries implement a strategy to counter those aspects of the global financial system that make it more difficult for them to pursue sustainable development. The purpose of this strategy is to protect the financial system to avoid global recessions, ensure full employment and coordinate their economic resources.

In other words, it makes sense to:

- Encourage economic policies based on domestic economic growth and development;
- Reduce the flows of destabilising short-term capital by the adoption of capital controls as necessary;
- Establish standards for the regulation of banks and non-bank financial institutions.

Review Questions

1. Discuss the dynamics of changing business environment in an economy.
2. Elucidate the learning from this chapter.

Class/Field Exercise

1. Divide the class into four groups. Two groups with people those argue for global capitalism and free enterprise system and the other two groups consist of people those who are against those frameworks. Discuss the topic within the group for five minutes. Select group representatives and conduct a debate. First, Group A arguing for the global capitalism, then Group B with arguing against global capitalism, then call Group C arguing for, and then Group D arguing against it.
2. Visit the sites www.globaledge.msu.edu and www.eiu.com and describe the shifts in the world economy over the past 20 years.

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Chapter 2

Political Environment and Economic Systems

Learning Objectives

- to understand the history of economic thought
- to learn how an economic system works
- to understand real life situations vis-á-vis economic systems in different countries

Chapter Structure

Section 1: **History of Economic Thought and Economic Systems**

Section 2: **Market Economy or Capitalism**

Section 3: **Planned Economy or Command Economy**

Section 4: **Mixed Economy**

Introduction

Every country in this world has an economic system to facilitate the production, trade and consumption of goods. Countries across the world have evolved through various ideologies to follow a mix of different thoughts and systems. An overview of evolution of economic thought in different countries would provide an insight into the success and failure of each of the systems adopted under different phases of a country. In this chapter, different economic systems have been compared and analysed in tandem with the political systems.

SECTION 1: HISTORY OF ECONOMIC THOUGHT AND ECONOMIC SYSTEMS

The term 'economics' was coined in around 1870 and popularised by Alfred Marshall, as a substitute for the term 'political economy' that was used during the 18th and 19th centuries, with Adam Smith, David Ricardo and Karl Marx as its main thinkers.

History of economic thought may be divided into two phases: pre-modern and modern. While the pre-modern economic thought was popular among Greeks, Romans and medieval Arabs, the modern economic thought was developed in the later part of the 18th century by Adam Smith. However, it was only in the modern era that systematic economic theory got its shape.

Pre-Modern Economic Thought

Several ancient philosophers had made various economic observations and contributed to the understanding of economics. In principle, economics can be applied to any type of organisation. However, the majority of economic theory centers around systems where goods are exchanged in a market—where buyers and sellers seek to maximise their profits in trading. The dominant form of market economics focuses on capitalist societies where property is owned by individuals, money has a rational basis and profit is derived from utilising labour and capital to produce goods for trade. However, economic theory is also applied to markets where capital is controlled by the state or the society, which include socialism and to societies where the allocation of resources is through political mechanisms, which includes communism.

Most of the mainstream economists of this phase felt that the basic framework of economics is relevant and flexible enough to be applied to any form of society.

Modern Economic Thought

'Classical Economics,' as the work of this period is called, forms the foundation of economics. Adam Smith who is considered the founder of economic theory published his 'Wealth of Nations' in 1776 and even today, his work is treated as gospel in 'market economics'. Today it is believed that classical economics that developed after Smith marked the beginnings of formal economic study, is still the centerpiece of market economics, and capitalism in particular.

The Marxist paradigm of economics is not generally held in high regard by market economists, though his work is used in mainstream contexts. The later part of 19th century also saw the 'marginal revolution' or neo-classical economics, which altered the basis of economic reasoning to include concepts such as marginalism and opportunity cost.[1]

1. Stiglitz, Joseph (1997), Economics, 2nd Edition. W.W. Nortm & Company.

Economic Systems

An economic system is a mechanism which deals with the production, distribution and consumption of goods and services in a particular society and comprises of people, institutions and their relationships. It addresses the problems like the allocation or scarcity of resources. Different economic systems adopt different ways to address these questions. In other words, an economic system defines the institutional framework regulating the business environment in a country.

The three basic and general economic systems are:

Market economy **(the basis for several "right-wing" systems, such as capitalism)**
Planned or command economy **(the basis for several "left-wing" systems, such as communism)**
Mixed economy **(arguably the "centrist" economic system)**

An economic system can be considered a part of the social system and is hierarchically equal to law system, political system, cultural system, and so on. The salient features of different economic systems have been discussed in detail, with country-specific case studies, in the following sections.

SECTION 2: MARKET ECONOMY OR CAPITALISM

By definition, market economy is an economic system that operates in a free market and is not planned or controlled by a central authority. Although a total market economy is probably only theoretically possible (because it excludes taxation and regulation of any kind), capitalist economies approximate it and socialist economies are antithetical to it. Market economies are also called free economies or free enterprise systems.

Although market economy is often identified with capitalism, it is possible to have government intervention in such an economy. The key difference between market economy and planned economies lies not in the degree of government influence but in how that influence is used. For example, in a market economy, if the government wants more steel, it collects taxes to buy steel at market price. However, in a planned economy, the government would simply order more steel production. In contrast, on the other hand, an economy where both central planning and market mechanisms of production and distribution are present is known as a mixed economy.

The government's role in a market economy remains debatable. Though most supporters of the market economy believe that government has a legitimate role in defining and enforcing the basic rules of the market, there has long been a debate on how strong a role the government should have in both guiding the economy and addressing the inequalities the market produces. In the Soviet Union, this process was known as 'Perestroika' while in China, the creation of a "socialist market economy" has been an element of Chinese economic reform.

Capitalism

This is an economic system which is usually closely related to *market economies*. Capitalism is grounded in the concept of free enterprises, which argues that government intervention in the economy should be restricted and that a free market, based on supply and demand, will ultimately maximise consumer welfare.[2]

Capitalism has existed in a limited form in the economies of all civilisations.

2. Smith, Adam (2003 Reprint), The Wealth of Nations, Bantam Books, USA.

Market Economy—Cases (1. USA, 2. Canada)

1. Case of United States of America (USA)

Capital	:	Washington DC
Area	:	9,631,418 sq. km
Population	:	300 million
GDP Per Capita (PPP)	:	46,000 (2008)
Life Expectancy	:	77.6 yrs

Source: Compiled from World Development Report, World Bank and Human Development Report, UNDP

Natural Resources The United States is rich in mineral resources and fertile farm soil and enjoys a moderate climate. It also has extensive coastlines on both the Atlantic and Pacific Oceans, as well as on the Gulf of Mexico. Rivers flow from far within the continent, and the Great Lakes—five large, inland lakes along the US border with Canada—provide additional shipping access.

Labour Throughout its history, the United States has experienced steady growth in the labour force. A strong emphasis on education, including technical and vocational training, and the country's willingness to experiment has also contributed to America's economic success.

Labour mobility has been vital for the American economy which has been successfully adapting the changing conditions. Today, Americans consider "human capital" a key to success and government leaders and business officials are now stressing on the importance of training industrial workers with adaptable skills.

Organisation of Resources In the American economy, managers respond to the signals from the markets and perform the function of organising and directing resources as efficiently as possible. The traditional managerial structure in America is based on a top-down chain of command wherein authority flows from the chief executive to those in the lower levels of the organisation. Numerous tasks are divided among different divisions and workers. In America, this specialisation or division of labour is said to reflect 'scientific management' based on systematic analysis.

Facing heightened global competition, American businesses are seeking more flexible organisation structures, especially in high-tech industries that employ skilled workers. The objective is to develop, modify, and even customise products rapidly.

Salient Features of the US Economy The case of the United States can be considered as an example of market economy. Private businesses produce most goods and services, and almost two-third of the nation's total economic output goes to individuals for personal use. The consumer's role in the US economy is so significant that the country's economy is sometimes defined as "consumer economy".

Though Americans generally believe that an economy characterized by private ownership is likely to operate more efficiently than the one with substantial government ownership, they are of the opinion that some services are better performed by public sector rather than private enterprises, such as the administration of justice, education, the road system, social statistical reporting and defense.

The population and the labour force have shifted dramatically away from farms to cities, from fields to factories, and, above all, to service industries. In today's economy, the providers of personal and public services far outnumber producers of agricultural and manufactured goods.

Government's Role in the US Economy In the United States, the federal government monitors the overall pace of economic activity, attempting to maintain steady growth. At the same time, the government facilitates market economy and private enterprises.

Direct Services The federal government is responsible for the nation's defense system, research operations that often lead to the development of new products, conducting space exploration projects, and running numerous programs designed to help workers develop skills and find jobs. State governments are responsible for road projects, education systems, and the law and order mechanisms. However, there are many private enterprises running educational institutes and universities.

Direct Assistance The government also lends help to businesses and individuals in various ways. Social security, Medicare, Medicaid and Food Stamps are a few examples of direct assistance by the government.

2. Case of Canada

Capital	:	Ottawa
Area	:	9,984,670 sq.km
Population	:	32,040,292
GDP Per Capita (PPP)	:	US$ 38,200 (2008)
Human Development Index Rank	:	4
Life Expectancy	:	74.6 yrs
Official Languages	:	English and French

Source: World Development Report, World Bank and Human Development Report, UNDP

Canada today closely resembles the United States in its market-oriented economic system, pattern of production, and high living standards. Since World War II, the impressive growth of the manufacturing, mining, and service sectors has transformed the nation from a largely rural economy into an economy that is primarily industrial and urban.

Natural Resources Canada is self-sufficient in energy, and has vast deposits of natural gas on the east coast and in the three western provinces, besides a plethora of other natural resources.

Regional Economic Treaties The 1989 Free Trade Agreement (FTA) between Canada and the US and 1994 North American Free Trade Agreement (NAFTA), which included Mexico, marked a dramatic increase in the country's trade and economic integration with the US. As a result of the close cross-border relationship, the economic downturn in the United States in 2008–09 also had a negative impact on the Canadian economy. However, the economy is once again doing well in Canada and high standard of living, although unemployment was up in the recent past.

Taxation Canada has a national sales tax of 7% on all purchases. The higher income groups in Canada are heavily taxed by the government. However, the lower half in the tax slab are taxed even less than their counterpart in the US.

Social Programmes Canada's per capita spending on healthcare is less compared to the US, but is considered employer-friendly as the healthcare in country is mostly paid through income taxes. Also, figures like standard of living and literacy are better in Canada.

Monetary Policy Canada's monetary policy is largely influenced by the American monetary policy as any huge difference in interest rates of the two countries could quickly lead to major problems for the Canadian economy. Both the US Federal Reserve and the Bank of Canada believe in combating inflation.

Standard of Living The United Nations Human Development Index has traditionally listed Canada above the United States. Other independent groups, such as The Economist, also rank Canadian cities as better places to live in than the American ones.

Question

What is the rationale for USA and Canada to have 'market economy'?

SECTION 3: PLANNED ECONOMY OR COMMAND ECONOMY

Before we delve into the explanation of 'command economy' and its features, a brief definition of communism would help in correlating the ideology to this form of economy.

Communism

This system refers to the theory of political and economic development proposed by Karl Marx and developed and implemented by V. I. Lenin. In Marxist theory, 'communism' denotes the final stage of human historical development in which the people rule both politically and economically. Since the government, according to the Marxist theory, is essentially an instrument of class oppression, the society which emerges in its final stage is classless.

"A totalitarian system of government in which a single authoritarian party controls state-owned means of production with the professed aim of establishing a society with equal rights".

"An economic system in which the means of production are owned and operated for the public by the government. The government determines the type, quantity, and price of goods produced. Communism promises to provide for everyone's needs and to have no social classes. Ideally government would not be necessary".[3]

Command economy or planned economy is an economic system in which government controls all or most of the factors of production and makes all or most of the production decisions. Command economy exists when the government uses central planning to allocate resources and determine output among various segments of the economy. Government ownership of land and the means of production characterise such economies.

A command economy essentially means a strong government control over the economy on the premise that individual wishes are secondary, while the best interests of the society are of prime importance and some level of shared minimum standards are attained in such economies. A command economy also denotes a communistic form of totalitarianism which is on the basis of the political and economical control of the whole country. (*See box on communism for definition*)

Broadly, the elements of a command economy are:

(i) Cooperation

This refers to working towards a common goal. In theory, the job is adapted to fit the needs of the worker in a command economy.

3. Marx, Karl (2000 Reprint), Das Kapital, Regnery Publishing.

(ii) Collectivisation

In command economy, one believes that collectively one is stronger. By combining the talents together, one can accomplish more. For example, a collective farm in a command economy shares the talents of all to reach 'common' goals which have either been decided upon collectively or have been directed by an 'expert'.

(iii) Public Ownership of Property

State ownership of property allows for control of all resources including human labour. In command economy, one believes that central ownership can maximise the collective use of land and even if private ownership is allowed in some cases, it is restricted and considered secondary to the common land.

(iv) Equality

All members should be given equal opportunity to share the wealth and produce of the land. Everyone has the same right to enjoy a defined "minimum" standard of living in a command economy.

(v) Central Planning and People's Planning

A group of "experts" study the economy with a futuristic approach and recommend production needs and targets to the governing body. "Central planning" is a key element in command economy and for a 'planned' advancement in vital areas, certain sectors can sometimes be allowed to suffer.

Most, if not all, communist governments have maintained people's plans. This includes targeted production levels and directions for the advancement of industry in a time-bound and planned manner, with participation of the people (grass root level).

Planned or Command Economies: Cases (1. Cuba 2. Vietnam)

1. Case of Cuba

Capital	:	Havana
Area	:	110,860 sq. km
Population	:	11,308,764
Population annual growth rate	:	0.34% (2004 est.)
GDP per capita	:	4500 $ (2008)
Infant mortality rate	:	6.45 per 1000 live births
Literacy rate	:	97%

Source: World Development Report, World Bank and Human Development Report, UNDP.

Cuba is a 'Communist state' in which a parliamentary republic is led by a Communist Party. Fidel Castro has been the head of state and the government since 1959, first as the prime minister and then as president of the Councils of State and Ministers after the abolition of PM office in 1976. The Communist Party is constitutionally recognized as Cuba's only legal political party.

The economy of Cuba is based on state ownership with some small scale private enterprise existing at the fringes. Tourism has become one of the largest sources of income for the country. The US dollar was made legal tender in Cuba in 1993 (the country operated under a dual-currency system); this arrangement was, however, revoked on 25 October, 2004.

The Cuban economy was hit hard in the early 1990s following the collapse of the Soviet Union with which it had traded predominantly. The Cuban economy, however, recovered recently with an increase in tourism levels and nickel prices. Another factor that led to the revival of the Cuban economy is the remittances of Cuban-Americans. Cuba currently trades with almost every nation in the world.

After the country's mechanized agricultural sector crippled, Cuba restructured the sector's chemical-based model and focussed on organic solutions. It managed to rapidly and successfully convert the country into an entirely organic production centre and is notable for its national organic agriculture initiative undertaken to feed a starving population. Currently, only organic agriculture is permitted by law in the country.

Cuba's capital Havana is the country's largest city and its other major cities include Santiago de Cuba and Camagüey. Some of the well-known smaller towns are Baracoa (the first Spanish settlement in Cuba), Trinidad and Bayamo.

For several decades, Cuba received a large Soviet subsidy, whereby Cuba provided sugar in exchange of oil by Soviet Union. Part of this oil was consumed by Cuba, while the remainder was sold in the world market for a profit of several billion dollars. In return for this subsidy from the Soviet Union, Cuba supported communist movements throughout Latin America (Nicaragua, El Salvador, Guatemala and Chile) and Africa (Angola, Mozambique and Ethiopia). In Angola alone, Cuba had over 50,000 troops. The collapse of the Soviet Union in 1991 dealt Cuba a giant economic blow and when the Soviets stopped their $6 billion per year subsidy, the Cuban government called for "a special period" of recovery. Cuba's economy today is roughly split into three parts: agriculture (tobacco, sugar, citrus), mining (nickel), and tourism.

2. Case of Vietnam

Capital	:	Hanoi
Area	:	329,560 sq km
Population	:	81.4 million
GDP per capita	:	US $479
GDP per capita (PPP)	:	US 2600 (2008)
Real GDP growth per capita	:	6.5%
Agriculture as share of GDP	:	23.8%
Exports as share of GDP	:	40%

Source: World Development Report, World Bank and Human Development Report, UNDP.

Vietnam is one of the few surviving communist countries organised on traditional Leninist lines. The overlap between the Communist Party of Vietnam and the government is extensive at all levels. Efforts are under way to make local government more accountable and transparent, but broader political change is not on the agenda.

The area now known as Vietnam emerged as ethnically distinct in around 200 BC, though from 111 BC to 939 AD, it was under Chinese rule. This period saw the establishment of considerable Chinese cultural influence, but the Vietnamese resisted full assimilation, and local uprisings during the decline of the T'ang dynasty led to the restoration of Vietnamese independence in 939 AD. By the early 11th century, the country was unified, and although Chinese and Mongol armies had made incursions, subsequent Vietnamese dynasties endured and gradually extended their domain south into the Mekong Delta. By 1757, Saigon and most of the southern regions of today's Vietnam had been incorporated.

The expansion, however, made it difficult to maintain Vietnam's characteristic central control, which it had from the Chinese, and by the early 17th century, the country was divided under two ruling families. The country was reunified only in 1802, when Nguyen Anh took power with the assistance of a French missionary, thereby making way for the French to enter Vietnam. Anh's successor tried to expunge that presence by executing French missionaries, but to no avail. France invaded in 1858 and by 1893, France had captured Vietnam, as well as Cambodia and Laos, which they consolidated into a single territory known as Indochina.

The French presence did not spur economic or political development. Most bureaucratic posts were filled by French officials, who treated Indochina as a source of raw materials for French factories and a captive market for French goods. Nationalist movements proliferated, and in 1925, Ho Chi Minh founded the predecessor to the Indochinese Communist Party. During the Second World War, when Vietnam became a Japanese colony administered by the Vichy French, Ho established a communist-nationalist alliance known as the Viet Minh, which cooperated with the Allies. Soon after Japan was defeated, he proclaimed Vietnam a republic with its capital at Hanoi. When the French tried to reassert their colonial power over Vietnam, a war broke out that lasted until May 1954. Viet Minh's victory at Dien Bien Phu forced the dispirited French to agree to a split of Vietnam into two parts along the 17th parallel: North Vietnam, a Communist state led by Ho, and South Vietnam, a French-backed republic.

After partition, the north continued to support communist insurgents in the south. In an attempt to contain communism in Southeast Asia, The United States established a military advisory in the region. However, after 1960 America played a more active role and in 1965, it began bombing the north Vietnam and sending troops to the south. The casualty figures were rising with no end in sight. The American public turned against the war and under Richard Nixon, the superpower withdrew its commitment. He removed the last of American troops by 1973, and in 1975 the south fell. The country was officially reunited in June 1976 and has since remained a communist, one-party state, though in recent years there have been some moves towards economic liberalisation and somewhat improved personal freedoms.[4]

Questions

1. Why did Cuba support communist movement?
2. What are the factors that contributed towards command economic structure and communist, one-party system in Vietnam?

SECTION 4: MIXED ECONOMY

'Mixed economy' is followed by socialist countries where equal importance is given to both public and private sectors.

All economists agree that a mixed economy must be adapted for the benefit of the vast majority of the people rather than for a small aristocratic or capitalist class. Today, in a world where many countries offer a broader electoral franchise, open support to the wealthy would be the equivalent to political suicide. Therefore, most ideologies claim to support the interest of the greatest number, something that was once advocated only by socialists.

4. www.countrywatch.com (Sourced from the website and rewritten to fit into the textbook theme)

Mixed economies entail democratic control of the economy, though they differ over issues like the extent to which an economy could involve markets and whether control should be centralised or extensively dispersed.[5]

Cases (1. India, 2. Poland)

1. Case of India

Area	*Total:* 3,287,590 sq km *land*: 2,973,190 sq km *water: 314,400 sq km*
Population	1.13 billion
Life expectancy at birth	*Total population:* 63.99 years *male:* 63.25 years *female*: 64.77 years
Legal system	Based on English common law; limited judicial review of legislative acts
GDP (Nominal)	1,217,490 USD (2008) in millions
GDP – per capita (PPP)	$2700 (2008)
GDP – composition by sector	*Agriculture:* 24% *industry:* 21% *services:* 55%

Source: CIA World Fact Book 2008.

India's leaders—especially the first prime minister Jawaharlal Nehru, who introduced the five-year plans—believed that strong economic growth and increased income among the poorest groups were necessary goals for the new nation. Government was assigned an important role in this process, and since 1951, a series of plans had guided the country's economic development. Although there was considerable growth in the 1950s, the long-term rates of growth were not remarkable and was less than those of many other Asian countries. From 1951 to 1979, the economy grew at an average rate of about 3.1 per cent a year at constant prices, or at an annual rate of 1.0 per cent per capita. During this period, industry grew at an average rate of 4.5 per cent a year, compared to an annual average of 3.0 per cent for agriculture. Many factors contributed to the deceleration of the economy after the mid-1960s, but economists differ over the relative importance of those factors. Wars with China in 1962 and with Pakistan in 1965 and 1971; a flood of refugees from East Pakistan in 1971; droughts in 1965, 1966, 1971, and 1972; currency devaluation in 1966; and the first world oil crisis, in 1973–74, all jolted the economy during the period.

Developments during 1950s to 1970s Many early post-independence leaders were influenced by socialist ideas and advocated government intervention to guide the economy, including state ownership of key industries. The objective was to achieve high and balanced economic development in the

5. Schiller, Bredley (1997), The Economy Today, McGraw-Hill, Seventh Edition.

general interest while particular programmes and measures helped the poor. The leaders also believed that industrialisation was the key to economic development and this belief had a strong foothold in India because of the country's large size, substantial natural resources, and desire to develop its own defense industries.

The Industrial Policy Resolution of 1948 gave the government a monopoly in armaments, atomic energy, and railroads, and exclusive rights to set up industries for iron and steel, aircraft manufacturing, shipbuilding and telephone and telegraph equipment. Private companies operating in these fields were guaranteed at least ten years of additional ownership before the government took them over. The Industrial Policy Resolution of 1956 greatly extended the preserve of the government. There were seventeen industries exclusively in the public sector. The government took the lead in another twelve industries, but private companies could also engage in production.

The Planning Commission was established in 1950. Answerable only to the Prime Minister, the Commission is independent of the cabinet. The Prime Minister is the chairperson of the Commission, and an expert of the rank of the minister of state serves as the deputy chairperson.

The Five-Year plans are an important concept in the mexed economy of India. Even as the actual results differ from plan targets in important respects, the plans help guide investment priorities, and financial mobilisation.

In 1970, Monopolies and Restrictive Practices Act was designed to provide the government with additional information on the structure and investments of all firms with assets of more than Rs 200 million. It aimed at strengthening the licensing system in order to decrease the concentration of private economic power, and to place restraints on certain business practices considered contrary to the public interest.

The 1980s The rate of growth marked improvement in the 1980s. From 1980 to 1989, the economy grew at an annual rate of 5.5 per cent, or 3.3 per cent on a per capita basis. Industry grew at an annual rate of 6.6 per cent and agriculture at 3.6 per cent. Investment rose from about 19 per cent of the GDP in the early 1970s to nearly 25 per cent in the early 1980s. India, however, required a higher rate of investment to attain higher economic growth.

Government Policies in the Recent Years The Government has played an important role in industry since independence. It has both owned a large proportion of industrial establishments and tightly regulated the private sector. Though the government sought to reduce its role in industrial establishments since early 1980s, the ball started rolling only after 1991 when it implemented new reforms.

2. Case of Poland

Area	:	*Total:* 312,685 sq km *land:* 304,465 sq km *water*: 8,220 sq km
Life expectancy at birth	:	*Total population:* 74.16 years *male:* 70.04 years *female:* 78.52 years (2004 est.)
GDP	:	567,400 (USD) million
GDP – per capita	:	Purchasing power parity – $16,200 (2008 est.)
GDP–composition by sector	:	*Agriculture:* 3.1% *industry:* 31% *services*: 65.9%

Source: CIA World Fact Book 2008.

In Poland, centralised planning ranged from broad, long-range statements of fundamental future development to guidance on the operation of specific enterprises. The basic planning unit for transformation of the Polish economy was its five-year plan, the first of which began in 1956. Within that framework, current production goals were established in an annual operational plan, called the National Economic Plan.

History of Socialism as an Economic System in Poland In 1956, after workers' riots in Poznan, a general uprising was averted only by a change in the leadership of the communist party, the Polish United Workers' Party (Polska Zjednoczona Partia Robotnicza—PZPR). The new government promised modification of the system and changes in the development strategy. Consumer goods received a larger share of the national product, and some quantities of grain and food were imported from the West.

1960s to 1980s By the early 1960s, the government began a new industrialisation drive, which was again far too ambitious. Additional investment funds were allocated to the neglected infrastructure and for the production of consumer goods. Modernisation efforts stressed on technological restructuring rather than fundamental systemic reforms, as a result of which the country faced an acute shortage of consumer goods in late 1970s.[6]

Post 1990: Mixed Economy Post 1990, the extent of "socialism" in Poland was diluted. As part of new reforms, most state-run monopolies were privatised and 516,000 new businesses were established, while 154,000 were liquidated. Another 100,000 small businesses, formerly owned by local government agencies, were now sold to private investors in the initial rush to privatisation. Between January to September 1991, an additional 1.4 million one-person businesses and 41,450 new companies were registered. Overall, in 1990 and 1991 about 80 per cent of the Polish shops went into private hands, and over 40 per cent of imports were dealt by private traders.

Poland has steadfastly pursued a policy of economic liberalisation throughout the 1990s. The privatisation of small and medium state-owned companies and a liberal law on establishing new firms has encouraged the development of the private business sector. Thus, the present position of the economy can be called as 'mixed economy' where private sector plays a role equal to that of the country's public sector.

Question

Discuss the process of implementation of mixed economic system in India and Poland?

Chapter Summary

It is worth noting that most of the countries in the world have moved to the 'market economy' from other economic systems in the last fifteen years. The private enterprises find it more comfortable to do business in a 'free and open economy' because of unlimited opportunities. Although the economic systems like those in the communist setups provide equal allocation of resources to the poor, the advocates of globalisation do not support such systems. Since the process of globalisation has slowly been gathering momentum, it would be prudent for the countries to work towards achieving 'global

6. Scott, Allen J (1998), Regions and The World Economy, Oxford University Press.

competitiveness' in the industries, in which they have got comparative advantage, to transform the challenges into opportunities. It has to be made clear that the government activity is necessary, atleast in defense of the country from external aggression for law and order, and justice. These cannot be supplied by private sector, or by a capitalist.

Review Questions

1. Elucidate the history of economic thought.
2. Discuss about economic systems with illustration of country cases.

Objective Type Questions

1. Name the economic system which is usually closely related to market economies.
2. Name the economic system in which both central planning and market mechanisms of production and distribution are present.
3. Name the economic system in which the means of production are owned and operated for the public by the government.
4. Name the capital city in the United States of America.
5. Name the free trade agreement between USA, Canada and Mexico.

Fill in the Blanks

1. Cuba's capital is ______________.
2. Cuba is an example for ______________ economy.
3. ______________ party is constitutionally recognized as Cuba's only legal political party.
4. ______________ invaded Vietnam during the second half of 18th century.
5. The contribution (in percentage terms) of ______________ sector to GDP is more than the other sectors in the case of Poland.

True or False

1. India is an example for mixed economy.
2. Poland (Post 1990) can be considered as a case for mixed economy.
3. Central planning is a key element in Command economy.
4. State Governments are responsible for education systems in the US, although there are many private enterprises running educational institutes and universities.
5. UNDP has listed Canada above US in terms of HDI.

Class/Field Exercise

Divide the students into six groups. Students those who support market economy (capitalism) should form 3 groups and those who are against it should form 3 opposite groups. Conduct a debate on the pros and cons of market economy.

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3. Marx, Karl (2000 print), Das Kapital, Regnery Publishing.
4. www.countrywatch.com
5. Schiller, Bradley (1997), The Economy Today, McGraw-Hill, Seventh Edition.
6. Scott, Allen J, (1998), Regions and The World Economy, Oxford University Press.

Answers

Objective Type Questions

1. Capitalism
2. Mixed Economy
3. Communism
4. Washington DC
5. NAFTA

Fill in the Blanks

1. Havana
2. Command Economy
3. Communist
4. France
5. Service

True or False

1. True
2. True
3. True
4. True
5. True

Chapter 3

Economic Growth and Development

Learning Objectives

- to study the meaning of the terms economic growth and development
- to understand the measurement of economic growth based on national income
- to know the measurement mechanism of growth and development like HDI

Chapter Structure

Section 1: **Economic Growth and National Income**

Section 2: **Measuring Development**

Section 3: **Measurement of Poverty—Issues**

Case: Country Analysis Using HDI

Introduction

It is important to recognise the role of income in reducing poverty and improving living standards. In this context, it is vital for each one of us to understand the process of economic growth. This includes analysing the factors and policies that drive growth and results in social development including poverty alleviation. From a policy perspective, learning the subject matter of economic growth is crucial to understand the relative merits of government interventions in areas like international trade, financial markets, health and education and public infrastructure. Increase in national income of a country can be considered as first step to economic growth of the country.

In a broad sense, 'economic development' can be defined as an activity that assists in the inducement of commercial as well as social endeavours. The process of economic development involves and facilitates activities that stimulate a self-sustaining process of economic development, create jobs at acceptable wages and benefits, and produce goods and services that meet social needs such as affordable housing, greater community control, and broader asset ownership.[1]

Economic development provides the resources needed to make further investments in education, government services, amenities, infrastructure and quality of life. It is also a necessary component for sustaining competitiveness of the economy and raising overall productivity and income.[2]

Although economic growth and development are similar in meaning, they have some essential differences. Economic growth refers to the increasing ability of a nation to produce more goods and services. Economic development implies that individuals of that nation will be better off and takes into account changes in economic and social structures that will reduce or eliminate poverty. Economic development can be measured in a number of ways including the Human Development Index, Gender Empowerment Measure, Human Poverty Index and Human Freedom Index. All these measures were developed by the United Nations Development Program. The World Bank also has its own indicator called the World Bank Development Indicator.

SECTION 1: ECONOMIC GROWTH AND NATIONAL INCOME

National income—income of a country in a given year—is the basic measure of economic growth. We study the concept of national income for two reasons. First, national income growth rate and data provide the formal structure for macroeconomic analysis. Secondly, knowledge of national income, its accounts, and movements is of importance to business firms, as the business sales is indirectly dependent on its magnitude.

They are four versions of national income as given below:

(a) Gross Domestic Product (GDP)
(b) Gross National Product (GNP)
(c) Net Domestic Product (NDP)
(d) Net National Product (NNP)

GDP is the basic measure of national output and economic growth. GDP is the value of all final goods and services produced within the country's geographical territory, irrespective of the ownership of resources.[3] It includes the value of cars manufactured, houses constructed and so on. The output of each of these is valued at its market price and money values are added together to get GDP. GDP

1. Human Development Report, UNDP, 2001.
2. World Development Report, World Bank, 2004.
3. Gupta G S, Macroeconomics, Tata McGraw-Hill, 2nd Edition.

per capita can be calculated if one has the figures of GDP and the population. For example, the value of GDP in the US economy was about $10,400 billion (or a little over $10 trillion) in 2002. Since the US population then was about 287 million, per capita GDP was roughly $36,000 per year (= $10, 400 billion/287 million).

GNP is the income produced through the country's owned resources, irrespective of the place of production. This means that GNP can be calculated by adding factor payments (receipts) from abroad to the GDP. For example, part of the US GDP include the profits earned by Japanese firm Honda from its US manufacturing activities. These profits are also part of Japan's GNP as it would be considered as receipts from abroad in Japan. Similarly, salaries of the Indian software professionals working in the US is part of the US GDP while Citibank's income in India is India's GDP.

The difference between GDP and GNP is accounted for by the Net Factor Income from abroad (NFIA). Therefore, GDP = GNP – NFIA.

The growth rate of the economy normally refers to the rate at which the GDP is increasing. There are two important reasons due to which GDP grows over time. The first reason for the change in GDP is that available amount of resources in the economy changes with time. The main resources are capital and labour. The second reason for GDP change is that the efficiency of factors of production may increase or decrease over a period of time.

As capital is used to yield output, it wears out or depreciates. Net Domestic Product (NDP) is equal to GDP minus depreciation. This means that the difference between the gross and the net is the capital consumption called depreciation (D). Therefore, NDP is the total value of production minus the value of amount of capital used up in producing that output.

The national income measurement is carried out, based on market prices and at Factor Cost. These can be specified as follows:[4]

GNP at market prices – Indirect taxes + subsidies = GNP at Factor Cost
GNP at Factor Cost – Net Factor Income from Abroad = GDP at Factor Cost
GNP at Factor Cost – Depreciation (Capital consumption) = NNP at Factor cost
GDP at Factor Cost – Depreciation (Capital Consumption) = NDP at Factor Cost

Economic growth can be measured based on: Percentage growth of National Income in the year *t* – Percentage growth of National Income in the year *t* – 1.

Gross Domestic Product (GDP) or Gross National Product (GNP) can be taken as value for National Income. Per capita income (GDP per capita) is a good indication for measuring economic growth in different countries.

Economic growth is the expansion of a country's productive capacity. This leads to a rise in total national output. Growth can occur in two different ways; the increased use of land, labour, capital and entrepreneurial resources by using better technology or management techniques; and increased productivity of existing resource increasing labour and capital productivity. While an increased national output theoretically means greater material welfare and a rise in living standards, it does not ensure higher levels of well being for individuals in that nation. Economic growth can, in fact, have negative impact on a nation including environmental degradation and the loss of traditional cultural values. It also may mean that there is greater inequality between different classes in the society, which means that the gap between the rich and the poor may be widening. It is for these reasons that indices for measuring 'development' have been devised and used. Growth is unidimensional, whereas development is multidimensional.

4. Dornbusch, Fisher and Startz, "Macroeconomics", Tata McGraw-Hill, Ninth Edition.

Table 3.1 Differences—Growth and Development Concept and Measurment

Growth	Development
Unidimensional	Multi-dimensional
Income based	Standard of living based
Economy	Society

SECTION 2: MEASURING 'DEVELOPMENT'

Human Development Index

Economic growth as a measure fails to account for some important social and economic factors such as the standard of living, life expectancy, literacy and inequalities in income distribution. Various indicators have been developed to compensate for the limitations of economic growth measurements. Rather than just measuring the economic living standards in a country, development indicators measure the welfare of individuals in a country. The main development indicator used is the Human Development Index (HDI). It was devised by the United Nations Development Program (UNDP) to measure the economic achievements of a nation in combining economic growth and social welfare. The HDI takes into account three major factors: [Human Development Report, UNDP 1999]

- Life expectancy at birth: High levels of longevity are critical for a country's economic and social well being (Living a long and healthy life).
- Levels of educational attainment: The HDI measures adult literacy and the ratio of people being imparted primary, secondary and tertiary education.
- Gross Domestic Product per capita: This is seen as a measurement of the ability of people to access goods and services.

The HDI is essentially a score between 0 and 1. While a score of 0 would mean zero human development, a score of 1 denotes the maximum on the scale. In 2003, the Human Development Report placed Norway as the top ranked nation with an HDI of 0.944 [see Table 3.1]. Australia was ranked fourth, with an HDI of 0.939 behind Iceland and Sweden. The lowest ranked nation was Guinea Bissau with an HDI of 0.275. When comparing the HDI of certain countries, the GNP per capita rank should also be considered. A nation with a much higher HDI than GNP per capita has had a relatively high level of economic development given their level of economic growth. Countries such as Sweden and Norway fall under this category. In contrast, some nations may have a higher GNP per capita ranking than their HDI ranking. This indicates that there is a very high level of inequality, which means that high income level is only enjoyed by a small proportion of the population. A country with this problem is Saudi Arabia whose GNP per capita ranking is much higher than its HDI ranking.

Other Measures of 'Development'

The UNDP has also developed a number of other indicators to measure 'development'. It has developed a specific Gender Development Index which compares the HDI between male and female populations, a Gender Empowerment Measure, which reflects gender inequality in economic and political opportunities and a Human Poverty Index (HPI) which measures outcome similar to that of the HDI, but examines the extent of disadvantage faced by people who are being deprived of human development. The HPI is adjusted for developing and developed countries.

In 1991, the UNDP had developed a one off indicator called the Human Freedom Index (HFI). This included topics like the right to travel in one's own country, right to teach ideas and receive information, right to have an ethnic language, freedom from forced or child labour, freedom from compulsory work permits, freedom from censorship, freedom for political, legal, social and economic equality for women, social and economic equality for ethnic minorities and the existence of independent trade unions. The UNDP discontinued this measurement as it was based on subjective facts and would not have been a consistent measurement on an yearly basis.

The World Bank developed its own indicator called the World Bank Development Indicator (WBDI). This was made to supplement the Human Development Index. The WBDI mainly measures the quality of life, the success of measures to alleviate poverty, the current account balance, malnutrition, traffic congestion, tax rates, life expectancy, population size, educational standards such as literacy and infant mortality.

Another smaller economic development indicator is the Measurement of Economic Welfare. This index takes into account real GNP per capita plus the value of a family's work. It also takes into account the balance of hours spent in leisure and work, pollution levels and the rate of environmental damage.

Human Development Concept

Human development is "the process of enlarging people's choices". The three essential choices are for people to lead a *long and healthy life, to acquire knowledge and to have access to the resources necessary for a decent standard of living*. Unless these three critical choices are available, many other desirable opportunities will not be attainable. Some of these choices include political, economic and social freedom as well as the opportunity to be productive and to enjoy self-respect and guaranteed human rights. [Human Development Report, UNDP, 1997]

Human development thus has two sides: the function of human capabilities, such as improved health or knowledge; and the use that people make of these acquired capabilities, for leisure or productive purposes.

The purpose of development is to enlarge all human choices, not just income. Income is means, not an end. It may be used for essential medicines or narcotic drugs. The well being of a society depends on the uses to which income is put, and not on the level of income itself. Moreover, country-specific studies have shown several cases of high levels of human development at modest income levels and poor levels of human development at fairly high income levels. The simple truth is that there is no automatic link between income growth and human welfare.

This concept of human development is much broader than the conventional theories of economic development. Economic growth models, for example, concern themselves with expanding GDP rather than improving the quality of people's lives. While GDP growth is necessary, it is not sufficient for human development. Again, theories of human capital formation and human resource development treat people mainly as means rather than as ends and as instruments to produce more goods. But people are more than capital goods; they are also the ultimate ends and beneficiaries of this process of development. Therefore, this concept of human capital formation captures only one side of human development. Similarly, welfare approaches look at human beings as beneficiaries rather than as agents of change or participants in the development process. And, finally the basic needs approach concentrates more on providing material goods and services to the deprived population groups rather than on enlarging human choices in all fields.

There are four major elements in the concept of human development, namely, productivity, equity, sustainability and empowerment. [Sen, On Economic Inequality, Oxford University Press, 1999]

Productivity

People must be enabled to increase their productivity and participate fully in the process of income generation and gainful employment.

Equity

People must have access to equal opportunities. All barriers to economic and political opportunities must be eliminated so that people can participate in and benefit from these opportunities.

Sustainability

Access to opportunities must be guaranteed not only for the present generations, but for future generations as well. For example, environment management would provide equal or better opportunities for future generations.

Empowerment

Development must be by people, not only for them. People must participate fully in the decisions and processes that shape their lives. Human development is impossible without gender equality. As long as women are excluded from the development process, development will remain weak and lopsided.

Gender-Related Development Index (GDI)

There is no doubt that disparities between women and men prevail in most of the countries. The fact that in developed countries, unemployment among women is higher than among men clearly illustrates the striking fact that gender disparities exist everywhere. In the developing world, this disparity may be even more prevalent, as we see a much larger enrolment of males even at the primary level and much higher wages paid to males than to their female counterparts. The HDI is certainly not immune to these disparities and when adjustments are made for them, the ranking of countries surely changes.

The Gender Development Index (GDI) attempts to capture achievement in the same set of basic variables as used in the HDI. Hence, the GDI also uses life expectancy, educational attainment and income in its construction, but the contribution of males and females is separated. The GDI therefore adjusts the HDI for gender inequality. In order to account for the fact that women tend to live longer than men, the maximum and minimum values of life expectancy for both males and females are also adjusted. Hence, women's life expectancy ranges from 87.5 to 27.5 and men's life expectancy from 82.5 to 22.5. In the HDI, life expectancy ranges from 85 to 25 years. [See Human Development Report, UNDP, 1997, 1999 and 2001 issues for more information].

Gender Empowerment Measure (GEM)

The Gender Empowerment Measure (GEM) is another measure of gender disparity. The GEM measures inequality in the main areas of economic and political participation and decision-making. In order to reflect economic participation and decision-making power, women's and men's share in administrative and managerial positions and their share of professional and technical jobs are used. Women's and men's percentage share of parliamentary seats is used to reflect political participation as well as decision-making power.

Table 3.2 HDI and GDI—Components

Index	Longevity	Knowledge	Decent Standard of Living
HDI	Life Expectancy at Birth	1. Adult Literacy Rate 2. Combined primary, secondary and tertiary enrolment ratio	GDP per capita
GDI	Female and Male life expectancy at birth	1. Female and male adult literacy rates 2. Female and male combined enrolment ratios	Estimated income earned by females and males, reflecting women's and men's command over resources

Source: Compiled from Human Development Report, UNDP, Oxford University Press, 2003.

SECTION 3: MEASUREMENT OF POVERTY: ISSUES

Significant resources nationally and internationally have been mobilised and earmarked for the elimination of poverty. Most international funding agencies have this as a high priority activity. It is noted that any real development cannot proceed successfully unless poverty is eradicated or at least alleviated.

One of the major difficulties associated with addressing the issue of poverty has to do with the very definition of poverty. What exactly does it mean when a person or family is classified as poor. For example, can it be genuinely claimed, as is sometimes the case, that since certain sections of the rural population may not be visibly earning much cash income, they are poor or poorer than their urban counterparts. There have been instances in different societies that even subsistence farmers, who earn little or no cash income throughout the year, have sufficient to eat and wear, depending on their standards. Further, it is possible that these people are quite happy and much more content than the urbanite, employed in the formal sector and earning a regular cash income, who has to deal with the trappings of modern day living. Yet, often experts classify the former as poor and the latter as at least above the poverty level. It soon becomes clear that considerable relativity forms the basis of any discussion on poverty, so much so that even in developed societies, segments of the population are considered poor.

If the definition of poverty is so difficult, its measurement can be even more elusive. Indeed, it can be argued that if a phenomenon like poverty cannot be defined, then it cannot be adequately measured. Over the years, three perspectives on poverty have evolved which have made it more possible to define a method for its measurement.

The income/expenditure perspective: It defines a person as poor if his income level is below a defined poverty line. Many countries, including India, have adopted this measure and use it to monitor progress in reducing the incidence of poverty.

The basic needs perspective: Poverty is seen as deprivation of material requirements for the minimal fulfillment of basic human needs including food. Other needs include basic health, education and other essential services. This perspective also recognises the need for employment and participation.

The capability perspective: In this perspective, poverty represents the absence of some basic capabilities to function. Associated functions here are being well nourished, being adequately clothed and sheltered.[5]

In the Human Development Report of 1997, the United Nations Development Programme had introduced a measurement of poverty called the Human Poverty Index (HPI), which is "an attempt to bring together in a composite index of the different features of deprivation in the quality of life to arrive at an aggregate judgement on the extent of poverty in a community". However, as with many other similar concepts, poverty is much larger than any particular measure including the HPI. Many aspects of human poverty like political freedom, ability to participate in decision making, personal security and respect for human rights, cannot be measured in a composite index like this. It is also recognised that even though this index may work well in the developing countries, the same cannot be claimed for the developed world. A simple reason for this is that whereas a clear difference in longevity or adult literacy, two variables which are integral parts of the HPI, exists between two developing countries like Belize and Uganda, the same cannot be said for developed countries like France and Germany. It is thus noted that for developed countries, a specialised index is needed.[6]

The HDI focuses on progress with respect to the entire population. The HPI, however, concentrates on the situation of the most deprived people within the population. This distinction is parallel to that between GDP and the income-based poverty index, where everyone's income counts in the GDP but only incomes of the poor factor into the income based poverty index. In the case of the HDI and HPI, both use information associated with human development. However, the former uses this information at the national level whereas the latter focuses only on the deprived section.[7]

Case: Country Analysis Using HDI

Rankings by HDI and GDP per capita can differ, indicating that high levels of 'human development' can be achieved without high incomes. On the other hand, high incomes do not guarantee high levels of human development. A quote from UNDP Human Development Report (2003, Page 60) has been reproduced here.[8]

"Pakistan and Vietnam have similar incomes, but Vietnam has done much more to translate that income into human development. Similarly, Jamaica has achieved a much better HDI than Morocco with about the same income".

Human development indicators for India remain much lower than for China (China has been ranked No.104 and India as No.127 in Human Development Report 2003 by UNDP). Social investment is required for sustained growth and development. In China, public spending on education is 2.3% of GDP while that on health is 2.1% of GDP. The outcome is clear. Literacy stands at 84%, infant mortality rates

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7. Paul, Justin, Measuring Development Using Index Numbers, UNDP & ISS Paper, 2000, New Delhi.
8. www.undp.org

at 32 per 1000 live births. India, in contrast, traditionally had lower spending levels. Health spending stands at 1.3% of GDP. Spending on education has increased significantly from 0.8% of GDP in 1950 to 3.2% today. However, literacy stands at 65% and infant mortality at 68 per 1000 live births (Human Development Report, 2003, Page 73, UNDP).

The data given in Table 3.3 shows the countries that have secured top ranks in terms of Human Development Index of United Nations. Norway, Sweden and Australia have done extremely well and their HDI ranks are higher than their 'GDP per Capita' rank. It is worth noting that countries like the United States, Switzerland, Ireland and Denmark have been ranked lower on the basis of human development indicators, compared to their high ranks in income level (GDP per capita).

Table 3.3 Ranking of Countries (High Human Development): UNDP Ranking 2009

HDI Rank	Country	GDP Per Capita (PPP US $) 2008	HDI Value
1	Norway	55,600	0.944
2	Australia	37,500	0.942
3	Iceland	39,400	0.941
4	Canada	38,200	0.939
5	Ireland	45,600	0.938
6	Netherlands	38,600	0.937
7	Sweden	36,900	0.937
8	France	33,800	0.937
9	Switzerland	39,800	0.932
10	Japan	33,800	0.932
11	Luxembourg	80,800	0.930
12	Finland	35,500	0.930

Source: Compiled from Human Development Report, UNDP, Oxford University Press, 2003, and CIA World Fact Book 2008.

The selected list of countries fall in the group 'medium human development' and is given in Table 3.4. From the table, it is evident that South Africa has the No. 47 rank in terms of per capita income. But, the country has been ranked as No. 111 on the basis of Human Development Index, showing that the majority of people in the country do not have equal access to income, health and education facilities. Botswana, Oman and Turkey also fall under this category. India was ranked as No.127 in terms of HDI and as No.115 in terms of income, in the Human Development Report 2003.

At the time of this book going to the press, UNDP released its Human Development Report 2009. It is worth noting that China's HDI rank has gone up to No. 92 (2009) from No. 104 (2003). Norway has been ranked as No. 1. The list of top 10 countries ranked in terms of Human Development Index by UNDP is given in Table 3.5 It is important to mention that the countries with high human development spend more money on health and education and less on military expenditure. (Public expenditure on health and education as % of GDP).

Table 3.4 Ranking of Countries (Medium Human Development): UNDP Ranking 2009

HDI Rank	Country	GDP Per Capita (PPP US $) 2008	HDI Value
56	Oman	12,040	0.755
87	Thailand	8,000	0.768
79	Turkey	5,890	0.734
105	Philippines	3,840	0.751
92	China	4,020	0.721
116	Vietnam	2,070	0.688
129	South Africa	11,290	0.684
125	Botswana	7,820	0.614
134	India	2,840	0.590
146	Bangladesh	1,610	0.502
150	Sudan	1,970	0.503

Source: Compiled from Human Development Report, UNDP, 2009, www.hdr.undp.orglen/statistics.

Table 3.5 Ranks of Countries (High Human Development): UNDP Ranking

Rank in 2005	Rank 2009	Country	Rank in 2003
1	1	Norway	1
2	3	Iceland	2
3	2	Australia	4
4	11	Luxembrug	was not in the list of top–10
5	4	Canada	8
6	7	Sweden	3
7	9	Switzerland	10
8	5	Ireland	12
9	17	Belgium	6
10	13	United States	7

Source: Compiled from Human Development Report, 2005 and 2009, UNDP.

Review Questions

1. Distinguish between economic growth and development.
2. What are the advantages of Human Development Index as an indicator of the 'development level' in different countries?
3. What are the components of Human Poverty Index?
4. Distinguish between HDI and GDI.
5. Distinguish between GDI and GEM.

Objective Type Questions

Fill in the Blanks

1. __________ introduced HDI
   (a) World Bank (b) IMF (c) UNDP
   (d) UNICEF (e) None of these
2. GNP-Net Factor Income from abroad = __________.
   (a) NNP (b) GDP (c) NDP
   (d) GDP per capita (e) PPP
3. GNP at market price–Indirect Taxes + Subsidies = __________.
   (a) GDP at factor cost (b) GNP at factor cost (c) NNP at factor cost
   (d) Disposable income (e) None of these
4. The extent of poverty in a community with different features of depreciation in the quality of life can be measured using = __________.
   (a) HDI (b) Human Poverty Index
   (c) GDI (d) HFI (e) None of these

True or False

1. The growth rate of the economy normally refers to the rate at which the GDP is increasing.
2. Economic Growth is undimensional whereas development is multidimensional.
3. HDI takes into account three factors i.e., life expectancy at birth, levels of educational attainment and GDP per capita.
4. Gender Development Index of UNDP adjusts the HDI for gender equality.

Class/Field Exercise

Conduct a voting in the class to decide the best indicator of economic growth development based on the information given in this chapter. Students can choose from one of the following.
(a) Real GDP growth (b) GDP Per Capita (c) GDI (d) HDI

References

1. Human Development Report, UNDP, 1999, 2001, 2003.
2. World Development Report, World Bank, 2004.
3. Gupta G. S (2003): Macro Economics, Tata McGraw-Hill, 2nd Edition.
4. Dornbusch, Fisher and Startz, “Macro Economics”, Tata McGraw-Hill, Ninth Edition.
5. Sen, Amartya (1999), On Economic Inequality, Oxford University Press.
6. Nafziger, Wayne (1997), Economics of Developing Countries, Prentice Hall, NJ, USA.
7. Paul, Justin (2000), Measuring Development Using Index Numbers, Paper Presented at the International Conference of UNDP & ISS, May 20–22, New Delhi.
8. *www.undp.org*
9. *www.wbank.org*

Answers

Fill in the Blanks

1. (c)
2. (b)
3. (b)
4. (b)

True or False

1. True
2. True
3. True
4. True

PART Two

Indian Economy and Business Environment

Chapter 4

Anatomy of the Indian Economy

Learning Objectives

- to understand the process of economic reforms
- to study the extent of openness of the Indian economy
- to analyse trends in different sectors of the economy

Chapter Structure

Section 1: Indian Economy—Overview

Section 2: Economic Reforms in India

Section 3: Analysis of Sectors

Section 4: SWOT Analysis of Indian Economy

Case: Lucent in the Era of Economic Reforms

SECTION 1: INDIAN ECONOMY—OVERVIEW

India is the second largest country in the world in terms of population. It has 16% of the world's population and roughly 12% of the world's land. It is also the fourth largest economy in terms of Gross Domestic Product (GDP) (Purchasing Power Parity), as per IMF estimates of 2006.

India is, without doubt, a key player in the world economy. The Indian economy is extremely diversified, ranging from technology to agriculture. Agricultural activity in India contributes only 23% to the GDP, but employs approximately 65% of the work force. This places a burden on the Indian economy. On the other hand, India has the comparative advantage in terms of the considerable command of the English language and the technological abilities in certain sections of the population.

Some of the problems faced by the economy like inadequate employment opportunities, inequalities in the socio economic status and poverty can prove disastrous to any globalising economy. Some of the other concerns regarding the Indian economy are poor infrastructure, fiscal deficit and a large amount of Non Performing Assets (NPA).[1]

Table 4.1 GDP Growth in India (%)

First Plan (1951–56)	3.6	Eighth Plan (1992–97)	6.02
Second Plan (1956–61)	4.2	Ninth Plan (1997–02)	5.35
Third Plan (1961–66)	2.7	2001	3.88
Fourth Plan (1969–74)	2.05	2002	4.55
Fifth Plan (1974–79)	4.83	2003	6.85
Sixth Plan (1980–85)	5.54	2004	7.89
Seventh Plan (1985–90)	6.02	2005	9.2
		2006	9.81
		2007	9.37
		2008	7.34

Source: Economic Survey 2006-07, Govt. of India & IMF-2009 World Economic Outlook.

India has changed from public sector domination in industries to an increasingly liberalised system, with both private and foreign players. It has also changed from a sellers' market with limited competition to a buyers' market with increased competition, from a country with quantitative restrictions and tariffs to Quota-free open economy and from a restricted financial market to a liberalised financial market with prudential norms. These changes are a testimony to the dynamic nature of the Indian economy. Some key strengths that India can leverage upon in creating its own indigenous industries can be its vast pool of human resources, natural resources and entrepreneurial talent. It should be noted that the country has a rich pool of skilled workers with the world's third largest reservoir of engineers and a handful of quality educational institutions.

The Indian economy achieved a growth rate of above 7% in the recent past. This robust performance of the economy was due to high growth rates in service sector and a world economic environment that provided a backdrop conducive to the Indian economy. Another factor that led to this upswing in the economy was the continued maintenance of relative stability of prices.

1. India Development Report, Oxford University Press & IGIDR, 2002.

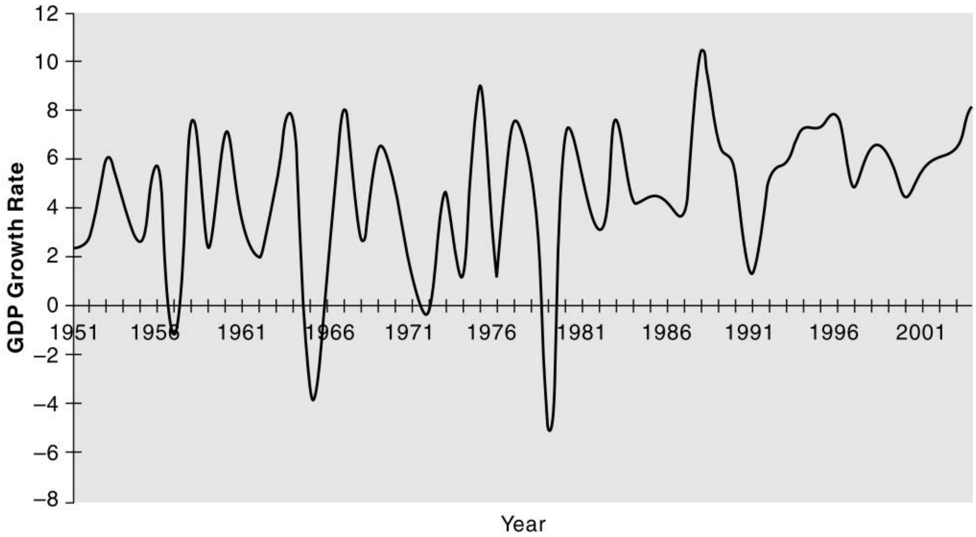

Fig. 4.1 India's GDP Growth Rate

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 December 19, 2003 and was in the range of $130 billion to $140 billion in 2005. The reserves have touched a new high, $260 billion in the year 2007. (Refer Reserve Bank of India website, www.rbi.org.in, for latest information on Forex Reserves). Capital inflows, increased exports 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.[2]

In India, current account of BOP has been in surplus in the recent years, although there has been deficit in between. While the trade deficit increased, the deficit was neutralised by a higher surplus in the 'invisibles' contributed mainly by software service exports and private transfers. Growth momentum in exports has been maintained; India has registered a growth of over 20% in exports in the last few years. Despite a higher value of total imports in the last few years mainly due to the petroleum and oil imports, India did not suffer a negative trade balance as it was highly compensated by the service exports. The main contributors to capital account surplus were the banking capital inflows, foreign institutional investments and other capital inflows. However, the latest statistics of Reserve Bank shows that the country has again slipped into current account deficit. The appreciation of Rupee against US Dollar (from 49-50 range, in the year 2000, to 40-41 range in 2007), has slowed down export growth in the recent past.

Characteristic Features of Indian Economy*

Indian Economy is considered as a 'developing economy' based on its characteristic features but it is also called an 'underdeveloped economy' mainly because of the country's low per capita income, low

2. Economic Survey, Government of India, 2006–07.

*It is advisable to refer to the Handbook of Statistics on Indian Economy, Reserve Bank of India, as well as Annual Report, for updates on Indian economy. Economic Survey, published by Ministry of Finance, Government of India, may also be used as supplementary reading material for this part.

literacy rate and rapid population growth.[3] The salient features of Indian economy can be specified as:

(i) Predominance of agriculture
(ii) Rapid population growth
(iii) Low per capita income (GDP per capita)
(iv) Unemployment
(v) Capital-scarce economy

SECTION 2: ECONOMIC REFORMS IN INDIA

The 1991 Crisis

In 1991, Indian economy faced a severe crisis. The symptoms of the crisis were evident in the second half of eighties itself in the form of macro-economic imbalances.[4] Pressures generated by the large and persistent fiscal deficits and foreign exchange crisis, high tariffs and the inefficiencies generated by the industrial licensing system had led to a huge deficit in the balance of payments position. Adverse global developments in 1990–91 i.e., the slowdown in world trade following recession in the industrial world, the disruption in Eastern Europe and the Gulf crisis of August 1990 aggravated the crisis. The current account deficit soared to a level of 3.2 per cent of GDP in 1990–91, which by all means was unsustainable. There was a massive shortage of the foreign exchange reserves. Despite draws of US $2.5 billion from the International Monetary Fund (IMF) under the Contingency and Compensatory Financing Facility, the foreign currency assets dipped from US $3.4 billion at the end of March 1990 to a very low level of US $975 million on July 12, 1991.[5] The amount was equivalent to barely a week's value of import bills. India responded to the crisis by simultaneously implementing measures for stabilisation and structural reforms.

Stabilisation Measures

The government implemented the following stabilisation measures in 1991 in order to correct the imbalances in the Indian economy.

(i) Devaluation of the currency followed by full convertibility in current account.
(ii) Cut in Government expenditures to bring about reduction in budget deficit. For instance, budget deficit reduced from 9% of GDP to 6.5% of GDP during 1991 to 1992.
(iii) Elimination of price controls and cutting down subsidies on agricultural inputs and products.

Structural Adjustment Programme and Measures

The Government of India implemented the following 'structural adjustment measures' as part of the economic reforms.

(i) Liberalisation of trade and the elimination of the protective entry barriers into industry with a view to make the industry more competitive. This meant delicensing and deregulation of industry, trade and commerce.

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3. Misra and Puri, Economic Environment of Business, Himalaya Publishing House, 2000.
4. Dutt and Sundaram, Indian Economy, S. Chand & Sons, 2001.
5. Jalan, Bimal, India's Economic Policy, Penguin Books, 1996.

(ii) Liberalisation of banking system and reducing the role of the public sector banks.
(iii) Lessening the control of the monetary authorities on policies such that the rates of interest in money market would be determined by market forces (and not by the Reserve Bank of India, and reduction in Statutory Liquidity Ratio (Percentage of aggregate demand and time deposits that the commercial banks are required to invest in specified government securities).
(iv) Gradual privatisation of commercial, financial and industrial enterprises.
(v) Reduction in the role of the state in the social sectors as well, like that in the education and health sectors, besides gradual move in the direction of the principle of cost recovery.
(vi) Tax reforms for rationalisation of the tax structure.
(vii) Poverty alleviation programmes through the creation of social development fund.

It is clear from the measures that the new industrial policy of 1991 has effected some very fundamental policy changes such as near abolition of licensing, easing of the rigors of MRTP (Monopoly and Restrictive Trade Practices Act) and FERA (Foreign Exchange Regulation Act) acts, reduced list of industries for the public sector, automatic approvals of foreign technology agreements and for 51% foreign equity participation, private investment in infrastructure, liberal location policy for industry, freer import of capital goods, deregulation in small scale industrial units and liberal policy measures for attracting Foreign Direct Investment (FDI), and Non-Resident Indian investment. The main objective of the liberalised policy measures was to enhance the productivity and competitive efficiency in the industrial sector.[6]

Reforms for Growth

Exchange Market Reforms[7]

The Eighth Five Year Plan in India had envisaged exchange rate reforms as part of the general trade policy reforms, and in March 1993 the exchange rates were unified and transactions on the trade account were freed from foreign exchange control. Further measures were taken to simplify procedures related to the purchase of foreign exchange so as to enhance current account convertibility. These included permission to Exchange Earner's Foreign Currency (EEFC) account holders to use these funds for business-related current account transactions. Authorized dealers were allowed to export surplus currency to private moneychangers abroad, besides their own branches and correspondents. Monetary ceilings on remittances for a wide range of purposes were also removed.

Reforms in the Foreign Investment Regime

Since export growth depends on the existence of a strong production base in thrust sectors, which could expand to meet further growth needs, the stimulus in such areas has been provided by streamlining the procedures for foreign investment. The Foreign Investment Promotion Board (FIPB) has been revamped to make the rules and regulations pertaining to foreign investment more transparent.

Priority areas for allowing 100% foreign equity have been spelt out. An expanded list of 46 industries eligible for automatic approval up to 51% foreign equity, and another set of industries eligible for

6. Patel, I G, Economic Reforms and Global Change, Macmillan, 1999.
7. Justin Paul and Ramanathan A, Globalisation, Foreign Trade and Industrial Sector, Chapter 7 in Managing Global Business Edited by Mukesh Chaturvedi and Aseem Kumar.

74% foreign equity have also been announced by the government. The limit on holdings by individual Foreign Institutional Investors (FIIs) in a company were raised from 5% to 10% of the company's shares, while the aggregate limit has been increased from 24% to 30%. FIIs have also been allowed to invest in non-listed companies. It is no longer necessary for automatic approvals by the Reserve Bank of India (RBI) that the amount of foreign equity should cover the foreign exchange requirements for import of capital goods needed for the project. To impart flexibility in souring of technology imports, technology transfer has been de-linked from equity investment.

Reforms in the Infrastructure Sector

Removing infrastructure bottlenecks has been another key component of the trade reforms package. In the telecommunications sector, significant progress has been made in involving the private sector in value-added services, such as cellular, mobile and paging services. Telecom Regulatory Authority of India (TRAI) was established in 1997, which is responsible for separating the regulatory functions from policy formulation and operational functions. Government is also planning to establish similar authorities for other infrastructure areas like power. New guidelines allow private participation in ports and fresh guidelines for private investment in the highway sector have been introduced. Also, procedures have been simplified and equity participation made easier. Major improvements in public transport system through the introduction/augmentation of rail-based transit systems in cities like Delhi, Bangalore, Hyderabad, Mumbai and Kolkata have been made.

Tariffs and Trade Reforms

Since 1993, tariff reform has brought down the simple average of all rates to a level lower than 15 per cent, with most of the goods having a ceiling of 35% duty (which was 71 per cent in 1993–94). The process of tariff reform and reduction is ongoing and has been pursued by successive governments since the establishment of World Trade Organisation in 1995. However, the structure of the tariff remains complex with a large number of bands in several industries, notably that of paper and paper products, printing and publishing, wood and wood products, food, beverages and tobacco. Reforms in the system of restrictive import licensing have moved ahead steadily. In general, products were first shifted to a Special Import License (SIL) list, (Producers were exposed to limited foreign competition when there were import licensing restrictions on diary items) before being moved to the list of freely importable goods.

There is re-emphasise in India to maintain a large number of incentive programmes for exports. These include income tax exemptions, subsidised credit, export insurance and guarantees, export promotion and marketing assistance schemes and access to certain imports that are normally subject to restrictive licensing. The scope of such incentives has been enhanced, orienting India's overall policy stance more explicitly towards exports.

With increased liberalisation and globalisation of trade, India's focus is on areas of her strength and advantage to meet global competition. This rationale has given the impetus for considerable shortening of the negative list of imports and expanding the freely importable list. As per the commitment to WTO, the country abolished the quantitative restrictions on imports of most of the items on April 1, 2001.

Since 1995, India has initiated a wide ranging programme of trade liberalisation and economic deregulation with the objective of integrating the Indian economy more closely with the world economy. The principal objectives of India's trade policy defined in the Export-Import Policy are: (a) to accelerate the country's transition to a globally oriented economy with a view to deriving maximum benefits from expanding global market opportunities; (b) to stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumer goods and capital goods required for augmenting production. [Exim Policy 1997–2002 Document, Ministry of Commerce, Government of India]

SECTION 3: ANALYSIS OF SECTORS*

This section is devoted to the study of trends in different sectors of Indian economy, viz. External sector, Industrial sector, Agricultural sector, Infrastructure sector, Social sector and Service sector.

(i) External Sector

The external sector plays a key role in enabling the conditions to accelerate the pace of the external liberalisation process. Despite the international uncertainties, Indian external sector is in a strong position and driving the macro-economic strength of the country. Global imbalances and their disruptive impact on currency markets, hardening of interest rates, volatility in crude oil prices etc. continue to be some of the major uncertainties and risks faced by the economy. The economic survey of the year 2004–05 had hinted that the Balance of Payments appears to be resilient and strong even after the increase in the imports. The sustained momentum of the manufacturing sector has helped greatly in the growth of exports. The export of services like software, business and other commercial services has also been playing a significant role in adding to the Balance of Payments. The reserves position is also very comfortable due to the increasing capital inflows into the country. The image of India from a land of farmers has changed to that of a technology hub and the country is seen as an international destination for R&D, engineering design, telecommunications, super specialty health care and a manufacturing hub for high technology products. In the area of biotechnology, India has tremendous potential to become a global R&D player with the changed patent laws. The high skilled Indian workforce has also imparted a comparative advantage for the country's software industry increasing the software service exports, thereby carving a niche for the country in IT and IT enabled services. Further export growth is possible if it is supported with an increase in the FDI limits in export-oriented sectors. An increase in the FDI would bring with it better technology, human capital formation, exports and increased productivity. The country also witnessed the appreciation in the value of the rupee with respect to the US dollar in the recent past.[8]

There was a rise in the case of imports in the country; this growth in the imports was also a broad based one with a surge in import of food, capital goods, raw materials, intermediates and consumer goods. Imports of capital goods accelerated from 6.3 per cent in 2001–02 to above 20 per cent in the recent years led by import of transport equipment, machinery and manufacture of metals. Trade is important for the economy of any country and the opportunities for the improvement in trade is further

*This section has been co-authored by Prof. Justin Paul with Avishek Mukhopadhyay, Nikhil Gupta and Pradeep Kumar S J.

8. Economic Survey, Ministry of Finance, Government of India, 2006–07.

aided by the formation of trade groups like SAFTA (South Asian Free Trade Association) with the SAARC nations. Even though trade prospects are high in the coming years, there are certain threats like firmness of the global oil prices, volatility of major currencies and the risk of interest rate hikes in developed countries. India also needs micro-strategies to put export growth on priority. There is also a need for sustained efforts towards the service sector in which the country has the potential to emerge as a major player.

(ii) Industrial Sector

Industrial sector in India contributes a meagre 27 per cent of the country's GDP. This is mainly because of the fact that India's competency lies in the services sector. In 2003–04 and 2004–05, the Index of Industrial Production (IIP) grew by 6.9 and 8.4 per cent respectively with the manufacturing sector being the driving force behind this growth with a contribution of almost 80 per cent. The highest growth rate of the IIP was achieved in 1995–96 with 13 per cent and the lowest being 2.7 per cent in 2001–02.

Automobile Industry

During the period 2003–'08, the automobile industry witnessed a growth rate of 15 to 20 per cent. The improved quality and performance of the Indian automobiles has driven the export and acceptance in the global market. The export has increased to 4.8 lakh units registering a growth rate as high as 55%. Globalisation, foreign collaboration and tie ups are the main reason for this surge in the export of automobiles. The reduction of the excise duties on passenger cars from 32 to 24 per cent, improvements in retail credits and reduction of tariffs has greatly fuelled the growth of this industry.

Gems and Jewellery

India is the largest consumer of gold in the world followed by China. Indian Jewellery industry imports the raw materials, adds value and exports them. During the last three years, the export in this industry has increased by 15 to 22 per cent. India's Gems and Jewellery Promotion Council (IGJPC) aims at transforming India into a global diamond trading center. Before the pre-liberalisation era, gold prices were kept artificially high and there were huge restrictions on the import of gold. The result of these policies led to the smuggling of gold in bulk quantities which were to be sold at higher prices in the country. But since liberalisation, this smuggling has been curbed. The main export destinations of Indian Jewellery are UK and Switzerland.[9]

Textile Industry

The textiles sector has been one of major sources for foreign exchange earnings for India. The textile industry has registered an export value of more than US $10.1 billion in the recent years as compared to US $9.6 billion in the previous year. One of the key strengths of the Indian textile industry is the abundance of raw materials with India being one of the major producers of fabrics in the world. The presence of low cost skilled labour and the growing domestic market can be considered as some of the other strengths of this industry. However, drawbacks for the country can be the fragmented nature of the

9. Annual Report, Gems and Jewellery Export Promotion Council.

industry which may be detrimental in India emerging as a world-class player, historical governmental regulations like the absence of exit options, lack of adequate economies of scale, low productivity of workers when compared to countries like China, and obsolete technology. India has a huge opportunity as far as the textile industry is concerned because of the implementation of the WTO agreement. The opportunities could be through concentration in R&D, introduction of new products and so on. The government has set up an autonomous body called Confederation of Indian Textiles Industry (CITI) in order to help the industry achieve global competitiveness and leverage the benefits through exports.

Steel Industry

The steel industry has been strong due to the strong growth of demand for steel in both China and in the domestic market. Some of the reasons for the successful steel production include improved technology and the thrust given for exporting steel from India. Automation of the routine blue collar jobs also helped in the transition of the Indian steel industry.[10]

(iii) Agricultural Sector

More than 65% of the country's population depends on the agricultural sector, which ironically produces only 23% of the GDP. In India, around 45 per cent of the total land is cultivated. Rice, wheat, pulses, and oilseeds dominate the agricultural production in India. Besides, crops like millet, corn (maize) and sorghum are also grown in large quantities. India is the largest producer of tea, jute and fibres like jute. Among livestock, cattle and buffalo are found maximum in India. Indian total milk production is the highest in the world. In terms of area, India tops the list of total irrigated land in the world. Among cereal production, India is placed third, being second largest producer of wheat and rice and the largest producer of pulses. Dairy farming, fishing and forestry are important parts of agricultural sector. However, full potential of the Indian agriculture as a profitable activity hasn't been realised as yet. There are many issues plaguing the country's agricultural sector and they have been discussed subsequently.

Trends in the Agricultural Sector

Food Grain Production According to the Economic Survey report, rice contributes to the largest share of food grain production at around 42 per cent with wheat at 35 per cent. Rice is grown throughout the country with highest concentration in the eastern and the southern regions, while wheat is primarily grown in the northern region. The food grain production in India depends largely on monsoons.

India is the world's fourth largest vegetable oil producer with an annual turnover of about $15bn, but the country imports nearly 40% of its annual need of 11 m tonnes of edible oil. This is because India imports items like palm oil and exports items like coconut oil, sunflower oil and soya oil.

Plantation Crops India is the largest producer and consumer of tea in the world and accounts for about 27 per cent of the world production and 13% of the world trade. Among other plantation crops, coffee has contributed significantly to the Indian economy since independence. Indian coffee has created a niche in the market particularly famous for its good blending quality. Rubber is primarily produced in the states of Kerala and adjoining districts of Tamil Nadu.

10. Economic Survey 2005–06, Government of India.

Live Stock, Poultry and Fisheries Livestock sector, which contributes milk and eggs, plays a significant role in meeting the animal protein requirement of the country. This sector has contributed about 6-6.5 per cent of the country's GDP in the recent years. The livestock sector also plays an important role in the utilisation of the non-edible agricultural by-products, besides being an important earner of foreign exchange.

Agricultural Credit There has been a steady rise in the flow of agricultural credit in the Indian context. The agency-wise share of the credit flow to agriculture shows that commercial banks have accounted for the major share followed by regional banks and the rural banks. Realising the need to enhance credit flow to agriculture, the government in consultation with the RBI, NABARD and other rural banks has announced a credit package for the agricultural sector, which aims at doubling the agricultural credit.

Irrigation As efforts continue to increase the irrigation potential in the country, the last 40 years saw the gross irrigated area reach 85 million hectares. Flood forecasting has become an important activity over the years. Over 500 hydrological stations collect and transmit data through 400 wireless stations for issuing forecasts for 157 sites. About 5,000 forecasts are issued in a year with 94 per cent accuracy. India receives international support, with the World Bank as a primary source, for developing its water resources.

Main Areas of Weakness

India's agriculture is highly sensitive to the variability in rainfall. Eighty per cent of the total rainfall over the Indian sub-continent occurs only during three months (June–August), as a result of the southwest monsoon. While drought is a recurring problem in some areas of India, floods cause serious damages to the livelihood and agriculture in other areas. Climate variability has considerable social and economic consequences in India, where almost three quarters of the population relies directly or indirectly on agriculture for livelihood.

Irrigation is another major issue of concern for the Indian agricultural sector. More than 60 per cent of the country's agriculture is rainfed. Apart from the states of Punjab, Haryana and Uttar Pradesh, most of the other states do not have high level of irrigation and depends more or less on the rainfall.

Apart from weak credit and insurance facilities, low land productivity and low level of mechanisation are some of the weaknesses plaguing the Indian agricultural sector today.

(iv) Infrastructure Sector

For the development of any country, infrastructure comprising transportation (railways, roads and civil aviation), communication, water supply and sanitation forms one of the most critical aspects. Infrastructure is one of the most important factors for high and sustained growth. India has been actively engaged in chalking out the appropriate policy framework which gives the private sector enough confidence in investing in the infrastructure sector, but simultaneously keeps adequate checks and balances through competition and regulation. Several fiscal incentives were announced by the government to boost investment in infrastructure projects. Ten-year tax holiday offered to projects in core sectors like roads, highways, waterways, water supply, sanitation and solid waste management systems can now be availed of during the initial 20 years. Projects in airports, ports, inland ports, industrial parks and generation and distribution of power can now avail tax holidays during the initial 15 years.

Power

The country's power generation has increased impressively in the recent years. Today, the power generation in the country is to the tune of 583.8 billion kilowatt hour, marking a healthy increase of 7-8 per cent each year. Some projects have been executed based on the public-private partnership agreements.

Railways

With a total route length of 63,221 km and a fleet of 7,000 passenger and 4,000 goods trains, the Indian Railways is the second largest network in the world. It carries more than 4,000 million passengers per year and transports over 382 million tonnes of freight every year. It is well equipped to meet its demands for locomotives, coaches and other components. Lately, the Railways launched a massive gauge-conversion drive as about a third of the track is metre or narrow gauge. The Railways has also started a scheme to privatise several services including maintenance of railway stations, providing meals to passengers, drinking water and cleaning of trains.

Road Transport

The roadways has grown rapidly in independent India. Ranging from the cross-country link of the national highways to the roads in the deepest interiors, the country has a road network of 2.1 million km. Indian roads carry 85 per cent of the passengers and 70 per cent of the freight traffic. The national highways make up only 2 per cent of the road transport and carry 80 per cent of the traffic.

India manufactures most of its motorized vehicles like cars, jeeps, trucks, vans, buses and a wide range of two-wheelers of various capacities. While Indian scooters have established a good foreign market, the car industry is also looking up with several foreign companies setting up their production units in the country.

Aviation

India has an aviation infrastructure which caters to every aspect of this industry. Hindustan Aeronautics Limited (HAL) is India's gigantic aeronautical organisation and one of the major aerospace complexes in the world. India's international carrier, Air-India, is well known for its quality service spanning the world. Within the country, five international airports and more than 88 other airports are linked by Indian Airlines. The government has adopted a liberal civil aviation policy with a view to improving domestic services. Many private airlines are already operating in the country like Jet Airways, Sahara, Paramount, Indigo, Air Deccan, Spice Jet, King Fisher and so on. Sahara has been renamed as Jetlite.

Telecommunications

With rapid advances in technology, India now uses digital technology in telecommunications, which derives advantage from its ability to interface with computers. The present strategy focuses on a balanced growth of the network, rapid modernisation, increased productivity, and innovations in organisation and management. Moving towards self-reliance, besides establishing indigenous R&D in digital technology, India has established manufacturing capabilities in both the government and private sectors. The private sector is expected to play a major role in the future growth of telephone services. The recent growth in telecommunications has also been impressive. The total number of telephone connections for both basic and combined telephones stand at 90 million presently. Few areas of India's economy has undergone structural changes like the telecom sector. This drastic pace of structural changes highlights the possibility of huge improvements in other sectors. This is again possible by the involvement of the private sector.

Challenges Ahead in the Infrastructural Sector

The main challenges which lie in the road of Infrastructural development are in the following areas:

Power Sector With a significant surge in demand, there is a need for growth in capacity as well. Some State Electricity Boards follow a restrictive and monopolistic captive power policy that leads to power surplus in some states and shortages in others. To combat this imbalance, this sector calls for centralised restructuring. One of the prime areas that needs focus should be the development of nationwide grid network. Since India suffers high transmission and distribution losses, the country needs to properly vigil the operation.

Railways The infrastructure facilities used by the Indian Railways are quite outdated. A majority of the bridges on which Indian Railways run were constructed during the British period. Moreover, there is an immediate need to bring the entire railway network into the broad gauge frame. Efforts are underway to make the complete network electrified and put a computerised signaling system in place.

Roadways There is a need for more number of national highways since they presently constitute a miniscule percentage of the total road network, but carry a majority of the traffic. Indian roads are highly vulnerable to monsoon rains reducing efficiency of traffic movement. Roads linking to the remotest of villages have to be constructed to provide accessibility to the basic facilities.

Aviation The airports, runways, terminals have to be modernised in keeping with times. India needs to have more international airports and the existing airports need to be upgraded to international standards. The air connectivity across the various parts of the country is expensive at present. Most of the airports across India do not have night landing facilities. However, government has come a long way in removing regulations in the air industry, and opening up the skies for private players.

Telecommunication India has one of the lowest telephone penetrations in the world with ten telephones per hundred people. There is a vast opportunity for growth in this sector. The country needs to move into new technologies, allow the entry of more private players and drive down prices through competition to make it accessible to the common man. Growth of telecom sector needs huge infrastructural investments and India has to attract larger amount of Foreign Direct Investment in the country. India also lags behind in the field of broadband telephony. Special emphasis should be laid on the coverage of telephones in the rural sector.

Social Sector

As per the Human Development Reports published annually by the UNDP, India has consistently improved its position on the human development front and is grouped among the countries registering "medium human development". However, some components of human development indicators for health and income continue to lag behind. India's rank in Gender Development Index continues to be low. High regional disparity across the states is also a cause for concern. Ongoing economic reforms and the National Common Minimal Program (NCMP) attach high priority to the development of the social sectors and encourage people to participate in the development process. Social sector programs and their implementation largely come under the purview of the state governments. However, the Central government augment the effort of the state governments by extending adequate resources to them. The total Central government spending in the social sector has increased three times between 1995–96 and 2008–09.

Poverty

- Even after more than 50 years of independence large scale poverty remains to be the face of India.
- India still has the world's largest number of poor people in a single country. Of its nearly 1 billion inhabitants, an estimated 250 million are below the poverty line.
- Roughly 25 per cent of the population is illiterate, with women, tribal and scheduled castes particularly affected.
- The main causes of poverty are illiteracy and high population growth rate.

Poverty Alleviation India has had a number of antipoverty programs since the early 1960s. These include, among others, the National Rural Employment Programme and the Rural Landless Employment Guarantee Programme. The National Rural Employment Programme evolved in the year 1980 from the earlier 'Food for Work Programme' to use unemployed and under-employed workers to build productive community assets. The 'Rural Landless Employment Guarantee Programme' was instituted in the year 1983 to address the plight of the hard-core rural poor by expanding employment opportunities and building the rural infrastructure as a means of encouraging rapid economic growth. To improve the effectiveness of the National Rural Employment Programme, it was combined with the Rural Landless Employment Guarantee Programme in 1989 and renamed Jawahar Rozgar Yojana, or Jawahar Employment Plan. Many new schemes have been introduced by the government in the recent past.

Elementary Education

Since independence, the central and state governments have been expanding the provision of primary formal and non-formal education to realise the goal of Universilisation of Elementary Education (UEE). The challenge now is to sustain and deepen current reforms in education and encourage local planning and management of strategies for expanding and improving primary education.

National Programme of Nutritional Support to Primary Education (School Meal Programme) This scheme was launched on 15 August, 1995 to give a boost to UEE in terms of increasing enrolment, retention and attendance in primary classes by supplementing nutritional requirements of children attending primary schools. It is an ambitious scheme that has been operationalised throughout the country in a very short period. Under the programme, nutritious and wholesome cooked meal of 100 gm of food grains is provided free of cost to all children in classes I–V per school day.

Secondary Education

The Secondary Education, which serves as a bridge between primary and higher education, is expected to prepare young persons between the age group 14–18 for the outside world and for entry into higher education. To accommodate children in schools at secondary level, India has at present 1.20 lakhs institutions. With the emphasis on universalisation of elementary education and programmes like District Primary Education Programme, the enrolment is bound to increase.

Higher Education

India has one of the largest 'Higher Education System' in the world. In higher education, roughly 71 lakh students are taught by 3.31 lakh teachers in 15,000 colleges. Central government is responsible for major policies relating to higher education in the country. It provides grants to the UGC and establishes central universities in the country. The Central Government is also responsible for declaration of Educational Institutions as 'University' on the recommendation of the UGC. At present there are sixteen (16) Central Universities in the country. State governments are responsible for establishment of state universities and colleges, and provide plan grants for their development and non-plan grants for their maintenance.

The coordination and cooperation between the Union and the states is brought about in the field of education through the Central Advisory Board of Education (CABE).

Healthcare

Healthcare resources in India though not adequate, are ample. There has been a definite growth in the overall healthcare resources and health-related manpower in the last decade. The number of hospitals has grown from 11,174 hospitals in 1991 to 19,000 (75% private). India has 1.25 million doctors and 0.8 million nurses that translates into one doctor for every 1800 people. If other systems including Indigenous System of Medicine (ISM) and homeopathic medicine are considered, there is one doctor per 800 people. It not only satisfies but also betters the required estimate of one doctor for 1500 population. Approximately 15,000 new graduate doctors and 5,000 postgraduate doctors are trained every year. The country has an annual pharmaceutical production of about 260 billion (INR) and a large proportion of these medicines are exported.

To a casual observer, this looks like a good proportion, however on further study, unequal distribution of resources becomes apparent. The ratio of hospital beds to population in rural areas is fifteen times lower than that for urban areas. The ratio of doctors to population in rural areas is almost six times lower than that in the urban population. Per capita expenditure on public health is seven times lower in rural areas compared to government health spending for urban areas. Though the spending on healthcare is 6% of gross domestic product (GDP), the state expenditure is only 0.9% of the total spending. People using their own resources spend the rest of it. Thus only 17% of all health expenditure in the country is borne by the state, and 82% comes as 'out of pocket payments' by the people. This makes the Indian public health system grossly inadequate and under-funded. As a result of this dismal and unequal spending on public health, the infrastructure of health system itself is becoming ineffective.

Service Sector

The service sector now accounts for more than half of India's GDP: This sector has gained at the expense of both the agricultural and industrial sectors through out the 1990s. The rise in the service sector's share in GDP marks a structural shift in the Indian economy and takes it closer to the fundamentals of a developed economy (in developed economies, the industrial and service sectors contribute a major share in GDP while agriculture accounts for a relatively lower share).

The service sector's share has grown from 43.69 per cent in 1990–91 to 55 per cent by now. In contrast, the industrial sector's share in GDP has declined from 25.38 per cent to 21 per cent from 1990–91 to 2005–06 respectively. The agricultural sector's share has fallen from 30.93 per cent to 24 per cent in the respective years.

Some economists caution that if the service sector bypasses the industrial sector, economic growth can be distorted. They say that service sector growth must be supported by proportionate growth of the industrial sector, otherwise the service sector growth will not be sustainable. It is true that in India, the service sector's contribution in GDP has sharply risen and that of the industry sector fallen.

SECTION 4: SWOT (STRENGTH, WEAKNESS, OPPORTUNITIES AND THREAT) ANALYSIS OF INDIAN ECONOMY

An attempt has been made to analyse the Indian economy with the help of SWOT Table in this section.

Strengths

Huge pool of labour force
High percentage of cultivable land
Diversified nature of the economy
Huge English speaking population, availability of skilled manpower
Extensive higher education system, third largest reservoir of engineers
High growth rate of economy
Rapid growth of IT and BPO sector bringing valuable foreign exchange
Abundance of natural resources

Weakness

Very high percentage of workforce involved in agriculture which contributes only 23% of GDP
Around a quarter of a population below the poverty line
High unemployment rate
Stark inequality in prevailing socio economic conditions
Poor infrastructural facilities
Low productivity
Huge population leading to scarcity of resources
Low level of mechanization

Red tapism, bureaucracy
Low literacy rates
Unequal distribution of wealth
Rural–urban divide, leading to inequality in living standards

Opportunities

Scope for entry of private firms in various sectors for business
Inflow of Foreign Direct Investment is likely to increase in many sectors
Huge foreign exchange earning prospect in IT and ITES sector
Investment in R&D, engineering design
Area of biotechnology
Huge population of Indian Diaspora in foreign countries (NRIs)
Area of infrastructure
Huge domestic market: Opportunity for MNCs for sales
Huge natural gas deposits found in India, natural gas as a fuel has tremendous opportunities
Vast forest area and diverse wildlife
Huge agricultural resources, fishing, plantation crops, livestock

Threats

High fiscal deficit
Threat of government intervention in some states
Volatility in crude oil prices across the world
Growing Import bill
Population explosion, rate of growth of population still high
Agriculture excessively dependent on monsoons

Case: Lucent in the Era of Economic Reforms

History of Lucent

The merger of various AT&T subsidiaries, including the Bell Labs, a leader in the innovations in telecom industry, formed Lucent in the early 1990s in the US. After this, Lucent became a major player in the telecom sector. AT&T had already been operating in India since 1980s in the form of joint ventures with various Indian conglomerates, including the Tatas in manufacturing and setting up of Network Access Systems, and with Birlas in Cellular services. They also had a joint venture with Finolex cables to manufacture Optic Fiber cables. Later on, when AT&T subsidiaries combined to become Lucent in 1996, Lucent consolidated its business with its partners in India also.

Telecom Policy in India

The Indian telecom sector in India, prior to the National Telecom Policy (NTP) of 1994, was the monopoly of the Department of Telecom, a government body. The NTP of 1994 concluded that private investment and involvement would be required to bridge the gap in resources for the telecom infrastructure, needed for the economic development. But the policy had many shortfalls. The policy allocated licenses on the basis of the highest bid resulting in unrealistic bids by the private service providers. The targets of NTP 1994 could not be achieved, as the shortfalls in the policy slowed down the private sector entry.

Indian Telecom Scenario

The Indian economy grew rapidly at an average rate of 7 percent during the last decade. Meanwhile, the telecom service providers were not able to provide the required infrastructure to facilitate this surge in the Indian economy. The IT industry in India has been consistently growing at the rate of over 30 percent in the past few years. IT spending, as a percentage of GDP in India, as compared to the developed nations, was very low. Hence, the scope for domestic demand for IT services was also very high. Nearly a quarter of the Fortune 1000 companies were outsourcing their software requirements to Indian companies. Lucent had strengthened its position in the broadband networking in the recent years.

The Indian government introduced various reforms through the new industrial policy of 1991. *These had strengthened through subsequent reforms through the last decade*. By the year 2000, they had reached a stage where they could contribute significantly to India's economic performance.

In the later 1980s, the fiscal deficit of the Indian Government was very high, which was a cause for concern. The health of India's financial sector was also weak. The non-performing assets constituted a large percentage of bank's portfolios in India. During the same period, India was involved in various frictions with Pakistan.

However, the telecom infrastructure was choking under the new requirements of the IT industry. The bandwidth and international gateway capacity were also bottlenecks. The fixed-line penetration in India was one of the lowest in the world, at 2.69 percent. The presence of a huge waiting list for telephone connections in the many Indian towns, alongwith an expected GDP growth of near to 7.5 percent per annum in the long run, led to a huge requirement in the telecom services sector. The cellular subscriber base in India was amongst the fastest growing in the world, at the rate of 6 percent per month. With further growth in income, this was expected to grow at a faster rate in the future. Till 1998, VSNL was the only ISP in India. This restricted the growth of internet subscriber base in India. After 1998, the subscriber base had grown 5 times to 750,000. This is expected to grow at similar rate in the near future. All these are expected to fuel growth for Lucent products in India.

Prospects for Lucent in India

Lucent is looking towards capturing the huge Indian telecom market. Out of the five private basic telecom providers, four became Lucent customers. In addition, Lucent is also supplying equipments to the Department of Telecom. The growing cellular market offers additional opportunities to the Lucent's operations in India. The Indian economy as a whole, was slated to grow at a very high rate; also the thrust on infrastructure in the reforms had increased, leading to an increase in investment in telecom sector. The growing IT industry needed better telecom services for its outsourcing operations, which needed high bandwidth as well. Lucent, with its expertise in the area of telecom innovations, had been able to capture a large chunk of the telecom products market. The availability of high quality workforce also contributed to establishment of its Bell labs in Bangalore in India. It had the opportunity to tie up with Indian Institutes of Technology. The Bangalore facility has developed software for various multi-media-messaging platforms. They also developed the 3-G mobile network platform. India has emerged as a software hub for many of the fortune 500 organisations. Lucent has been able to leverage this advantage due to its presence in India.

The Road Ahead

There has been a marked slowdown in the US telecom industry and as such, India represents an opportunity for Lucent to keep growing at an increased pace. Also, India gives it an opportunity to hire low cost competitive workforce. This will help the company compete effectively in the international markets, at the same time keeping the cost of its products low. Even though the current political situation is not favourable, the benefits of investments in India far out weigh the costs.

Question

Discuss the business opportunities for a foreign company like Lucent in India, based on the present scenario in Indian economy and telecom industry?

Review Questions

1. Outline the anatomy of Indian Economy with reference to Agricultural, Industrial and service sectors.
2. Discuss the environment in the External sector of the Indian economy.
3. Explain the major developments pertaining to "Infrastructure" in India in the recent past.
4. Critically examine the progress made in social sector in India.
5. Do you think that increase in the contribution of service sector to GDP helps the economy?

Objective Type Questions

1. The salient features of the Indian economy are:
   (a) Pre-dominance of agriculture
   (b) Rapid population growth and unemployment
   (c) Low per capita GDP & capital scarcity
   (d) None of the above
   (e) a, b and c
2. The increasing trade deficit in India was neutralized by a surplus due to:
   (a) Invisibles in the form of services exports and private transfers
   (b) Expansionary Trade Policy
   (c) Fiscal Policy
   (d) Devaluation of Rupee
3. Which of the following was not a stabilisation measure implemented by the government in 1991, to correct the imbalances in the Indian economy:
   (a) Devaluation of currency and convertibility in current account
   (b) Liberalisation of domestic markets
   (c) Cut in government expenditures
   (d) All of the above
   (e) None of the above

4. The principal objecives of India's trade policy defined in the Export-Import Policy are:
   (a) Accelerate country's transition to globally oriented economy and stimulate sustained economic growth
   (b) Increase exports to a maximum and decrease imports to a minimum
   (c) Cuts in Export and Import duties
   (d) None of the above
5. The major threat(s) to India's trade prospects in the coming years are:
   (a) Global oil prices
   (b) Interest rates hike in developed countries
   (c) Volatility of major currencies
   (d) All of the above
   (e) None of the above
6. What is the full form of MRTP?
   (a) Monopoly and Restrictive Trade Practices Act
   (b) Market Research Techniques and Practices
   (c) Monopoly in Rare Items Trade and Practice
   (d) Market Retail Tariffs and Prices
7. Which of the following are the main areas of weakness of the Indian agricultural sector?
   (a) Low level of income in the hands of farmers
   (b) Improper irrigation
   (c) Low level of mechanization
   (d) All of these
8. Co-ordination and cooperation between the centre and the states in the field of education is brough-about through ______________.
   (a) Central Advisory Board of Education
   (b) Central Board of Secondary Education
   (c) National Council of Education Research & Training
   (d) University Grants Commission
9. Before being moved to the list of freely importable goods, products in the system of Resrictive import licensing were shifted to a ______________.
   (a) Duty free goods List
   (b) Watched Imports List
   (c) Tax Free List
   (d) Special Import License (SIL) List
10. Which of the following is not an area of concern for the Indian Economy?
    (a) Poor infrastructure
    (b) Fiscal deficit
    (c) Forex Reserves
    (d) Large amount of Non-Performing Assets in banks
11. A strong Balance of Payment (BOP) position in recent years has resulted in:
    (a) Steady accumulation of Foreign Exchange Reserves
    (b) Low trade and fiscal deficits
    (c) Increasing exports
    (d) Increasing FDIs

12. The severe crisis faced by the Indian Economy in the late eighties was evident from the
    (a) Macro-economic imbalances
    (b) High illiteracy
    (c) High infant mortality rate
    (d) None of these
13. The Foreign Investment Promotion Board (FIPB) revamps rules & regulations pertaining to
    (a) Foreign Currency Exchange
    (b) Accounting Rules for Investment
    (c) Investments by NRIs
    (d) Foreign Investments
14. India abolished the quantitative restrictions on imports of 1429 items in 2000 and 2001 as per commitment to
    (a) General Agreement on Tariff and Trade (GATT)
    (b) World Trade Organization (WTO)
    (c) South Asian Free Trade Association (SAFTA)
    (d) Non-Aligned Movement (NAM)
15. An increase in FDI would bring with it:
    (a) Better technology
    (b) Capital formation and increased productivity
    (c) More imports
    (d) All of the above
    (e) a and b

Class/Field Exercise

Visit the website of Central Intelligence Agency of the US given below.
https://www.cia.gov/library/publications/the-world-factbook/geos/in.html
Analyse the data pertaining to the Indian Economy given on the site mentioned above.

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Answers

Objective Type Questions

1. (e)	2. (a)	3. (b)	4. (a)	5. (a)	6. (a)
7. (d)	8. (a)	9. (d)	10. (c)	11. (a)	12. (a)
13. (d)	14. (b)	15. (e)			

Chapter 5

Globalisation and Business Environment

Learning Objectives

- to outline the phases of globalisation
- to analyse the impact of globalisation on different sectors

Chapter Structure

Section 1: **Globalisation—Meaning and Scope**

Section 2: **Globalisation—Phases and Indicators**

Section 3: **Business Environment—Sectorwise Analysis**

Case: Global Expansion of NIIT, Wipro and Aptech

SECTION 1: GLOBALISATION—MEANING AND SCOPE

Globalisation is the term used to describe the process of removal of restrictions on foreign trade, investment, innovations in communications and transport systems. These changes have encouraged nations to reduce the high levels of protection between countries and to adopt policies to liberalise their economies in order to increase their volume of trade. People are linked together economically and socially by trade, investments and governance. These links are spurred by information, communication and transportation technologies.[1]

Globalisation of the economy means integrating the economy with the rest of the world. This involves dismantling of high tariff walls i.e., reduction of import duties thereby facilitating the transition from a protected economy to an open economy, removal of non-tariff restrictions on trade such as exchange control and import licensing, quotas allowing Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI), allowing companies to raise capital abroad and encouraging domestic companies to grow beyond national boundaries. In the process of globalisation, national economies are integrated in several fundamental ways—through trade, finance, production and a growing web of global treaties and institutions. Both foreign investment and international trade volume have grown rapidly over the last few years. Firms go global as part of their business strategy mainly because of three reasons:

(i) They get access to more markets and customers.
(ii) They can create better 'brand' by way of expansion so that the acceptance at home market also increases.
(iii) There could be a saturation point in the domestic business.

A world economy has existed since the 16th century, based on the development of international trade, foreign direct investment and migration. The engine of the world economy is the national state. However, a global economy has the capacity to work as a unit, in real time, on a planetary scale. Four primary, interrelated factors have driven globalisation in the recent past.[2]

- Increased international trade
- The growth of multinational corporations
- The internationalisation of finance
- The application of new technologies in all these operations, especially computer and other information technologies

Two macro factors seem to underlie the trend towards greater globalisation. They are:

- The decline in trade barriers to the free flow of goods, services, and capital that has occurred since the end of world war.
- The technological change, particularly the dramatic developments that have occurred in recent years in communications, information processing and transportation technologies.

It is interesting to note that globalisation has not been a continuous process. The countries have been back and forth with globalisation and nationalisation.

Multinational Corporations (MNCs): Benefits and Problems to the Host Country

Several factors have contributed for the growth of multinational corporations during the last 20 years.

1. The Economist: Globalisation and its Critics, October 4, 2001, pp. 3–5, London.
2. Jalan, Bimal: Management Challenges in a Globalising Economy, Chapter 6 in India's Economy in the New Millennium, Oxford University Press, 2003, New Delhi.

The important among them are:

(i) Momentum created by the process of globalisation.
(ii) Financial superiorities of MNCs over national companies.
(iii) Technological capabilities of the MNCs

Benefits from the multinational corporations to the host country could be in any of the following ways:

(a) The income level and the investment level increases consequent upon the entry of MNCs.
(b) The host country's industry gets latest technology from other countries through the MNCs.
(c) The host county's business firms and people get to know about best international management practices.

Despite these advantages, it is often said that there could be some problems because of the MNCs. The major problems are:

(a) Since MNCs are not operating within the national territory, their operations affect the sovereignty of the host country government.
(b) Small and medium scale domestic industries find it difficult to compete with MNCs.
(c) MNCs, sometimes, withdraw their capital and shut down their production units suddenly, which create labour problems in the host country.

SECTION 2: GLOBALISATION—PHASES AND INDICATORS

Overall one can identify three distinct stages of globalisation:[3]

- **1870–1914: First Wave of Globalisation**
  Globalisation drivers during this period were:
  - Falling transportation costs
  - Lowering of tariff barriers

  Impact of the first wave of globalisation was reflected on the following parameters:
  - Exports as a share of world income almost doubled
  - Total labour flows nearly 10% of the world population
  - Foreign capital stocks in developing countries increased to 32% from 9% of the national income
  - Growth rate in per capita income of the world increased from 0.5 % to 1.3 % p.a.
- **1914–1945: Retreat to Nationalism**
  Globally, protectionism drove international trade back down due to World War - I.

  The retreat into nationalism produced anti-immigrant sentiment and government imposed drastic reductions on newcomers.
- **1945–1980: Second Wave of Globalisation**
  Globalisation drivers during the post-world war stage (1945–80) were:
  - Lack of growth with protective policies in nationalism
  - Reduction in transport cost
  - Reduction of the trade barriers and tariffs

3. Classification of phases is based on the chapter 'New Wave of Globalisation and its Economic Effects', published by World Bank, World Development Report.

The second wave of globalisation brought about a situation:
- Overall trade doubled
- Economies of scale opportunities for many multinational corporations
- Greater inequality between developed and developing countries

- **1980 onwards: Third Wave of Globalisation**

  This stage is distinctive mainly because of two reasons.

  (a) A large group of developing countries actively involved in global business.

  (b) International migration and capital movements, which were negligible during second wave of globalisation, have become substantial.

  The impact of this wave is visible in terms of:
  - Movement towards Free Trade
  - Creation of a Global Labour Force
  - Economic interdependence among countries
  - Significant increase in cross-border investments
  - Capital flows to developing countries increased over ten times
  - Indian Software industry serves the needs of Europe and American markets
  - China leverages its cost-effective manufacturing to lead consumer goods
  - Globalisation of Financial Markets
  - Interest rates, stock markets, currency values are all interconnected
  - Significant and sustained growth in the world GDP (refer Exhibit 5.1. See Annexure)

Standard Globalisation Menus

There are a few set procedures (menus) listed by the IMF, World Bank and the WTO which outlay how globalisation should be attained in any country. These are listed below:

IMF and World Bank

- Reduction of budgetary subsidies
- Removal of subsidies for agricultural inputs
- Pursuance of liberal economic policies
- Promotion of foreign investment
- Privatisation of the banking sector

WTO

- Pursuance of free trade
- Removal of restrictions on MNCs

Globalisation Indicators

There are some variables that can be considered as the indicators of globalisation. These indicators tell us about the extent of globalisation.

1. Foreign Direct Investments (FDI)

Investment in the real assets like factories, sales offices etc. by foreign firms falls under the category of Foreign Direct Investment. Total inflow of FDI has increased many folds during the last 15 years.

2. Foreign Portfolio Investments (FPI)

Accompanying the FDI boom, foreign portfolio equity investment has also accelerated globally. Cross-border transactions in bonds and equities have soared in most countries, from less than 10% of GDP in 1980 to 150–250% in the recent past.

3. Trade

Since 1983, the pace of world trade has accelerated, reaching an average annual rate of 6 to 7%. This well outpaces the expansion of the world GDP, which has risen at an average of only 3.5% per year. However, the pace of world trade has been slower than the pace of world FDI, which has risen at above 15% per year since 1985.

4. Global Governance by International Organisations like World Trade Organisation

This is clear from the three factors outlined below:

- Deepening economic integration
- Reduction of import duty rates
- Increasing cooperation between countries for foreign investment

5. Business Restructuring—Flexibility and Closeness to Market

For many companies, this new environment of continuous change meant restructuring, and in particular:

- Flexible, just-in-time production systems (to supply a greater variety of goods in smaller lots, and to offer rapid response to market impulses with minimal inventories)
- Moving production closer to the consumer and securing access to the local market (replacing exports with Foreign Direct Investment)
- Diversification of operations (shifting resources out of declining sectors or regions and into promising ones).

Goldman Sachs Economic Research Report[4]

A drastic change in the global economic balance has been predicted by the Goldman Sachs Economic Research report, which forecasts that, by 2050, the BRICs (standing for Brazil, Russia, India and China) economies together could be larger in US dollar terms than the G-6, consisting of the US, Germany, Japan, the UK, France and Italy. This has significant implications for international policymakers and investors.

Let us understand what this report means for India. Higher growth in the economy may lead to higher returns and increased demand for capital. The weight of India in investment portfolios could

4. BRIC Report, Goldman Sachs.

rise sharply. Capital flows might move further in its favour, prompting major currency realignment.

India could become a very important source of new global spending in the not too distant future. Certain estimates suggest that India's economy could be larger than Japan's by 2032 and the BRICs economies taken together could be larger than the G-6 by as early as 2039. This focus on India as an emerging nation is linked more closely to the impact of globalisation, by many economists. However, this is a debatable topic.

SECTION 3: BUSINESS ENVIRONMENT— SECTORWISE ANALYSIS*

Liberalisation Era (1991 Onwards)

Since July 1991, India has taken a series of measures to structure the economy and improve the balance of payments position. The New Economic Policy (NEP–1991) introduced changes in several areas.[5]

The salient features of NEP–1991 are:

(i) Liberalisation (internal and external)
(ii) Extending privatisation
(iii) Redirecting scarce Public Sector resources to areas where the private sector is unlikely to enter
(iv) Globalisation of the economy
(v) Market-friendly state

The effects of globalisation on India will become clearer when we study Indian economy across different sectors. Analysis pertains to nine sectors/industries of the Indian economy. The purpose is to list down the paths to globalisation, the issues faced, and the current happenings and to integrate them with the current budget announcements. The sectors covered are: (i) Telecom (ii) Insurance (iii) Banking and finance (iv) Retail sector (v) Pharmaceutical (vi) FMCG (vii) Textiles (viii) Agriculture (ix) Automobiles.

1. Telecom Sector

The effects of globalisation are very visible in this sector of the Indian economy. This sector has moved from being completely under public control to privatisation and now foreign investment up to 72% has been allowed. Post-Independence, the Indian government had decided that the telecommunication systems would be entirely managed under the public sector. Posts, Telephone and Telegraph (PTT) was instituted in 1947 under the Ministry of Communications. India responded to the emerging wave of globalisation and technology; and introduced first telecom reforms in the 1980s.

In 1984, private companies were allowed to manufacture and market the equipments/instruments. Telecom Commission was set up in 1989. During the 1990s, the next phase of telecom reforms was included in the liberalisation programmes of the economy. In 1991, the telecom equipment manufacturing was de-licensed and value-added services were opened in 1992. Gradually, cellular and basic telephony sectors were also opened up. National Telecom Policy (NTP) was formulated in 1994 which placed emphasis on Universal Service and qualitative improvement in telecom services. Under this policy, the government stimulated domestic private investment and foreign direct investment to cover the huge capital requirements. This helped in further opening up of the telecom sector. But the

*Author Professor Justin Paul co-authored this section with Rahul Dhanuka, his ex student at IIM Indore.

5. Pant, Manoj and Patnayak Manoranjan, 'Does Openness Promote Competition?', Economic and Political Weekly, September 24, 2005.

environment was still highly regulated and the foreign partners were allowed only small stake in the companies (around 29%). This step was not good enough to attract FDI to the telecom sector. New National Telecom Policy, called as NTP 99 was announced in 1999. It allowed the existing operators to shift from fixed-license fee regime to a revenue sharing scheme.

The policy also aimed to increase the competition with a plan to license additional cellular operators. The sector was further deregulated from 1999–2004 and the FDI limit was raised to 49%. This helped in attracting a lot of foreign capital in the sector and telecom reforms were underway in full swing.

Current Developments

In India, government has increased FDI limit in telecom sector from 49% to 72%. This will be a lucrative opportunity for foreign investors and a huge inflow of FDI is expected. However, there is another clause which makes it mandatory for all Indo-foreign partnerships to have an Indian partner with 10% stake. This may limit the expansion plans of a partnership if the Indian firm is not able to produce its 10% share required for expansion plans. Taking another step towards globalisation and market-controlled economy, the government has abolished charges (paid by private operators in lieu of public operators providing infrastructure in rural and non profitable areas. It formed a part of interconnectivity charges). Also the government has stated that they would not provide any fiscal incentive for broadband players, amongst which the largest is BSNL (publicly owned). This will further encourage healthy competition and encourage new foreign investors to enter the telecom sector. However, one appreciable part of the government policy is that it has started opening up the sector only when the local players like BSNL, Reliance, and Bharti have grown strong enough to compete with any new foreign company.

2. Insurance Sector

Insurance sector used to be one of the most regulated sectors of the Indian economy. But the sector has been opened up for the private sector in India, as part of the liberalisation programmes.[6]

Earlier, the general insurance business was nationalised after the implementation of General Insurance Business (Nationalization) Act, 1972. The post-nationalisation general insurance business was undertaken by the General Insurance Corporation of India (GIC) and its 4 subsidiaries. The penetration rate of life insurance in India was only 0.5%. This was partly due to the inefficiencies of the public players.

In 1993, Malhotra Committee, headed by former Finance Secretary and RBI Governor R.N. Malhotra, was formed to evaluate the Indian insurance industry and recommend its future direction. The Malhotra Committee was set up with the objective of complementing the reforms initiated in the financial sector. The reforms were aimed at creating a more efficient and competitive financial system suitable for the requirements of the economy. The committee recommended (in 1994) bringing down the government stake in the insurance companies to 50% and that private companies with a minimum paid up capital of Rs 1 bn should be allowed to enter the industry. One of their most important recommendations was to allow foreign companies to enter the industry in collaboration with the domestic companies.

Hence, it was decided to allow competition in a limited way by stipulating the minimum capital requirement of Rs 100 crores. Also an independent regulatory body was set up to ensure independence of insurance companies. Accordingly, the Government of India liberalised the sector in March 2000

6. Information has been collected from the website of IRDA, Regulatory Authority under Government of India.

with the passage of the Insurance Regulatory and Development Authority (IRDA) Bill, lifting all entry restrictions for private players and allowing foreign players to enter the market with some limits on direct foreign ownership. Under the current guidelines, there is a 26 per cent equity cap for foreign partners in an insurance company. The current players in the life insurance field and their partners are listed in Exhibit 5.2, See Annexure.

3. Banking and Financial Sector

Financial sector can be considered as the most vulnerable sector with respect to globalisation. Indian reforms have taken a step-wise approach in this sector rather than the Big Bang approach like Chile. This means that India has launched reforms in this sector gradually. The content of the reforms has been deregulation, liberalisation of interest rates and pro-market policies. The liberalisation process started in 1990s with 10 new private banks being set up. Two major steps were taken in the direction of financial deregulation and globalisation. First was permitting Foreign Institutional Investors (FIIs) to enter Indian markets e.g., aggregate FII cap (and NRI) raised to 40% from 24% in 1998. FIIs are now allowed to purchase and sell T-bills. Second step was to allow domestic companies to raise capital from abroad. The recent government decision to increase FII limit and the move by several companies to hike their FII investible stake to 49% will surely have positive implications and will prove to be yet another step on the road to globalisation of India.

The banking sector reforms were guided primarily by the recommendations of the Committee on Financial System (Narasimhan Committee, 1991) which related, among others, to (a) reduction in the levels of statutory pre-emptions, (b) dismantling the complex structure of administered interest rates, (c) laying down of capital adequacy requirements; (d) introduction of prudential norms and (e) liberalisation of entry norms for domestic and foreign banks.

At the macro level, first there has been a reduction in the level of banks' reserve requirements. The statutory liquidity ratio (SLR) was reduced from 38.5 per cent in 1991–92 to 25 per cent. Over the years, the average Cash Reserve Ratio (CRR) has been reduced. Secondly, interest rates have been deregulated. The number of administered interest rates on bank advances had been reduced from 20 in 1989–90 to just 2 by 1994–95. Prime Lending Rates (PLR) have declined from 19 per cent in 1991–92 and the benchmark PLR now, in respect of five major banks, is in the range of 9 to 11.5 currently. Interest rates on domestic term deposits have also been deregulated. Liberalisation of Branch Licensing Policy has allowed banks more freedom to plan branch expansion.

Of late, India is slowly but surely moving from a regime of "large number of small banks" to "small number of large banks". The new era is going to be one of consolidation around identified core competencies. Mergers and acquisitions in the banking sector have already become the order of the day. Successful merger of HDFC Bank and Times Bank earlier and Stanchart and ANZ Grindlays have demonstrated that the trend towards consolidation is almost an accepted fact. One can expect such signs in respect of a number of old banks, many of which are not able to cushion their Non-Performing Assets (NPAs), expand their business and induct technology due to limited capital base.

Recent Developments

As part of the move towards full Capital Account Convertibility and to promote the mutual fund industry, the government has been giving more freedom to the mutual fund companies every year. The ceiling on aggregate investment by mutual funds in overseas instruments raised from $1 billion to $2 billion in the Union Budget-2006. Also, the requirement of 10% reciprocal shareholding has been removed [under the norms prevailed, mutual fund companies' choice of foreign company for investment were restricted to companies that directly held atleast 10% stake in a listed Indian company].

The above measures, together with the strengthening of prudential norms and market discipline, and the adoption of international benchmarks to suit India specific needs have served to make the Indian financial sector competitive, viable and resilient.

4. Retail Sector

The Indian retail industry is no more in a nascent stage today. From small street-corner groceries to big super markets—a transition is happening. Though the unorganised sector still holds a dominant position and the organised share today remains about 1.5% of the current Rs. 10,00,000 crores (US $ 245 billion) retail market, which is expected to almost double by 2020, it has been touted as the second most attractive retail investment destination after Russia, in the recent studies. This has been possible only due to the increasing globalisation of the sector and the hordes of MNCs joining the market (Refer Exhibit 5.3, See Annexure).

Recent Developments and their Impact

Despite the huge presence of the unorganised sector, the Indian retail industry is attractive for international players. Moreover, the initiatives taken by the WTO and the Indian government are making the environment conducive to allow the foreign players to enter the industry. Though the Indian retail industry is still a "protected industry", in the Budget 2005, the Finance Minister announced up to 74% FDI both in the organised retail sector as well on the real estate front. The pros and cons of FDI cannot be easily adjudged since on one hand, it will generate employment while on the other, it poses great threat to smaller businessmen. The fear of better quality products at cheaper costs and price-wars cannot be ruled out.

Major consultants and research analysts across the world are also optimistic and willing to wager on the Indian retail boom. A McKinsey report has laid great emphasis on the needs to remove barriers in the growth of organised retailing, which would ensure increase in the efficiency and productivity of all the economic activities. Already bigwigs like Carrefour, Debenhams, Wal-Mart and Target have big plans in India, Germany's Metro Cash & Carry run their operations in Bangalore. These MNCs will bring superior quality, variety and unique value propositions to the consumers, by drawing on their competitive and superior items as they sprawl across the globe.

The Road Map

FDI need not be seen as threat but as a growth engine which can help in filling the resource and technology gaps in the retail segment. The various tax and licensing systems will have to be restructured to ease this movement while at the same time protecting some interests of the regional players. The key to success will lie in building an extensive network of stores across the country so that a wider audience can be reached. Use of electronic tools and technology like e-commerce will be added attractions in this vast populace. These measures, if rightly implemented, would provide a competitive environment for the retail sector.

With growing Internet awareness, rise in incomes and the willingness of the urban people to experiment and taste the way the world shops, the techniques of home shopping, direct mails and telemarketing are fast becoming a reality. It remains to be seen whether the domestic industry lays flowers in the path of the global giants or not.

5. Pharmaceutical Sector

Despite restrictions such as the Drug Price Control Order (DPCO), the Indian pharmaceutical industry has come a long way. But this is where the paradox lies. India has gained so much ground that today drug exports exceed imports. However, even today, India's per capita consumption is the lowest in the world, as only 30% of the population has access to modern pharmaceuticals. India has moved on to become a net foreign exchange earner, and is increasingly making its presence felt in the global pharmaceutical arena through companies like Ranbaxy, Cipla and Dr. Reddy's Laboratories. The MNC market share has dropped to approximately 35% today with the rest being catered by the domestic companies. One interesting aspect of the Indian Drug Policy is that the domestic companies that export, formulations are eligible for duty-free imports of bulk drugs. This causes about $3/5^{th}$ of India's bulk drug requirements to be imported while Formulations represent about 83% of the industry production. Under patent, drugs are primarily sent to developing nations such as China, South Africa, and CIS countries, while the generics go to developed nations. This makes India relatively self-sufficient in the formulation drugs with the exception of certain new and patented ones. The current Indian Formulations market, growing at a rate of 15-16% p.a, is today worth an astounding Rs 90 billion.

Recent Developments and the Impact

A committee headed by Shri R. A. Mashelkar, former chairperson, CSIR, had recommended ways to enhance R&D activity by Indian companies and some of its suggestions were as follows:

- Need to increase cross-border collaborative research practices
- Immediate increase in funding and infrastructure by government for R&D

The WTO decided to enforce a product patent life of 20 years in all countries, causing drug prices to remain high when protected by patents. The major negative fallouts of this decision are—(i) If approval takes, say 5 years, the remaining patented life would be only 15 more years, and this results in hiked prices (ii) Not every R&D project is successful, causing the cost of these failures to be absorbed by the marketed drugs.

The current world drug market is about $ 315 billion with Glaxo SmithKline & Pfizer being the top two companies in this sector. Immediate goals of a developing country should be to—

- Ensure that consumers are not subjected to huge prices and prevent the MNCs from creating cartels.
- Encourage increasing investments in R&D projects from private and public sectors.
- Support low-cost formulation manufacturers and small pharmaceutical companies.

One has to understand and accept that the product patent regime will bring about major changes in the industry, leading to acquisitions and mergers. The companies will move from an age of protection to that of fierce competition. Globalisation will lead towards more internal consolidation and alliance with major players to serve the global customers. Recently, there has been such kinds of tie-ups, one between Ranbaxy and Bayer and another between Dr. Reddy's Lab and Nova Nordisk.

The Road Map

Research and development so far has not been a focus area for Indian companies. In the post-patent regime, this will become a key factor. Indian companies can leverage on this factor as their costs are likely to be 10–20% of such costs in developed countries. The domestic companies can also ride the bandwagon of outsourcing phenomenon by doing contract research and development for the MNCs. Biotechnology opens up further opportunities for them. The firms should look at the opportunities in the generics market as the country already has a stronghold in the formulations category. Given its low cost manufacturing, India could transform into a production centre for these items. All in all, the regime and the industry both will have to adopt a long-term view and play on their strengths to thwart off the international pressures in the shorter run.

6. FMCG Sector

The Fast Moving Consumer Goods or the FMCG sector has been the cornerstone of the Indian economy, taking shape post-Independence and recently emerging as one of the pillars of growth. Generally, FMCG refers to consumer non-durable goods, like toothpastes, soaps and shampoos, etc., required for daily or frequent use. This industry is a low-margin business and here the profitability stems from sheer volumes. These factors, coupled with fierce competition, lay stress on marketing and distribution. The players in this field are not the companies or their employees, but the brands. Brand perception influences purchase decisions and this results in heavy advertising to create and/or retain that perception.

Recent Developments and the Impact

As India opens its doors to globalisation, stipulated by the WTO and treaties, it is exposing itself to a completely new market field. The global corporations look forward eagerly to extend their investments in Indian market. Unilever recently announced its intentions to rename its Indian arm Hindustan Lever Limited, as Unilever India Ltd. which was a surprising move, given the strong reputation HLL enjoys. But these moves are gradual shifts towards consolidation and creating a single identity. Another interesting development in the Indian FMCG sector has been that of brand acquisitions. The Procter & Gamble's acquisition of Gillette and Dabur India's acquisition of Balsara Company in 2005 are the most recent examples. At the same time, the real challenge for all FMCG players is in ensuring that their employees are not poached upon by competitors. This is one of the biggest worries of domestic companies as MNCs have landed on Indian shores with fat paychecks.

Traditionally, the domestic FMCG companies were family businesses and thus shrouded in typical mindsets and this hampered their growth trajectory. Here, the MNCs gain the edge over them. They have extremely good product propositions, professional management and deep pockets to back them. Their global products' portfolio allows them to constantly offer variety and choices to the consumer, at low costs and world quality standards. As a result of lifting of the QRs (Quantitative Restrictions) by the government, the inflow of imported consumer goods has increased manifold, especially from China, and this is a cause of concern for the domestic players. Lifting of the QRs and de-reservation or removal of items from the restricted list of several items, is expected to have adverse impact on Small Scale Industries (SSIs).

The Road Map

In the wake of such developments, the distribution strength of a company would determine success or failure. The fast advent of Internet and the penetration of mobile telephony will expand the horizons of this battlefield. The domestic bigwigs are taking pre-emptive measures by weeding out small or weak brands and putting their plans firmly in place. The mantra is to focus on urban markets for value and on rural markets for volumes. But the biggest barrier lies in the methods to woo the rural consumer who is still evolving. Only companies with resources, unflinching commitment and staying power can win in this ruthless game, now in the international arena.

7. Textile Sector

Besides agriculture, textile and clothing is the only industry, which has a separate and independent agreement, multilaterally negotiated under the aegis of WTO.[7]

The international trade in textile and clothing has transformed significantly owing to the phasing out of the Multifibre Arrangement (MFA- in force from 1 Jan. 1974 to 31 Dec 1994), and with the quota-free trade. Each country/region has become busy preparing its own national/regional strategy for competitiveness in the new scheme of global trade.

Implications for Textile and Clothing Industry

At present, the contribution of the textile industry to GDP is about 4 per cent. The textile industry provides direct employment to about more than 30 million people and is the second largest employment provider in India after agriculture. The contribution of this industry to gross export earnings is about 37% and it adds less than 1.5% to the gross import bill of the country.[8]

- The textile industry is a self-reliant industry from the production of raw materials to the delivery of final products with considerable value-addition at each stage of processing.
- The industry was delicensed in 1991 and under the current policy, no prior government approval is necessary to set up textile mills.
- The per capita cloth availability in the country has increased from 24.1 square metres in 1991 to 30.7 square metres.
- 100% foreign equity participation is allowed in this sector.
- India's cotton textile industry has a high export potential. Cost competitiveness is driving the penetration of Indian basic yarns and grey fabrics in international commodity markets.
- The world trade in textiles and clothing has grown 55 times between 1955 and 1995, whereas Indian exports had grown only by 15 times in the same period.
- Garment is the engine of growth in this sector in the foreseeable future.
- Given that the developed countries are likely to remain deficit countries, in this segment, it is of paramount importance for the developing countries to ensure a meaningful market access to the developed country markets.
- Import of textile has grown remarkably in the last couple of years is a well-known fact.

The export market has become more competitive post-2005, although the opportunities are more in the global market.

The quota phase-out (2005) can be considered an opportunity as well as a threat. And with the emerging trade patterns, the pressure to become globally competitive is stronger than ever before, while the time to attain such global competitiveness is increasingly shorter now.

7. Based on the information collected from the Textile Times, Periodical and Website of Confederation of Indian Textile Industry.
8. Narula Anupam and Mittal, Competitiveness of Indian Textile Industry, edited by Pramod Verma and T R Bishnoi, Wisdon Publication, 2004, New Delhi.

8. Agriculture Sector

Agriculture is a way of life in the most developing countries. Recent changes, especially the technological changes and the processes of globalisation, pose new challenges to the agriculture sector and livelihoods dependent on it.

Major Issues Related to the Agricultural Sector in the Era of Globalisation are as Follows

- Preservation of biodiversity
- Subsidised agriculture
- Import/Export of food
- Shift to cash crops
- Use of water resources and chemicals
- Role of governments and impact of WTO
- Employment in rural areas
- Food Chain: The role of super markets in food supply

Statistics

The important statistics pertaining to the agricultural sector would give you clear idea about the structure and trends in the sector.

Employment of population: around 2/3 of population, Small Farms: 60–70% of total farms, Exports: 21% of total exports

Main Export Products from the Agricultural Sector

The main export products from the agricultural sector are tea, coffee, spices, cashews, basmati rice and seafood, soybean meal, fruits and vegetables, processed food products, and dairy and poultry products.

Main Import Products

The main import products are pulses, rubber, sugar, vegetable oil, rice, wheat, cashew nuts, oilseed, wool, silk, cotton. Various research studies and policy papers highlight that the Indian Agricultural sector faces resource constraints, infrastructure constraints, institutional constraints, technology constraints and policy induced limitations. To achieve sustainable agricultural development, it is essential to combine natural resources, capital resources, institutional resources and human resources. Information Technology and Bio-Technology, which are “the drivers” of globalisation with their complementarities of liberalisation, privatisation and tighter Intellectual Property Rights (IPR) are bound to create new risks of marginalisation and vulnerability in the Indian agricultural sector.

9. Automobile Sector

Automobile industry has universally emerged as an important driver in the economy. This industry currently accounts for nearly 4% of the GNP and 17% of the indirect tax revenue in India.

Automobile Industry in India

The automobile industry in India is nearly six decades old.

Until 1982 Only three manufacturers, M/s. Hindustan Motors, M/s. Premier Automobiles and M/s. Standard Motors. Owing to low volumes, it perpetuated obsolete technologies and was out of sync with the world industry.

In 1982 Maruti Udyog Ltd. (MUL) came up as a government initiative in collaboration with Suzuki of Japan to establish volume production of contemporary models.

In 1993 Delicensing and opening up of the sector to FDI took place due to which 17 new ventures came up.

April, 2004 Removal of Quantitative Restrictions on imports

With the removal of quantitative restrictions on imports in this sector, car manufacturing units were issued licences to import components in Completely Knocked Down (CKD) or in Semi Knocked Down (SKD) form only on executing a Memorandum of Understanding (MoU) with the Director General Foreign Trade (DGFT). 11 companies signed MOUs with DGFT under which they agreed to:

(i) Establish actual production of cars and not merely assemble vehicles;
(ii) Bring in a minimum foreign equity of US \$ 50 Million if a joint venture involved with majority foreign equity ownership;
(iii) Indigenize components up to a minimum of 50% in the third and 70% in the fifth year or earlier from the date of clearance of the first lot of imports. Thereafter the MoU and import licensing will abate;
(iv) Neutralise foreign exchange outgo on imports (CIF) by export of cars, auto components and so on (FOB). This obligation was to commence from the third year of start of production and to be fulfilled during the currency of the MoU. From the fourth year, imports were to be regulated in relation to the exports made in the previous year.

Current Status of Indian Automobile Industry

- India manufactures about 38,00,000 2-wheelers, 5,70,000 passenger cars, 1,25,000 multi utility vehicles, 1,70,000 commercial vehicles and 2,60,000 tractors annually. India ranks second in the production of two-wheelers and fifth in commercial vehicles.
- The new policy has drawn many overseas companies into India but needs to be more investor-friendly, address emerging problems.
- Auto components: It should be possible to achieve an export target of US \$ 2.7 billion per annum. This would require three pronged marketing strategy—exports through OEMs (original equipment manufacturers) for their global sourcing requirements, export to tier I manufacturers as a part of their international supply chain and direct exports.
- Import tariffs on auto-components are kept at approximately 25% in India (Basic customs duty).

Foreign Direct Investment

- Automatic approval for foreign equity investment up to 100% of manufacture of automobiles and component is permitted.

Case: Global Expansion Strategies of NIIT, Wipro and Aptech, based on the New Economic Regime in China[9]

In the past few years, Indian IT service majors have announced aggressive expansion plans in China.

By expanding their presence in China, Indian IT service companies will be able to develop China as a hub, to cater to the needs of clients in Japan, Hong Kong and Korea, while the Indian base would cater to US and European markets. Over a period of time, China will also form a part of the global delivery capabilities of these companies. Thus, the expansion into China can be viewed as a part of the strategy to expand the revenue base for Indian companies.

The domestic market in China is also rather large and is growing at a rapid pace. This provides a great opportunity for Indian companies, as the domestic companies in China are largely fragmented and small. Hence, with the scales that the Indian companies have to offer, they can capture larger shares of these markets.

Economic Outlook of China

The information technology (IT) industry is one of the most lucrative ones in the global economy, with a contribution of nearly a trillion dollars every year, and garners almost $700 billion in taxes. Since this industry is not hampered by geography or availability of natural resources, even developing countries, such as India, can challenge the supremacy of developed countries, such as the United States or Europe. The rapid growth of the Asian and East European markets is expected to further fuel growth of the global IT industry. China is an industry leader in the Asian markets. The Chinese IT industry is driven by a thriving economy and favourable national policies, and is a prime contributor to the economy. The largest IT market in Asia after Japan, China is ranked 51 in the network readiness index of the World Economic Forum.

China's accession to the World Trade Organization (WTO) is expected to give the IT industry, especially the software markets, a further boost. Some of the reforms implemented by the Chinese Government as part of the WTO agreement, include signing of the Information Technology Agreement (ITA), allowing import and distribution of most products into all regions of China, as well as removing quotas, technology transfer and export performance requirements. China has made rapid progress in all spheres for the past 20 years, to become one of the global economic powerhouses. Stable political conditions, a large Chinese market, low interest rates, cheap labour and stable exchange rates have aided this fast growth, making it one of the most attractive destinations for foreign investment. In 2004, China's gross domestic product (GDP) touched 9.5 percent, with a substantial rise in fixed investment levels. Even as inflationary pressures affect the economy, the People's Bank of China is actively responding by adjusting interest rates.

Information Technology Industry

China's spectacular economic success has prompted speculation that the country's software outsourcing industry could soon compete with India's. The number of engineering graduates and software applications professionals has grown considerably in recent years.

9. Dr Justin Paul prepared this case based on the information he collected during his visit to Fudan University, Shanghai and from an Aptech franchisee, next to the Fudan University. Few paragraphs in this Case has been co-authored with Amit Murarka, Hari Narayan, Amit Jain and Abhishek Sharma.

Without adequate scale, Chinese players are unlikely to attract top international clients. In general, smaller companies are riskier and less reliable partners. They are more vulnerable to the loss of key personnel, may not have the financial muscle to survive for the duration of a project, and often don't have the capacity or breadth to absorb large projects easily. Only about 12 percent of Chinese software services providers see mergers, acquisitions and alliances as a priority. Managers in China have little M&A experience, and although the culture tends to favour organic growth, relying on it to counter new competitors isn't realistic. Meanwhile, several Indian companies are considering expanding their operations by acquiring Chinese firms. Fragmentation exacerbates Chinese industry's other problems, including weak process controls and product management. Only 6 of China's 30 largest software companies are certified at levels five or four of the Capability Maturity Model (CMM); by contrast, all of the top 30 Indian software companies have achieved these rankings. Chinese software services providers will also have to manage their talent much better.

With greater size and an improved talent base, Chinese software services companies will be in a better position to address other issues, such as building credible brands in international markets and developing knowledge of specific industries, including finance and pharmaceuticals. Organizational and operational changes are also needed to protect the intellectual property of clients. Last, most companies will have to abandon their project based mentality and adopt a new focus to give clients long term value. China has witnessed tremendous economic growth since 2000, and its accession to the World Trade Organization (WTO) has opened up its economy further, driving more growth, foreign investments and competition. The Chinese ICT industry has been growing at a rate of 20 per cent per annum, higher than the growth rate of the country's gross domestic product (GDP). China has one of the lowest computer production costs worldwide.

Government Policy

The Chinese Government has implemented several policies with an aim to make the country, the world's largest producer of ICT products and services. Tax concessions and permission to foreign participation in research and development (R&D) activities, have attracted substantial foreign direct investment (FDI) in Chinese ICT industry. The 10th five-year plan (2001–2005) emphasised R&D and new product development in the IT industry, with a focus on development of e-commerce solutions and security software packages, based on LINUX. The 11th five-year plan focuses on developing basic software, integrated systems, large key applied software, building next generation Internet projects, as well as making technological breakthroughs in areas such as advanced computing, which consists of computer systems, grid-based computing platforms and commercially producing teraflop computers. The Chinese IT industry is already liberalized to a great extent, and has become competitive after the country's accession to the WTO in 2001. China has also opened up the telecommunications industry to foreign investment. Telecommunication regulations aim to standardise the telecommunications market to ensure the security of telecommunication users. The government permits foreign companies to enter into joint ventures with Chinese telecommunications companies, with upto 49 per cent stake in mobile and fixed line services; in value-added mobile services, these companies can hold a 50 percent stake. De-regularization is expected to increase competition, as foreign participants would find it easier to enter the market.

To promote ICT trade, the Chinese Government exempts the industry from all trade tariffs, and has established more than 50 high-technology free trade zones. The ASEAN-China Free Trade Area (ACFTA) is expected to become operational by the year 2010 and is likely to facilitate free flow of information and technology among the member countries, due to the e-ASEAN agreement.

NIIT's Global Expansion

NIIT, an Indian company, launched its first centre in Shanghai, in cooperation with Pudong Continuing Education Centre (PCEC), education arm of Municipal Government of Shanghai. Taking its initiative forward, NIIT, in 2001, was given permission by Chinese Government to set up a Wholly Owned Foreign Entity (WOFE), thereby enabling NIIT to become the first Indian company to set up professional education centres anywhere in China. After achieving the 100 education centre mark in China in March 2003 quarter, NIIT geared up to further strengthen its presence by evaluating a number of initiatives in China's IT training space, where it works in partnership with local companies, leading universities and Software Technology parks. NIIT is committed to building a large IT manpower pool in China by enhancing the knowledge assets of individuals and organisations. The company would be expanding its reach in China to offer its complete range of IT Training offerings for different segments, using different modes of training.

NIIT has tied up with over 10 leading universities of China for setting up centres within the University campuses. Three of the leading Software Parks have also become NIIT partners, and they are setting up NIIT centres in their parks. NIIT has established its credibility by acquiring prestigious placements for its students in organisations like Fujitsu, IBM, Shanghai Stock Exchange, China Mobile, Bank of Shanghai and Pudong Software Park. It's benchmarked global quality IT education has touched thousands of students in the 25 Chinese provinces. Owing to its long standing presence in China, coupled with over two decades of experience in developing world class IT education curricula, NIIT has fine-tuned its education offerings for the Chinese market, and customised its education offerings to target all segments of IT training in China. Reinforcing its efforts on new curriculum development, as well as usage of new technology for improving course delivery, NIIT has launched the 'e-Tian Tong' curriculum in Mandarin. The unique 'e-Tian Tong' (a Chinese expression which loosely translated means 'the key that opens all learning in the latest technologies') curriculum has evoked considerable interest for high-end, high-quality training in China. NIIT's industry relevant GNIIT and Career Edge education programs have also helped students across the globe, build careers in the IT and non-IT worlds.

NIIT's move into China, that started in 1998, has been followed by successful forays into other Asia-Pacific markets such as Hong Kong, Thailand, Malaysia, Indonesia and the Philippines. The company's vast experience in the IT segment is reflected in its experience in training over 2 million people in 31 countries, backed by its ability to provide solutions in the local language. NIIT's IT education solutions are available in Mandarin, Spanish, French, Arabic, Thai and Japanese. From a company which was focused on the Indian market, to one that is entirely global in its outlook-NIIT's metamorphosis has been complete. Over the years, NIIT has built up a significant global presence through a network of offices in the key markets it addresses. NIIT's professional moorings have led it into a corporate culture that is focused on quality. Quality, in fact, is the mantra that has enabled NIIT to find favor with demanding global customers.

Wipro in China

Wipro Technologies Incorporated, a subsidiary in China, set up a 50-seat development centre in Shanghai in August 2004, to strengthen its position in the Asia-Pacific region, Wipro Shanghai Ltd, the Chinese subsidiary of India's third largest software exporter, was meant to serve as a regional hub for the company's global operations. By opening a subsidiary in China, Wipro joins the league of other software exporters like Tata Consultancy Services and Infosys Technologies, who have a presence in China.

Wipro got a license to do business in China in April, 2004. With an investment of $200,000 in its China operations, Wipro planned to expand its development centre in Shanghai, and open new centres at other locations, as its client base in China grew. Initially, the focus of Wipro's Chinese subsidiary was the company's global customers. It set up a subsidiary and development centre in Shanghai, as many of its global customers wanted to work with it in China as well and assigned management responsibilities to its Japan head. The second phase was the setting up of an offshore development centre. Wipro initially deployed 35 to 40 Chinese-speaking workers from Yokohama, Japan and later on hired Chinese workers for their software centre. This approach is different from what software service rivals, Tata Consultancy Services and Infosys Technologies did, who planned to set up software centres with Chinese workers right from the start.

Wipro hoped that its China operations would also help it in focusing on the huge domestic market and address the needs of its Japanese customers, who have made substantial investments in China. Since most of its basic research and development work is done in India, the China development centre of Wipro was to work on the localisation of software, and provide implementation and support services. While functioning in China, Wipro has faced the problem of Intellectual Property Rights. IPR laws in China are not very strict, and anything that can be copied, is copied. Hence, a workaround has been achieved, and the company passes on only what is absolutely needed, and what is required for local implementation. The whole application is never developed at one place and may even be developed at remote locations.

Another unique issue for Wipro was the cost factor in China; contrary to popular notion working in China was not that cheap. By its own reckoning, China is about 10% to 15% less expensive in terms of programmer cost, but 25% more expensive when it comes to supervisory staff, project lead and project managers, as compared to India. Hence, it was reckoned that the net cost between projects with a 10-person or 20-person team, would be the same.

Aptech in China

In China, Aptech, an Indian company, has a 50:50 joint venture with a Chinese company, Jade Bird. Moreover, Beijing University (called Baida) has a stake in Jade Bird. So, unlike India, where IT education and, by extension, firms like Aptech operate from the periphery, in China, the government seeks them out and embraces them totally. A Beijing University tag is precious to most Chinese students. In five years, Aptech has set up over 200 training schools in 57 different Chinese cities. The joint venture, according to the China Centre for Information Industry Development, had 19 percent of China's IT training market in 2005, up from around 15 percent in 2004. The business itself is growing close to 20 percent annually, with total billings at $40 million. Aptech is not just running IT-training classes through franchisees, it is also re-designing curriculum for several universities. Aptech plugs its two-year course into a three-year university degree in computer science. At the end, students sit for Aptech and University exams, and get twin degrees.

In 2004, Aptech was adjudged the leading IT training organisation in China, according to a study by the Ministry of Information Industry, People's Republic of China. Following this survey, the China Centre for Information Industry Development has proclaimed Baida Aptech as the number one brand in China.

Aptech has also to its credit, the pride of being the first IT training company to achieve the ISO quality certification in China, in the scope of development and service of computer software, education and training management. Aptech is the only IT training company to be acclaimed as one of the most popular IT enterprises in China in 2002, by a survey conducted by China Computer World, along with leading IT companies such as IBM and Microsoft.

IT has been oriented to government bodies, enterprises, industry communities and the society, and offers a complete and comprehensive set of information services. It is widely recognised as one of the largest, most influential and modern China's, top-tier information service conglomerates. It has made a conscientious subdivision of dissemination channels, and opened up world-class services in building a perfect bridge between clients and end-users, both at home and abroad.

Questions

1. Discuss the business environment in the Information Technology Industry in China.
2. Why did Indian companies NIIT, Wipro and Aptech expand globally to China?

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Chapter Summary

Opportunities arising from globalisation: Globalisation would lead to influx of new technology and increase in economic opportunities, and also lead to a greater international competitiveness in many sectors.

Threats: But the fact that it could lead to a rise in unemployment, deterioration in the quality of jobs and also the fact that it could increase the economic and political inequalities are some of the negative issues. For some communities within the country, the transition from a protected, centrally-controlled economy may bring with it serious and negative consequences.

We need to consider the impact of globalisation on the country's economy, society, culture and even its democracy itself. Globalisation can be seen as a process that introduce new structures. At times, the force of globalisation might altogether displace older patterns. It is an open-ended and contradictory process that generates forces working in different, often opposite directions. These forces need to be balanced. One should understand that globalisation is a wave that no country can avoid. Hence, the need of the hour is to capitalize on all the opportunities that this wave brings with it, by leveraging the capabilities.

Review Questions

1. Elucidate the phases of globalisation chronologically.
2. Discuss the indicators of globalisation.

3. Discuss the impact of globalisation on Telecom and Financial sector.
4. Examine the recent developments in retail sector.
5. Discuss the business environment in Pharmaceutical sector and FMCG sector.
6. Analyse the effects of globalisation on the following sectors:
   (a) Textile and clothing
   (b) Automotive sector

Objective Type Questions

1. Globalisation is the term used to describe the process of removal of restrictions on:
   (a) Foreign trade (b) Investment (c) None of these (d) (a) and (b)
2. The interrelated factors that have driven globalisation in the recent past are:
   (a) Increased international trade.
   (b) The growth of multinational corporations
   (c) The internationalisation of finance
   (d) All of the above
3. Globalisation drivers during the first wave of globalisation (1870–1914) were (more than one options may be ticked)
   (a) Falling transportation costs
   (b) Removal of subsidies for agricultural inputs
   (c) Lowering of tariffs
   (d) None of the above
4. Impact of the first wave of globalisation was reflected on:
   (a) Export, as share of world income was almost doubled
   (b) Total labour flows nearly 10% of the world population
   (c) Growth in world per capita income increased
   (d) All of the above
   (e) None of the above
5. Globalisation drivers during the second wave of globalisation (1945–1980) were:
   (a) Lack of growth with protective policies in nationalisation
   (b) Reduction in transport costs
   (c) Reduction in trade barriers and tariffs
   (d) All of the above
   (e) None of the above
6. Which of the following is a World Bank & IMF procedure to attain globalisation:
   (a) Reduction of budgetary subsidies (b) Fall in transport costs
   (c) Pursuance of free trade (d) Removal of restrictions on MNCs
7. Which of the following is a WTO procedure to attain globalisation:
   (a) Pursuance of free trade
   (b) Reduction of budgetary subsidies
   (c) Fail in transport costs
   (d) Promotion of foreign portfolio investment

8. Investment in real assets like factories sales offices, etc., by foreign firms falls under the category of:
   (a) FDI (b) Fll
   (c) None of the above (d) All of the above
9. The salient features of NEP-1991 are:
   (a) Liberalisation (b) Privatisation
   (c) Globalisation measures (d) All of the above
10. Two major steps were taken in the direction of financial deregulation:
    (a) Permitting FIIs
    (b) Allow domestic companies to raise capital from abroad
    (c) None of the above
    (d) (a) and (b)
11. ____________ is the second largest employment provider in India after agriculture
    (a) Transport industry (b) Textile industry
    (c) Chemicals industry (d) Fireworks industry
12. ____________ is a factor for global governance by international organizations like WTO
    (a) Deepening economic integration (b) Reduction of import duty rates
    (c) None of the above (d) All of the above
13. Lifting of Quantitative Restrictions and de-reservations of items from the restricted list will adversely affect the Indian ____________
    (a) Automobile industry (b) Medium scale manufacturing plants
    (c) Textile Industry (d) Small scale industries
14. Which of the following is not an indicator of globalisation:
    (a) FDIs & FPls
    (b) Global Trade—Imports & Exports
    (c) Agreement with Global organisation like WTO
    (d) Business restructuring—through disinvestment
    (e) None of the above

Class/Field Exercise

Experts analyse emerging markets through the use of economic indicators. Market Potential Indicators (MPI) developed by Michigan State University (MSU-CIBER) compare emerging markets on a variety of dimensions. Visit the respective websites and provide a description of the indicators used to construct the Index. Which of the indicators would have greater importance in the era of globalisation from the point of view of foreign companies interested in investing in emerging markets? Study the MPI rankings.

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Answers

Objective Type Questions

1. (d)	2. (d)	3. (a) and (c)	4. (d)	5. (d)	6. (a)
7. (a)	8. (a)	9. (d)	10. (d)	11. (b)	12. (b)
13. (d)	14. (d)				

Annexure

Exhibit 5.1 Growth in World GDP and Exports

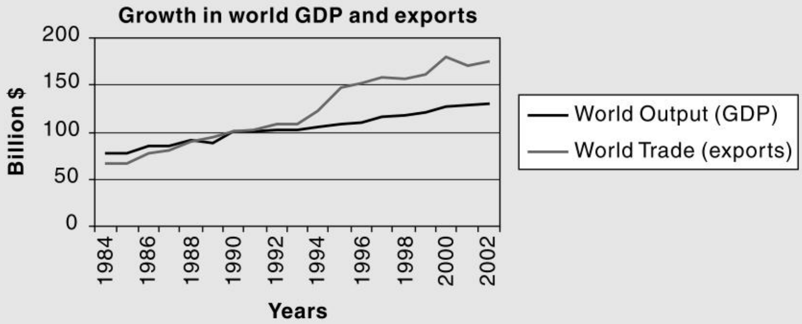

Exhibit 5.2 Major Insurance Companies in India

	Name of the Company and Head office	Partner
1.	Life Insurance Corpn. of India	100% government-owned
2.	Tata-AIG Life Insurance Co. Ltd, Mumbai	AIG
3.	Bajaj Allianz Life Insurance Co. Ltd. Pune	Allianz, Germany
4.	ICICI Prudential Life Insurance Company Ltd. Mumbai	Prudential
5.	OM Kotak Mahindra Life Insurance Co. Ltd, Mumbai	Old Mutual of South Africa
6.	HDFC Standard Life Insurance	Standard Life, UK
7.	Max India Ltd	New York Life, USA
8.	Birla Sun Life Insurance	Sun Life, Canada
9.	SBI Life Insurance	Cardiff, France
10.	ING Vysya Life Insurance	ING, Netherlands
11.	CGNU Dabur Life Insurance	CGNU, UK
12.	Hero PNB Zurich Life	Zurich Life, Switzerland
13.	Sahara India Life Insurance	No Partner
14.	Reliance Life Insurance	No Partner

Exhibit 5.3 International Retailers and their Activity in India

International Retailer	Retailing Activity	Current Status In India
Auchan	Hypermarket	Plan Evaluation
Dairy Farm	Multi-format Retailer	Collaboration with RPG
Landmark	Lifestyle Stores	Operating
Marks & Spencer	Lifestyle Stores	Operating

PART Three

Industrial Policies and Regulatory Structure

The McGraw-Hill Companies

Chapter 6

Industrial Policy

Learning Objectives

- to understand the various industrial policies developed in the post-Independence period and need for the same
- to study the significance of small sector enterprises in the growth of industrial sector
- to understand the various financing sources available to the industry, foreign direct investment, sickness in industries and the way all the above have evolved over the decades

Chapter Structure

Section 1: **Five Year Planning**

Section 2: **Industrial Policy**

Section 3: **Industrial Licensing Policy**

Section 4: **Industrial Policy 1991**

Section 5: **Small Scale Industries**

Section 6: **Industrial Finance**

Section 7: **Competition Policy and Competition Act, 2002**

Section 8: **Foreign Direct Investment**

Cases: Birla Corporation; Eveready Industries India; STI and GAIL

SECTION 1: FIVE YEAR PLANNING

In India, the *First Five Year Plan* (*1951 to 1956*) was formulated against the backdrop of the Second World War and partition of the country. It accorded high priority to agriculture, irrigation and power projects in order to reduce the country's dependence on food grain imports, solve the food crisis and ease the raw material problem, particularly in jute and cotton. Almost 45% of the resources was allocated to agriculture, while industry got a paltry 4.9%.

In the *Second Five Year Plan*, (*1956 to 1961*) which was formulated in an atmosphere of economic stability, agriculture was given a complementary role and emphasis was on industrial sector, especially heavy goods industry. Agricultural programs were aimed at meeting the raw material requirements of the industry, besides meeting the food needs of the increasing population. Industrial sector was perceived as the leading sector which could enable the economy to grow at a rapid pace.

At the time of the formulation of the *Third Five Year Plan (1961 to 1966)*, it was found that the limiting factor in economic growth was the growth in agricultural production. Hence, once again agriculture was given top priority. Also, allocation to power sector was enhanced considerably to 14.6% of the total outlay. Power generation was considered an important factor in ensuring rapid growth of the industrial sector, which could lead to a self sustaining economic growth.

The government was forced to declare a *'plan holiday' for 3 years*, sensing the wave of pessimism that had generated after the failure of the *third plan. Instead of the fourth plan, three annual plans were introduced.* The economy, which was already in the grip of recession, had to grapple with another drought in 1966–67.

At the time of the *Fourth Five Year Plan (1969–70 to 1973–74)*, it was realised that GDP growth and high rate of capital accumulation alone may not help in improving the standard of living or in attaining economic self-sufficiency. Emphasis, therefore, shifted towards providing necessary consumption benefits to the less privileged and weaker sections of the society through employment and education. The plan also aimed at accelerating the momentum of economic development and improving stability of food grain production. During the fourth plan period, the country faced severe inflationary pressures.

The *Fifth Five Year Plan (1974–75 to 1978–79)*, therefore, concentrated on reigning inflation and achieving stability in the economic situation. It also aimed at improving the quality of life of especially the downtrodden section of the economy. Several new economic and non-economic variables, such as nutritional requirements, health and family planning, were incorporated in the planning process.[1]

The Janata Government, which formulated the *Sixth Five Year Plan (1978–79 to 1982–83 and 1980–81 to 1984–85),* sought to achieve higher production targets with concomitant increase in employment opportunities for the poorest section of the society.

The first three years of the *Seventh Five Year Plan (1985–86 to 1989–90)* saw severe drought conditions, despite which food grain production grew by 3.2%. Policies were aimed at rapid growth in food grain production, higher employment levels etc., and several special programs like Jawahar Rozgar Yojana were introduced.

The *Eighth Five Year Plan (1992–93 to 1996–97)* was launched immediately after a severe balance of payment crisis, which was accentuated by the Gulf War in 1990. Several structural adjustment policies were introduced in order to put the country on a higher growth path and remedy the precarious balance of payments situation. These included a substantial devaluation in the value of

1. Prepared based on the information collected from the Planning Commission website and documents.

rupee, dismantling of licensing requirements, reducing trade barriers, reforms in the financial sector and tax systems.[2]

It was found in the eighth plan that though the economy performed well, the benefits did not percolate down to the poor and disadvantaged sections of the economy. The key task in the *Ninth Five Year Plan (1997–98 to 2001–02),* therefore, was to improve the living conditions of the poor and provide them with adequate employment opportunities. The ninth plan made serious efforts to raise the level of agricultural and rural incomes and target programmes at small, marginal farmers and landless labourers. The plan also aimed to check the growth rate of population.

The *Tenth Five Year Plan (2002 to 2007)* was formulated keeping in line with the Prime Minister's vision of doubling per capita income in the country and creating 100 million employment opportunities in the next ten years.

SECTION 2: INDUSTRIAL POLICY

The concept of 'industrial policy' is comprehensive and covers all those principles, policies, rules and regulations that control the industrial undertakings of a country and shape the pattern of industrialisation. It incorporates fiscal and monetary policies, tariff policy, labour policy and the government's attitude not only towards external assistance but also towards the public and private sectors.

Industrial Policy Resolution, 1948

In reference to the Industrial Policy Resolution of 1948, government recognised the need for a mixed economy and **reserved national monopolies only for atomic energy, and rail & road industries.**

While many industries held by private firms could continue, the government had the exclusive rights to initiate projects in six other industries—coal, iron and steel, aircraft manufacturing, shipbuilding, telephone and telegraph, and minerals. Yet it could seek the aid of the private sector if necessary. Moreover, the government could regulate and license 18 other industries of national importance.

The main thrust of the (1948) industrial policy was to lay the foundation of a mixed economy in which both private and public enterprises could march hand in hand to accelerate the process of industrial development.

Industrial Policy Resolution, 1956

After the adoption of the 1948 resolution, significant development took place in India. Economic planning proceeded on an organised basis and the first Five Year Plan was completed. Also, Parliament accepted 'the socialist pattern of the society' as the basic aim of social and economic policy. These important developments necessitated a fresh statement of industrial policy. Hence, a second Industrial Policy Resolution was adopted in April, 1956 replacing the Resolution of 1948.

The resolution laid down three categories, which bore a close resemblance to the earlier classification, but were more sharply defined and broader in coverage as to the role of the state. The categories were:

2. *Source:* Information collected from Articles, mainly Dandekar, Forty years after independence Indian Economy, edited by Bimal Jalan, Penguin, 1902.

Schedule A

Those which were to be exclusive responsibility of the state.

Schedule B

The industries which were to be progressively state-owned and in which new enterprises were generally set up by the state while the private enterprise were expected only to supplement the effort of the state; and

Schedule C

All the remaining industries and their future development would, in general, be left to the initiative and enterprise of the private sector.

In spite of this clear-cut grouping of industries under the three schedules, these categories were not water-tight compartments and room for exceptions could be made. Other features of the resolution were:

- Fair and non-discriminatory treatment for private sector.
- Encouragement to village and small-scale enterprises.
- Removing regional disparities.

In a nut shell, the Industrial Policy of 1956, for the first time, **emphasised on the role of small-scale industries in the development of the national economy**. The statement pointed out the **importance of the SSI Sector in providing employment**. It also laid emphasis on the equitable distribution of national income and the effective mobilisation of resources. The industrial policy, therefore, recommended the development of ancillary industries in areas where large industries were to be set up.[3]

Industrial Policy Statement, 1977

In December 1977, the Central Government announced a new industrial policy by way of a Statement in the Parliament. The industrial policy, despite some desirable elements, resulted in certain distortions viz., “Unemployment increased, rural-urban disparities widened and real investment stagnated. On an average, the growth of industrial sector was not more than three to four per cent per annum. The incidence of industrial sickness also become widespread.”

The thrust of the Industrial Policy Statement of December 1977 was on effective promotion of Cottage and Small Industries widely dispersed in rural areas and small towns. It emphasised that “whatever can be produced by small and cottage industries must only be so produced.”

The focal point of development of small-scale industries was taken away from the big cities to districts. **The concept of District Industries Centers was introduced for the first time.** Each district would have such a district centre which would extend all the support and services required by small entrepreneurs. These included economic investigation of the districts, supply of machinery and equipment, raw material and other resources, arrangement for credit facilities, call for quality control, research and extension, and so on.

3. These historical facts have been sourced from the publications of the Government, specifically, Ministry of Industries & Commerce.

To ensure that no unit of business group acquired a dominant or monopolistic position in the market, large industrial houses were to rely on their own internally generated resources for financing new projects or the expansion of the existing ones.

Within the SSI sector, a new concept of tiny sector was introduced. It was defined as an industrial unit with investment in machinery and equipment of up to rupees one lakh and situated in a town with a population of less than 50,000 as per the 1971 census. This tiny sector was to be given special attention and helped by way of provision for margin money assistance.

The policy statement considerably expanded the list of reserved items for exclusive manufacture in the small-scale sector. This concept, recommended by the Karve Committee, was introduced in 1967 with 47 products. The list of such reserved items was 504 till 1977. The 1977 policy expanded this list to 807. [Industrial Policy Statement, 1977, Government of India]

Industrial Policy of 1980

The Industrial Policy Statement of 1980 focused on the need for promoting competition in the domestic market, technological upgradation and modernisation. The policy laid the foundation for an increasingly competitive export base and for encouraging foreign investment in high-tech areas. The policy, therefore, suggested the following measures:

- Effective operational management of the public sector.
- Integrating industrial development in the private sector.
- Regularisation of unauthorised excess capacity installed in the private sector.
- Encouragement of merger and acquisition of sick units.

The industrial policy (1980) was guided merely by considerations of growth. It liberalised licensing for large and big businesses but by blurring the distinction between small-scale and large-scale industries. It sought to promote the latter at the cost of the former. Broadly speaking, the Industrial Policy chose a more capital-intensive path of development and thus, it underplayed the employment objective.[4]

SECTION 3: INDUSTRIAL LICENSING POLICY

Industries (Development and Regulation) Act, 1951

The industries (development and regulation) Act was passed in 1951 to implement the Industrial Policy Resolution of 1948.

The important provisions of the Act were:

- No new industrial units could be established or substantial extension to existing plants be made without a licence from the Central Government.
- Government could take under its own management undertakings which failed to carry out its instructions for improvement in management and policies.
- This act also empowered the government to prescribe prices, methods and the volume of production and channels of distribution.
- The act empowered the government to set up Development Councils for groups of industries.

4. Dutt and Sundaram, Indian Economy; and Saleem, Shaikh, Business Environment, Pearson Education, may be seen for further information.

New Licensing Policy and Procedures, 1970

In February 1970, the government announced its new industrial licensing policy. It accepted the recommendation of the Industrial Licensing Policy Inquiry Committee that there should be a list of core industries in the economy, which would consist of:

- Agricultural inputs
- Iron and steel
- Non-ferrous metals
- Petroleum
- Coal
- Heavy industrial machinery
- Ship building and dredgers
- Newsprint and electronics

Liberalisation of Industrial Licensing after 1980

The industrial policy of 1980 made a sea change in terms of liberalisation of licensing policy in favour of large business houses, particularly in terms of making them free from the provisions of MRTP Act. The major changes introduced were as follows: [See Chapter 14 for more information on MRTP Act. Also, Section 7 in this chapter.]

- Liberalisation of licensed capacity
- Relaxation of industrial licensing
- Industrialisation of backward areas.

SECTION 4: INDUSTRIAL POLICY (1991)

The central government led by the then Prime Minister Mr Narasimha Rao announced the new industrial policy in July 1991. As an aftermath of previous policies and some unstable politics, India's economy was on the verge of collapse at that point of time.[5]

It must be noted that the reforms announced in 1991 were not completely contradictory to the general trend in policy. Concerns about the lack of competitiveness of Indian industry and consequent poor export performance (and poor growth record compared to the East Asian economies that had focused on export-led growth) had led to some liberalisation of both the licensing and trade policies in the late 70s and 80s. However, **the reforms in 1991 did make significant changes in industrial, trade and public sector policies.** Growth rate in India as incident from the policies being followed before and after 1991 can be compared with each other from **Table 6.1.** Some significant changes in industrial policies announced in July 1991 are summarised below:

- Abolished licensing for all projects except in 18 industries.
- *MRTP Act* amended to eliminate prior approval to large companies for capacity expansions.
- The requirement of Phased Manufacturing Programs (PMP) discontinued for all new projects.
- Schedule A of industries reserved exclusively for state enterprises cut down from 17 to 8.
- Schedule B of industries, where state enterprises were to acquire a dominant position, abolished.
- Small scale enterprises allowed to offer up to 24 per cent of shareholding to large enterprises.

5. Summary of the News item in the Economic Times, based on the Report presented by the then Prime Minister Narasimha Rao, in 1991.

Table 6.1 Industrial Growth Rates in India, for last 25 years

Year	Index Numbers of Industrial Production (Growth Rates) in India (1981-1982 to 2004-2005)			
	Mining and Quarrying	Manufacturing	Electricity	General
Base: 1980-81 = 100				
Weight	11.46	77.11	11.43	100
1981–82	17.7	8	10.2	9.3
1982–83	12.4	1.3	5.7	3.2
1983–84	11.8	5.7	7.6	6.7
1984–85	8.8	8	12	8.6
1985–86	4.1	9.7	8.5	8.7
1986–87	6.2	9.4	10.3	9.2
1987–88	3.7	7.9	7.6	7.3
1988–89	7.9	8.7	9.5	8.7
1989–90	6.3	8.6	10.9	8.6
1990–91	4.5	8.9	7.8	8.2
1991–92	0.6	–0.8	8.5	0.6
1992–93	0.6	2.2	5	2.3
1993–94	3.5	6.1	7.5	6
1994–95	7.5	9.8	8.5	9.4
1995–96	7.4	13.6	8.1	12.1
1996–97	0.4	8.6	3.9	7.1
1997–98	4.9	3.6	6.9	4.2
Base: 1993-94 = 100				
Weight	10.47	79.36	10.17	100
1994–95	9.8	9.1	8.5	9.1
1995–96	9.7	14.1	8.1	13
1996–97	–1.9	7.3	4	6.1
1997–98	6.9	6.7	6.6	6.7
1998–99	–0.8	4.4	6.5	4.1
1999–00	1	7.1	7.3	6.7
2000–01	2.8	5.3	4	5
2001–02	1.2	2.9	3.1	2.7
2002–03	5.8	6	3.2	5.7
2003–04	5.2	7.3	5.1	6.9
2003–04	4.1	6.5	2.5	5.9
2004–05	5.2	8.2	7.7	7.9

Source: Compiled from Annual Issues of Economic Survey, Govt of India.

As far as **foreign direct investment** regulations were concerned, following changes were made:[6]

- Limit on foreign equity holdings raised from 40% to 51% in a wide range of industries.
- Foreign equity proposals need not be accompanied by Foreign technology transfer agreement.
- Procedures for foreign direct investment streamlined by creating a Foreign Investment Promotion Board to consider individual applications case-by-case.
- Technology imports liberalised by increasing royalty limits.

From **public sector policy** point of view, following changes were made:

- List of industries reserved for the public sector (Schedule A) reduced from 17 to 8.
- List of sectors reserved for dominance by public sector (Schedule B) effectively abolished.
- Disinvestment in selected public sector enterprises to raise finances for development, bring in greater accountability and help create a new culture in their working for improved efficiency.
- Government equity ranging from 5% to 20% in 31 PSEs (Public Sector Enterprises) with 'good track record' disinvested to public sector mutual funds and financial institutions.

As far as **trade policy** is concerned, following changes were made in the 1991 Industrial Policy:

- Administered licensing of imports replaced by import entitlements linked to export earnings. These entitlements called exim scrips made freely tradable.
- Exim scrips can be used for all OGL* items for actual users, limited permissible list, non-sensitive canalised list and non-OGL capital goods not in the restricted list.
- Permission to import capital goods without 'indigenous clearance' provided import covered by foreign equity or was 25% of the value of plant and machinery (subject to a limit of Rs 200 million).
- Scope of canalisation narrowed.
- Short-term import compression measures (such as interest surcharge on bank credit and cash margin on import payments) introduced.

As far as environmental issues are concerned, following changes were brought about in India.

(i) Pollution control has assumed a significant role and commensurates with industrial expansion, and now a strong regulatory mechanism is required to ensure minimum environment standards to achieve this objective. A total of 2,155 pre and post 1991 units of 17 categories have been identified for this purpose by the CPCB (Central Pollution Control Board).

(ii) In order to strengthen the environmental management capacity at national, state and local levels, the ministry had launched an Environment Capacity Building project in 1997.

(iii) The government has also come up with a comprehensive national **environment policy**. The policies of the government are being implemented through various Acts such as the Wildlife (Protection) Act, 1972, the Water (Prevention and Control of Pollution) Act, 1974 and the Water (Prevention and Control of Pollution).

6. Nagraj R (2006): Foreign Direct Investment in India, Trends and Issues (Ed., Raj Kapila & Raj Uma, Economic Developments in India, Vol 100.

*OGL stands for Open General License. Items placed under OGL can be freely imported and exported. They do not fall under Restricted List or Special Import License list.

SECTION 5: SMALL SCALE INDUSTRIES (SSI)

The concept of Small Scale Industries (SSIs) was brought to fore by the Industrial Policy Resolution, 1956. The various arguments that were put forward for the SSIs were as follows:[7]

1. More Employment per Unit of Capital

The emergence of SSI was propagated through the principle of self employment. Small enterprises are labour-intensive and thus create more employment per unit of capital. Even as SSIs have low output employment ratio than the large sector, its employment generation capacity has been found to be 8 times that of the large sector.

It is not only the employment but also the productivity per unit of capital in SSIs which have been found to be higher than that of large sector.

2. Ensures More Equitable Distribution of Wealth

Also, it was found that income generated by SSIs are more widely dispersed in the community than the income generated in a few large enterprises.

3. Regional Dispersal of Industries

Large enterprises are normally concentrated in the metropolitan cities. However, the industrialisation of a country can be completed only if it permeates into the remote corners of the country. Hence, the development of SSIs has been given major thrust in all the industrial policies.

Various industries such as watches, food processing, animal feeds and textiles were reserved under the SSIs.

Over the years, significant support was given to the SSI sector and village industries in the five years plans. A summary of this is as follows:

Table 6.2 Allocation of Resources for SSI Sector Under Plan Periods

Plan	Allotment
First Plan	Rs 42 crores allotted to SSI and village industry
Second Plan	Rs 187 crores allotted to SSI and village industry
Third Plan	Rs 241 crores were spent on the SSIs
Annual Plans (1966–69)	Rs 132 crores were spent on the SSIs
Fourth Plan	Rs 251 crores allocated
Fifth Plan	Rs 388 crores allocated
Sixth plan	Rs 1952 crores allocated
Seventh plan	Increase in production with very high annual average growth rate achieved
Eighth Plan	Provided growth impetus in infrastructure facilities, financial support measures, etc.

7. Ministry of Small Scale Industries document, Government of India.

SSIs have been handicapped due to an inequitable allocation of scarce raw materials and imported components, lack of provision of credit at low interest rate, low technical skill and managerial ability and lack of marketing contracts. This resulted in sickness of SSIs.

To overcome these problems several steps had been taken:[8]

(i) Financial Support Measures

Inadequate access to credit has been a problem for the Small Scale Sector. To address this, following steps were taken:

- Allowed equity participation by other industrial undertakings in the SSI, not exceeding 24 per cent of the total shareholding. This encouraged modernisation and technological upgradation. Further, such a step was taken in order to boost ancillarisation and sub-contracting.
- Setting up of factoring services through Small Industries Development Bank of India (SIDBI) so that it takes the responsibility of collecting the payments.
- SIDBI has set up a small and medium enterprise (SME) fund of Rs 10,000 crores, to address the problems of inadequacy of financial resources at highly competitive rates for SSIs.
- RBI enhanced the composite loans limit for SSIs from Rs 25 lakhs to Rs 50 lakhs, delegated more powers to Bank branch managers for granting ad-hoc facilities to the extent of 20 per cent of the limit sanctioned, strengthening recovery mechanism, imparting special training to bank personnel for appraisal of small projects, opening of special SSI branches, making customer grievances machinery more transparent and simplifying the procedure of handling complaints.
- Laghu Udyami Credit Card Scheme has been liberalised with enhanced credit limit of Rs 10 lakhs for borrowers with satisfactory track records.
- Selective enhancement of Investment in plant & machinery has been carried out in respect of 13 items in stationery sector and 10 items of drugs sector.
- 417 SSI specialised bank branches have been made operational throughout the country.

(ii) Infrastructural Facilities

To extend help to SSIs in infrastructure, following steps were taken:

- Under Small Industries Development Organization (SIDO), a Technology Development Cell (TDC) was set up to provide technology inputs to improve productivity and competitiveness of the products of the small scale sector. TDC also interacted with other industrial research and development organisations for the above.
- It also aims to help SSIs obtain ISO 9000 certification.
- Efforts of state governments in this area are being supplemented through a Plan Scheme 'Integrated Infrastructure Development' (IID) for providing infrastructural facilities to SSI units in rural and backwards areas.
- Various steps have also been taken by SIDBI for technology upgradation.
- NSIC (National Small Industries Corporation) registers SSI units under Single Point Registration scheme for participation in Government purchases.

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8. *Source:* Ministry of Small Scale Industries, Government of India.

(iii) Marketing and Exports

The marketing activities were given focus in the recent years. Some of them were

- National Small Industries Corporation focused on the marketing of mass consumption items under common brand name.
- SIDO has been supporting the small sector in tapping the exports market

Various organisations have been set up to support the SSIs. For the complete list, refer to the Exhibit 6.1 given in the Appendix of the chapter.

For lowering the competition for SSIs from large scale enterprises and to provide them with a conducive environment for growth, 47 items were reserved for SSIs. Later in 1984 they were increased to 873 items. Recently the list has been brought down to 675 items.

Future Outlook

Due to phasing out of Quantitative restrictions as per the WTO policy, it has become important that the small industries technologically upgrades itself. Also to sustain SSIs profitably, continued support in the form of credit facilities, infrastructure provision, etc. is also needed.

The Ministry of SSI had recommended that import tariff should be fixed as near the bound rates as possible, so that SSI units are able to upgrade themselves technologically.

However, despite all these changes the contribution of SSIs continue to remain significant to the industrial GDP and due to the potential of the SSIs to provide employment in the wake of low capital availability, it shall continue to remain a major contributor to the industrial sector in terms of output and employment.

Sickness in the Industrial Sector

Sickness in the Industrial sector is attributed to a number of factors like inefficiency in management, over-ambitious projects, dispute among partners and non-availability of credit which is one of the major factors responsible for rendering SSI units sick. Government of India has taken various measures from time to time to detect sickness at the incipient stage and rehabilitate sick units in the small scale sector. Nayak Committee, set up by the Reserve Bank of India in 1991 dealing with aspects of adequacy and timeliness of credit to SSIs, had studied the issue of sickness in detail. Reserve Bank of India had taken action based on its recommendations which relate to modified definition of sick SSI units, reduced rate of interest for rehabilitation, prompt viability studies/nursing programmes of identified sick units, setting up of cells at important regional centres and Head Office to deal with sick industrial units and provision of expert staff, including technical personnel to look into technical aspects.

The incidence of Industrial sickness in India has grown from traditional industries like cotton, textiles, jute and sugar to other important industries like engineering, chemicals, rubber and cement.

An SSI in India is considered as sick if:[9]

1. Any one of the borrowal accounts of the unit remains sub-standard for six months i.e. principal or interest in respect of any of its borrowal accounts has remained overdue for a period exceeding one year;
2. There is erosion in the net worth due to accumulated losses to the extent of minimum 50% of peak net worth during the previous accounting year; and
3. The unit has not been in commercial production for at least three years.

9. Nayak Committee Report on Adequacy and timeliness of Credit to SSIs, Reserve Bank of India, 1991.

The Board for Industrial and Financial Reconstruction (BIFR) is assigned with the responsibility of hearing cases that apply for being declared 'sick' and deciding whether or not the unit deserves to be termed "sick." The BIFR is also the authority that approves takeover of a sick unit.

SECTION 6: INDUSTRIAL FINANCE[10]

The major sources of industrial finance include money raised through capital market, bank credit and foreign direct investment. Capital market consists of: (i) debt capital market (ii) equity capital market. The mechanism of how capital market contributes towards the development of industrial sector and the trends have been covered in this section.

Debt Capital Markets

Debt markets in India have suffered from neglect on the part of policy makers, despite the fact that there is clear evidence of fairly strong debt preference among households for their financial investment portfolio. Very little has been done to create an efficient and developed debt capital market. In fact, the debt markets in India is limited to a few brokers and institutional investors, with very inadequate provisions for active participation of the small investors.

Thus, the Indian debt market is more or less restricted to a fairly small set of domestic institutional investors, all of whom are probably driven by roughly the same needs and expectations.

Equity Capital Markets

A precedent for successful implementation of policies for financial sector development in India was set during the 1990s in the process of creating a viable and competitive equity capital market. Prior to these reforms, the equity markets suffered from many ills that the debt markets suffer from today.

This targeted and focused prioritisation on the part of policy makers led to a welcome and rapid turnaround in the equity capital markets.

Transformation over Last Decade

The Indian capital markets have **witnessed a transformation over the last decade**. India is now placed among the mature markets of the world. Key initiatives in recent years include:

- The depository and share dematerialisation systems.
- Replacing the forward trading mechanism with rolling settlement to bring about transparency. The IT-driven National Stock Exchange (NSE) with a national presence (for the benefit of investors across locations) and other initiatives to enhance the quality of financial disclosures.
- Corporatisation of stock exchanges.
- The Securities and Exchange Board of India (SEBI) has effectively been functioning as an independent regulator with statutory powers.
- Indian capital markets have rewarded Foreign Institutional Investors (FIIs) with attractive valuations and increasing returns.

10. Author Justin Paul acknowledges the help received from Preeti Agarwal for writing this section.

- The Mumbai Stock Exchange continues to be the premier exchange in the country with an increase in market capitalisation from US $40 billion in 1990–1991 to over US $200 billion in the recent past. The stock exchange has about 6,000 listed companies and an average daily volume of about a billion dollars.
- Many new instruments have been introduced in the markets, including index futures, index options, options and futures, in select stocks.

The Road Map

There are some common features that contribute significantly to the efficient characteristics of capital markets. These are given below:

Transparency

The market's functionality needs to be transparent both to the entity issuing the security and the investors.

Regulatory Effectiveness

The regulatory mechanism is key to fair pricing of securities. Without effective regulation, transparency will remain a dream. This function comes in the domain of the Department of Company Affairs, and especially the Registrar of Companies, under the central government.

Autonomous Credit Rating Agencies

Credible professional credit rating agencies that are autonomous are required to rate organisations and their securities. The condition of autonomy is important for credibility purposes. The major issues relate to the accessibility of the credit rating information and to the perceived autonomy of the agencies.

Liquidity

Liquidity is perhaps one of the most important requirements for an efficient, developed capital market. This, in turn, requires an efficient settlement system; and the existence of multiple market makers. To some extent, the issue of an efficient settlement system has been addressed by the shift to rolling settlements in the equity markets.

Legal System

A functioning legal system that all parties have faith in is another critical component. Without a viable legal infrastructure in place, it is very difficult to build investor confidence.

SECTION 7: COMPETITION POLICY AND COMPETITION ACT, 2002

The MRTP Act, 1969 was enforced in the era of licences, permits and controls. Monopoly in trade and industry was regarded as bad in law. Public interest and consumer welfare were at the core of the objectives of the said Act. The provisions of the Civil Procedure Code, 1908 (CPC) were fully applicable as and when required.

Except for orders directing a respondent to 'cease and desist' from the alleged monopolistic, restrictive or unfair trade practices, the Commission could not impose penalties for breach of law; no other penalty or fine could be imposed either.

Several amendments were made of which the prominent ones was in 1991. The major changes in the 1991 ammendment are given below:

- Chapter dealing with Mergers & Acquisitions was deleted (i.e., Mergers were permitted).
- Also, award of compensation to a petitioner was added during pendency of a regular enquiry proceeding of Restrictive Trade Practice Enquiry or Unfair Trade Practice Enquiry.
- PSUs (Public Sector Undertakings) statutory corporations, undertakings under the management or authorised controller appointed under any law, co-operative society and financial institutions—all were brought within the purview of the MRTP Act.

However, these amendments acted as stepping stone in broadening MRTP Act which was completely attained through the introduction of Competition Act, 2002, along with repealing of MRTP Act, 1969.

The Competition Act's theme areas are:

- Prohibition of anti-competitive agreements;
- Prohibition of abuse of dominant position;
- Regulation of combinations;
- Competition Advocacy

Basic objective of the competition policy is to protect and preserve competition as the most appropriate means of ensuring the efficient allocation of resources—and thus efficient market outcomes—in free market economies.

The main differences in both the acts are as follows:

- Every order passed by the Competition Commission is appealable whereas under the MRTP Act, orders could not be challenged before the Appellate Authority.
- Review of Orders and Rectification of Orders have been separated in Competition Act whereas in MRTP Act though power to rectify orders was available, this power was also exercised for 'review' of the orders passed by the Commission.
- Anti-competitive practices committed overseas but having effect in India have been covered under the Competition Act whereas though MRTP Act recognised this, there were no enabling provisions to enter into agreements with foreign agencies.
- Competition Commission can impose fines besides 'cease and desist', however, earlier no fines could be imposed and instead a notice of 'contempt' was issued.
- 'Predatory price', 'cartel', 'relevant market', 'relevant product market' etc. terms have been specifically defined in the new Act whereas these important definitions were not available in the earlier Act.

The above differences show that the Competition Act covers in its ambit all the contemporary issues, the anomalies in MRTP Act stand corrected and most importantly it aims at facilitating the efficient allocation of resources rather than being restrictive in nature.

SECTION 8: FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment refers to investment in real assets like factories, sales offices, distribution channels etc. by foreign enterprises. Equity investment exceeding 10% of stake in a company by a foreign investor with long-lasting interest is also known as FDI [as per US Deptt. of Commerce definition].

The economic model followed by India after independence relied on import substitution and selective foreign capital inflow, both through portfolio investment and the Foreign Direct Investment (FDI) route. This changed radically with the liberalisation measures announced in 1991.

Both portfolio and FDI were not only allowed but also actively encouraged. The Foreign Investment Promotion Board (FIPB) was created to approve FDI proposals. Similarly, the Reserve Bank of India gives automatic approvals for foreign direct investment in industries, particularly in the infrastructure sector.

During the 1990s, the 'ceilings' on FDI in different sectors were progressively raised and presently, 100 per cent foreign investments is allowed in several industrial sectors.

Modes of Foreign Direct Investment

FDI can enter India through two channels:

- The automatic route under which companies receiving Foreign Direct Investment need to inform the Reserve Bank of India within 30 days of receipt of funds and issuance of shares to the foreign investor.
- For sectors that are not covered under the automatic route, prior approval is needed from the Foreign Investment Promotion Board (FIPB).

The key foreign direct investment policy changes from 1991 to date are given in Exhibit 5.4 (Appendix).

FDI Growth in India

FDI inflows in India have increased manifold in the post liberalisation phase. There has been a huge increase in the number of FDI approvals and the amount of FDI received. The FDI inflows have increased many times between 1991 to 2008. Exhibit 6.3 provides the details (Appendix).

FDI permitted on Various Sectors According to the FIPB Regulations (per cent)

Automobiles	100
Telecom	72
Electricity generation, transmission and distribution (except nuclear power)	100
Roads and Highways	100
Ports and Harbors	100
Civil Aviation (in Greenfield airport ventures)	100

Multilateral agencies such as the World Bank, the Department for International Development (DFID), Japan Bank for International Cooperation (JBIC) and Asian Development Bank (ADB) have financed projects in India across infrastructure sectors such as power, roads and highways, telecom and irrigation.

Source: Compiled from the Economic Survey, Ministry of Finance, Government of India, 2004, 2005 & 2007 issues.

China and India–What Explains their Different FDI Performance?

It is important to understand the reasons why China has been so successful in obtaining FDI.

Even today, FDI is estimated to account for less than 10% of India's manufacturing exports. For China, the lion's share of FDI inflows are to a broad range of manufacturing industries. Meanwhile, for India, services, electronics and electrical equipment and engineering and computer industries get a major share of the FDI.

China's total and per capita GDP are higher, making it more attractive for market seeking FDI. Reasons for high FDI in China:

- Higher literacy and education rates suggest that its labour is more skilled, making it more attractive to efficiency-seeking investors.
- China also has large natural resource endowments.
- China's physical infrastructure is more competitive, particularly in the coastal areas.
- China has more "business-oriented" and FDI-friendly policies than India.
- China's FDI procedures are easier, and decisions can be taken rapidly.
- China has more flexible labour laws, a better labour climate and better entry and exit procedures for business. China opened its doors to FDI in 1979 and has been progressively liberalising its investment regime. India allowed FDI in 1980s in some sectors, but did not take comprehensive steps towards liberalisation till 1991.

However, India may have an advantage over China in technical manpower, particularly in information technology. It also has better English language skills.

The two countries focused on different types of FDI and pursued different strategies for industrial development. For long, India followed an import-substitution policy and relied on domestic resource mobilisation and domestic firms encouraging FDI only in higher technology activities.

Some of the differences in competitive advantages of the two countries are illustrated by the composition of their inward FDI flows.

Country	FDI flows in following (Major areas):
China	Information & communication technology, hardware design and manufacturing by such companies as Acer, Ericsson, General Electric, Hitachi Semiconductors, Hyundai Electronics, Intel, LG Electronics, Microsoft, Mitac International Corporation, Motorola, NEC, Nokia, Philips, Samsung Electronics, Sony, Taiwan Semiconductor Manufacturing, Toshiba and other major electronics TNCs
India	IT services, call centers, business back-office operations and R&D

Source: Compiled from the annual reports of Reserve Bank of India and People Bank of China.

China's accession to the WTO in 2001 has led to the introduction of more favourable FDI measures. With further liberalisation in the services sector, China's investment environment may be further enhanced. For instance, China has allowed 100% foreign equity ownership in such industries as leasing, storage and warehousing and wholesale and retail trade, advertising and multi model transport services.

Is is important to note that the heavy FDI inflows to China are not 100% true. China's ability to attract phenomenal amount of foreign investment is a puzzle for many. "About 40% of China's FDI represents its domestic savings, recycled as foreign investment, via Hong Kong, to take advantage of economic incentives, popularly called 'round trapping'. Another 25% or so seems to represent investment in real estate by overseas Chinese. This is potentially problematic, as such investment could easily give rise to property bubbles. Thus, the quantum of foreign investment from advanced economies, that could improve domestic production capability, is perhaps not very different from that in India, in relation to its domestic output". [Nagraj R, 2006—'*Foreign Direct Investment in India—Trends & Issues*' (Eds, Raj Kapila & Raj Uma, Economic Developments in India, vol. 100, page 326)].

Future Outlook

India's rising growth process requires rapidly expanding infrastructure facilities to support it.

The government realises the fact that domestic resources alone may not be adequate to sustain the required expansion in infrastructure. Thus, it has followed a strategy to create incentives for Foreign Direct Investment. India, today, has an extremely liberal regime for FDI in terms of entry norms. International experience shows that there can be a number of other barriers for those willing to invest in infrastructure projects. The government has taken systematic initiatives to address these problems largely through comprehensive reforms in sectors like power and telecommunications. The combination of domestic private foreign investment and multilateral investments is likely to propel India's economic growth momentum in future.

Cases*

Birla Corporation

This company manufactures cement, jute products, automobile components, pvc flooring, carbide, gases, synthetics and steel castings. Their calcium-carbide industry struggled much due to competition from low priced materials from China and Romania, and duty free imports from Bhutan. Increase in power tariff also contributed much to their struggle.

Low interest rates activity in housing sector will continue to boost demand for cement. Taking this into advantage, Birla Corporation has decided to expand capacity at its Durgapur Cement Plant by 1 million tonnes. They are also working hard to make the production capacity of Chanderia Cement 3 lakh tonnes per annum. Projects are underway to set up power plants of 27 MW, as new industrial undertaking at Satna, M.P. and Chanderia, Rajasthan. These power plants would enhance the cost efficiency of the units.

Question: Discuss the business activities of Birla Corporation based on the recent developments?

Eveready Industries India

Eveready Industries India produces products ranging from carbon zinc batteries, rechargeable batteries, alkaline batteries and flashlight, to packed tea and bulk tea. In 2003-04, the company had to

*These cases have been prepared solely on the basis for class discussion. These are neither intended to serve as endorsement of source of data nor illustration of effective or ineffective management.

face a loss before tax of Rs 38 lakhs, against a profit before tax of Rs 11.13 crore in 2002–03. Sales increased by about 3%.

Eveready has started to focus on outsource production. They are trying to improve their quality, and reduce costs. They had a very tough time due to the rising cost of input materials in global markets, especially non-ferrous materials like zinc and brass. Due to high demand for cheap flashlights in the market, they have started to source flashlights from small scale industry units and price them attractively. They have a market share of 43% in zinc carbon batteries, and have launched a rechargeable torch, and 2 models of CFL rechargeable lanterns. They have also started to manufacture cordless telephone batteries and other type of batteries.

The company is also concentrating on controlling costs, and increasing the yield and efficiency of their workers. They are planning to further improve their distribution channels for packed tea. They are also initiating capacity enhancement at their tea factories. The tea plantation sector had to face a number of problems, including low prices, increasing cost of production, declining export volume and price realisation, in the recent years. A general over-supply situation and the slowdown of consumption growth adversely affected prices. Eveready has initiated various steps to rationalise the operations of their tea estates.

Question: Discuss the business trends with reference to Eveready Industries?

Steel Authority of India

Steel Authority of India, is a leading steel maker in India. They produce and sell a broad range of steel products, including hot and cold rolled sheets and coils, galvanized sheets, electrical sheets structurals, railway products, plates, bars and rods, stainless steel and other alloy sheets. They produce iron and steel at 4 integrated plants and 3 special steel plants, located mostly in the eastern and central regions of India.

The company recorded its highest ever sales turn over of Rs 24,178 crore in 2003–04, compared to Rs.19,207 crore in 2002–03. The company has recorded a significant turnaround with net profit of Rs 2,512 crore during 2003–04, from a loss of Rs 304 crore in 2002–03. The reasons for this turnaround are the increase in production, cost reduction measures, reduction in borrowings, improved product mix and buoyancy in the steel market. The company has performed reasonably well in the recent years too.

The debt-equity ratio improved dramatically due to better cash management and improved profitability. The total cost of production was lowered by 4% on account of measures focused on reduction in usage of coking coal/other raw materials, in energy consumption and control on administrative expenditure. The company relieved 2000 employees through voluntary retirement.

The major challenge that the sector faces is the shortage of raw materials, including coking coal, coke, etc. The scarcity has resulted in rise in international coal prices. The company can face this challenge only by finding alternative input materials like coal tar, petroleum, fuel etc.

Question: Discuss the business performance of Steel Authority of India? Do they face challenges?

Gas Authority of India Limited (GAIL)

The Gas Authority of India is a leading public sector enterprise, whose activities range from gas marketing and distribution through trunk and regional systems, to retailing of natural gas, and processing gas for production and marketing of liquefied petroleum gas (LPG), liquid hydrocarbons and petrochemicals. They are ranked among the top 10 companies of India.

The intensification of domestic exploration activities under the new exploration and licensing policy has led to the discovery of new oil and gas reserves. The current share of gas in primary energy consumption is 8%. Macroeconomic policies would drive the demand for gas in the coming years. The industrial sector also has a large appetite for gas. The growing urban population will require greater availability of compressed natural gas.

While supply sources of gas are geographically dispersed, India lacks interstate pipeline infrastructure for supply of gas to the markets. Gas Authority of India (GAIL) has made some progress in the implementation of the grid, covering acquisitions, preparing feasibility studies, identification of markets and procurement of gas management systems. Exploration, production, import of gas and other technology oriented projects make up the bulk of GAIL's business development plans for the coming years. The company's aim is to transform itself into an integrated energy company with involvement in the upstream and downstream power sector, and also undertake projects in countries in West Asia and South East Asia in gas infrastructure development and processing. It is already associated with various transnational gas pipeline projects in India, and is also involved in liquefied natural gas (LNG) import projects. It also plans to interface with similar initiatives for increasing gas supplies in the market. It would undertake a low cost expansion of its infrastructure of gas pipelines and networks, to increase gas usage in the market.

Question

Discuss the business structure and performance of Gas Authority of India?

Chapter Summary

The Indian industry does possess the potential to meet the targets, provided appropriate policy interventions are carried out within the specified time frames. With the revival of industrial growth, the demand for key infrastructure services such as power, telecom, railways, roads and ports, will press harder against existing supply constraints. The strategy to relieve infrastructure bottlenecks must encompass both the creation of additional capacity in various sectors as well as initiatives to induce much better capacity utilization. The strategy must also encourage both private and public provision of infrastructure services in a competitive environment and with an appropriate and transparent regulatory framework. This broad approach calls for an acceleration of sector-specific reforms in the implementation of policies.

The eradication of poverty and unemployment is the abiding goal of India's development policies and programmes. The achievement of this goal will require sustained and rapid industrial growth combined with well functioning public programmes for social services, rural development and employment generation.

Review Questions

1. 'Infant Mortality' is said to be very high in India with regard to SSIs. Do you agree? Why?
2. Discuss salient features of new industrial policy – 1991.
3. What are the major sources of industrial finance?
4. Why did Competition Act replace MRTP Act?
5. Discuss the rationale for encouraging foreign direct investment.

Objective Type Questions

1. In reference to Industrial Policy Resolution of 1948, government recognized the need for a ____________ economy.
2. According to Industrial Policy Resolution, 1948 government reserved ____________, only for atomic energy, and rail industries.
3. The Industrial Policy Resolution, 1956 laid down three categories, of which ____________ included industries exclusively as state responsibility.
4. The Industrial Policy, 1956 emphasised the role of ____________ sector in the development of the national economy and providing employment.
5. The concept of District Industries Centres was introduced for the first time in ____________.
6. The Industrial Policy of 1980 chose a more capital-intensive path of development and thus, underplayed the ____________ objective.
7. The ____________ Act was passed in 1951 to implement the Industrial Policy Resolution of 1948.
8. MRTP Act stands for ____________.
9. The Industrial Policy of 1980 made changes in favour of large business houses, particularly in making them free from the provisions of ____________.
10. The requirement of ____________ was discounted in Industrial Policy (1991) for all new projects.
11. In the run up to Industrial Policy (1991), East Asian economics had focused on ____________ growth.
12. As per Industrial Policy (1991), procedures for foreign direct investment were streamlined by creating ____________ to consider individual applications case-by-case.
13. The reforms of 1991 made significant changes in ____________, trade and public sector policies.
14. From public sector point of view (Industrial Policy, 1991), list of sectors reserved for dominance by ____________ was effectively abolished.
15. Small enterprises are ____________ and thus create more employment per unit capital.
16. ____________ takes responsibility of collecting the payments by setting up factoring services.
17. Under SIDO, Technology Development Cell (TDC) was set up to provide technological input to improve ____________ and ____________ of the products of small scale sector.
18. The ministry of SSI had recommended that import tariff be fixed as near the ____________ as possible, so that SSI units are able to upgrade themselves technologically.
19. An SSI is considered sick if the unit has not been in commercial production for at least ____________ years.
20. The major sources of industrial finance include money raised through capital market, bank credit and ____________.
21. Capital market consists of ____________ and equity capital market.
22. Liquidity in capital market has been promoted by the shift to ____________ settlement systems.
23. Basic objective of ____________ is to protect and preserve competition as the most appropriate means of ensuring efficient allocation of resources.
24. FDI ceiling in Civil Aviation (in Greenfield airport) ventures is ____________.

Class/Field Exercise

Visit the website http://planningcommission.nic.in/plans/planrel/fiveyr/welcome.html Planning Commission of India, collect the information and analyse the salient features of the Eleventh Five-Year Plan of Government of India. Students may prepare Power Point slides and make presentation in the class.

References

1. Economic Survey, Govt of India 2004–05 and 2003–04.
2. Pramod Verma and T.R. Bishnoi, Competitiveness of Indian Industry, Wisdom Publication, 2005, New Delhi.
3. Justin Paul, A. Ramanathan, Foreign Direct Investment in 1990s, Udyog Pragati, Vol. 22, No. 2, April–June 2002, pp. 63–73.
4. Raj Kapila and Raj Uma, Economic Developments in India, Vol. 100, 2006.
5. Competition Commission of India website.

Answers

Objective Type Questions

1. Mixed
2. Natural monopolies
3. Schedule A
4. Small Scale Industries
5. Industrial Policy Statement, 1977
6. Employment
7. IDR
8. Monopoly and Restrictive Trade Practices Act
9. MRTP Act
10. PMP
11. Export-led
12. FIPB
13. Industrial
14. Public sector
15. Labor-intensive
16. SIDBI
17. Productivity, competitiveness
18. Bound rates
19. Three
20. Foreign direct investment
21. Debt
22. Rolling
23. Competition policy
24. 100%

Appendix

Exhibit 6.1

Organisations for Support of SSIs

- Technology Upgradation
  - National Small Industries Corporation (NSIC)
  - Small Industries Development Organisation (SIDO)
  - Small Industries Service Institutes (SISIs)
  - Regional Testing Centres (RTCs)
  - Process & Product Development Centres (PPDCs)
- Technical Training
  - Small Industries Development Organisation (SIDO)
  - Small Industries Service Institutes (SISIs)
  - Technical Consultancy Organisations (TCOs)
  - Process & Product Development Centres (PPDCs)
  - District Industries Centres (DICs)
  - Regional Testing Centres (RTCs)
  - Central Footwear Training Institutes CFTIs
  - Tool Rooms
- Industrial Infrastructure
  - Industrial State Infrastructure Development Corporations (ISIDCs)
  - Small Industries Development Corporations (SIDCs)
  - Housing Urban Development Corporation (HUDCO)
- Entrepreneurship Development
  - Small Industries Development Organisation (SIDO)
  - Specialised Institutes
  - National Institute for Entrepreneurship and Small Business Development (NIESBUD)
  - Small Industries Service Institutes (SISIs)
  - Entrepreneur Development Institutes (EDIs)
- Marketing
  - Small Industries Development Organisation (SIDO)
  - National Small Industries Corporation (NSIC)
  - State Small Industrial Development Corporations (SSIDCs)
  - Small Industries Service Institutes (SISIs)

Exhibit 6.2 Total FDI Approved and the Actual FDI Inflows in India (1991 to 2004)

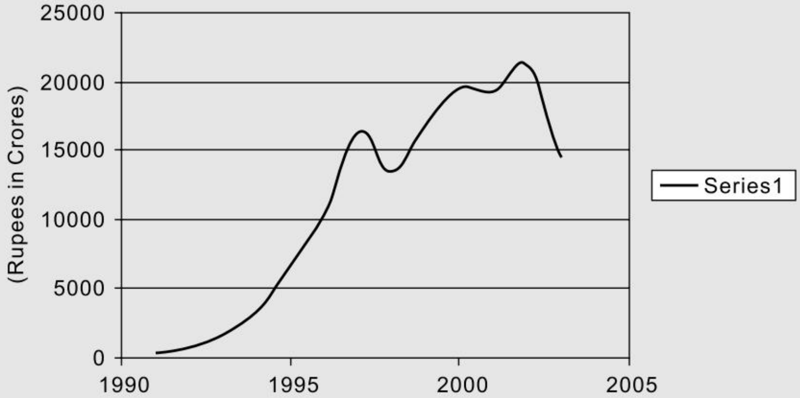
(*Rs in Crores/US$ in Million*)

Year	Approvals Involving Foreign Investment	Amount of FDI Approved	Amount of Inflow of FDI	%age of Realisation Rate-Inflow with Approval
1991	289	Rs 534.11 US $ 218.27	Rs 351.43 US $ 143.62	65.8
1992	692	Rs 3887.54 US $ 1485.49	Rs 675.18 US $ 258.00	17.36
1993	785	Rs 8959.33 US $ 2890.48	Rs 1786.71 US $ 582.94	20.17
1994	1062	Rs 14187.19 US $ 4522.53	Rs 3289.28 US $ 1048.54	23.18
1995	355	Rs 32071.72 US $ 10213.92	Rs 6820.03 US $ 2171.98	21.26
1996	1559	Rs 36146.81 US$ 10510.85	Rs 10389.20 US $ 37020.99	28.74
1997	1665	Rs 54891.35 US $ 15302.86	Rs 16425.33 US $ 4579.13	29.92
1998	1191	Rs 30813.50 US $7800.89	Rs 13339.84 US $ 3377.17	43.29
1999	1726	Rs 28366.53 US $ 6753.94	Rs 16867.79 US $ 4016. 10	59.46
2000	1726	Rs 37039.45 US $ 8613.83	Rs 19341.74 US $ 4498.07	52.22
2001	1063	Rs 26874.73 —	Rs 19265.10 —	71.68
2002	—	Rs 11139.79 —	Rs 21285.97 —	191.08
2003	—	Rs 6042.19 —	Rs 14300.94 —	—
2004 (Jan. – March)	—	Rs 1599.10 —	Rs 5076.61 —	—
Total (1991–March, 2004)	—	**Rs 292453.34**	**Rs 149215.15**	—

Abbr.: FDI: Foreign Direct Investment.

Source: Secretariat for Industrial Assistance (SIA), Department of Industrial Policy & Promotion, Ministry of Commerce Industry & Annual Report 2003–04, Ministry of Commerce and Industry & Past Issues, Govt. of India.

Exhibit 6.3 The Phenomenal Growth of FDI Inflow in India after 1991.



Source: www.indiastat.com

Chapter 7

Industry Analysis: Textiles, Electronics and Automobiles

Learning Objectives

- to analyse the impact of economic reforms on different industries
- to understand the strength, weakness, opportunity and threat of various sectors

Chapter Structure

Section 1: **Economic Reforms and Competitive Environment**

Section 2: **Textiles Industry**

Section 3: **Electronics Industry**

Section 4: **Automobiles Industry**

Cases: Ashok Leyland, Bajaj Auto and Hero Honda

The Structural Adjustment Programme and the new economic policies are supposed to have significant impact on the industrial sector. The measures such as removal of quantitative restrictions on imports, reduction of customs duty rates and removal of restrictions on foreign direct investment have been expected to expose the industrial sector to a greater market competition. In this chapter, an attempt has been made to analyse the impact of economic reforms in the context of globalisation on taxtiles electronics and automobile industries. The choice of industries for analysis, is based on the (i) size of industry (ii) vulnerability of industry to policy measures, and (iii) the importance of the industry in the global context. Sub-sectors of selected industries have also been covered, wherever possible. Five sub-sectors of electronic industry have been taken up for the analysis. The impact of the policy changes on the domestic industries has been analysed in a descriptive framework based on the available literature dealing with trade, industry and ministerial reports pertaining to respective industries. A brief SWOT (Strength, Weakness, Opportunity and Threat) analysis has been undertaken in each of these industries. Further, the implications of trade liberalisation has been discussed from the point of view of both the domestic firms and multinational firms.

SECTION 1: ECONOMIC REFORMS AND COMPETITIVE ENVIRONMENT

The external policies in 1960s, 1970s and 1980s were guided by the principle of import substitution in India, which in turn had been prompted to some extent by the strategy of self-reliance, due to the scarcity of foreign exchange. The strategy naturally involved the use of policy instruments like import licensing and high tariff rates.[1] In addition, there were restrictions on (i) foreign direct investment, (ii) import of technology and (iii) foreign collaborations in industrial units. Within the generally sheltered economic environment, small-scale units were further protected through measures such as reservation of certain products for exclusive production in the sector, input price concessions (for example, lower interest rates on loans) and fiscal concessions involving excise duty exemptions. The general trade and industrial policies that India adopted till the 1990s insulated Indian industry from competition, domestic as well as foreign. But the policy environment of the industrial sector has changed drastically since the 1990s due to the new economic policies.

Globalisation, whether taken in a limited sense in terms of 'multilateral trade liberalisation' or in the broader sense of increasing internationalisation of production, distribution and marketing of goods and services, has resulted in the opening up of markets leading to intense competition. For example, the World Trade Organisation works with the objectives to remove all restrictions on imports and reduce import tariffs. With the removal of quantitative restrictions on imports, hundreds of items reserved for manufacturing in the small-scale sector have been put up on the freely importable list (Open General License). This has made the reservation of items for small-scale units to a significant extent meaningless. Also, there is direct competition in the domestic market with the imports of high quality goods from developed countries and cheaper products from less developed countries. Competition in the domestic market has further intensified with the arrival of multinational companies, as the restrictions on foreign direct investment have been removed. The 1990s had witnessed the entry of many multinational companies in areas such as electronics and automobiles. Indian industrial units, small and large, have

1. Edwards, Sebastian (1993), Openness, Trade Liberalisation and Economic Growth in Developing Countries, Journal of Economic Literature, Vol. 31, Sep. pp 1358–1393.

been forced to improve their productivity and quality in order to (i) compete with the imported goods or with the goods produced by multinational corporations in the domestic market and (ii) export successfully without any government support.

Major changes in the past few decades, in fields like technology, have altered the manufacturing processes. Mechanical devices were replaced initially by electrical, later by electronic and very recently by computerised machines.

SECTION 2: TEXTILES INDUSTRY

Indian textiles industry has a rich heritage and a glorious tradition. The textiles industry contributes more for exports as a traditional exportable item. An attempt has been made to analyse the industry structure, production trends, stock prices and export growth of the sector.

Structure and Policy Changes

Indian textiles industry contributes six per cent to the gross domestic product and earns 18 percentage of the total foreign exchange earned by the country. It directly employs about 33 lakh workers and, in addition, gives employment to several million families of workers engaged in ancillary units. The textiles industry is one of the major sectors of the Indian industry, with the production growing at a remarkable rate for the past two decades (*Report of Apparel Export Promotion Council of India, 2004*).

The Indian textiles industry has been considered as an unorganised sector. The scattered and small players entered the business to avail immediate gains that came in the form of external demands in the past. The small players had got more boost from the reservation of textiles for exclusive production in the small-scale sector. Nearly 80 per cent of the units in the industry are very small and tiny units. In a majority of the cases, pattern making, cutting and finishing jobs are done in-house. Tailoring, the basic production operation, has generally been subcontracted to numerous fabricators located in residential, commercial and industrial areas of metropolitan cities. As the industry consists of a large number of small-scale units and there are no entry or exit barriers except in case of reserved items, the industry structure approximates to perfect competitive market conditions. The industry has been focusing on production in response to the demand in the west, i.e., the export market, although exports of textiles were subjected to quantitative restrictions in many of the importing countries. A major proportion of Indian textiles exports has so far been to countries like United States, United Kingdom and Germany, despite the restrictions therein. However, the percentage share of these countries in Indian textiles exports has been declining over a period of time.

Of the 30,844 garment exporters registered with the Apparel Export Promotion Council (AEPC), 9.97 per cent were manufacturer-exporters and 90.03 per cent were merchant-exporters (Report of Apparel Export Promotion Council of India, 2001). At the production level, as mentioned earlier, core tailoring operations are mostly subcontracted to fabricators. The significance of the fabricators can be seen from the fact that they have 71 per cent of the total machinery and contribute an equal percentage to the total employment of the industry (Bhavani, 2002)[2].

Although the export demand has increased, there is severe competition for Indian units from countries like China, Vietnam and Bangladesh. A multi-country analysis of modern textiles equipment use reveals that the technology level in India is low compared with that of other competitors (Rangarajan K., Foreign Trade Review, January–March, 2005).

2. Bhavani T. A. (2002), 'Small Scale Units in the Era of Globalisation', *Economic and Political Weekly*, July 20.

There has been a shift away from the 'standard' products to 'differentiated' products as part of the transformation of the industry into a 'global industry'. Organisations have to undergo restructuring to achieve global competitiveness by way of offering 'high value-added' items for export market. The plus point is that time has come for all firms to pursue 'international strategy' to countries where there are not many local competitors.[3]

Both USA and Europe are facing problems in handling quota-free imports. They are likely to introduce whatever non-tariff barriers they can in order to safeguard their domestic T&C (Textiles and Clothing) sector. However, these are unlikely to prove effective since their domestic industries are not really competitive in the T&C products.

CITI for Competitiveness

The process of broad-basing the activities and reach of textile and allied industries culminated in an umbrella organisation called 'Confederation of Indian Textile Industry' (CITI) in 2005.

The growth rate of production in the textile industry is given in Tables 7.1 and 7.2.

Table 7.1 Growth Rate of Production in the Textile Industry—Annual Trends (% change)

Year	Industry
2000-01	2
2001-02	4.1
2002-03	5.3
2003-04	7.9
2004-05	9.6

Source: Textile Times, CITI, August 2005.

CITI has constructed a stock index and monitors its movements in comparison with SENSEX of Bombay Stock Exchange (BSE). CITI Index covers 30 textile scripts from different textile segments, i.e., spinning and weaving units, garmenting and textile machinery companies, with January 2002 as the base period and is based on full market capitalisation.

Table 7.2 Segment-wise Growth (Textiles)

Year	Manufacture (79.4%)	Wool/Silk/Manmade Textiles (2.3%)	Textile Products (2.5%)	Cotton Textiles (5%)	Jute and other Fibre Textiles
2000-01	2.2	9.6	1.6	–0.9	12.7
2001-02	4.0	8.2	12.2	–4.3	–4.6
2002-03	5.5	–17.7	–3.8	–6.7	11.4
2003-04	8.1	36.5	7.2	9.3	–1.7
2004-05	10.5	–8.1	27.9	8.4	–3.5

Source: Compiled from Textile Times, Confederation of Indian Textile Industry, October 2005.

International Scenario

Changes in the rules of international trade in textiles and the ongoing domestic policy reforms have

3. Banik, Nilanjan (2001), An Analysis of India's Exports, *Economic and Political Weekly*, Nov. 3.

provided more opportunities for Indian garment units in post-2004, with the removal of the Quantitative Restrictions on Textiles and Clothing as per the Agreement of Textiles and Clothing (ATC) of WTO. Consequently, international trade in textile products have directly come under the jurisdiction of the WTO. Until 2004, world trade in textiles was governed by quotas. With the entrance of other low-wage countries like Bangladesh and Vietnam, there would be severe competition for Indian garment units even in the low-end market. On the other hand, India has already opened its domestic market to textile imports. In addition, liberalisation of investment policies is bringing in multinational companies to the domestic market. However, India has the strength and resources to become a significant player in the global garment industry, by way of exports.

On the demand side, North America and West Europe together account for nearly 70% of India's exports of textiles and both have removed the licensing restrictions on imports since 1st January, 2005. There is also scope for increasing exports to countries like Japan, Australia, Hong Kong and Latin American countries, where there has been a shift from the standard products to the differentiated products. The textile industry is transforming into a global industry with different operations of its production and distribution located in different countries. In order to absorb these changes, the Indian garment industry has to undergo a total restructuring. This would require dealing with the manufacturing and marketing of the products directly. In other words, focus may be made on direct dealing with manufacturing units, immediate in-house tailoring operations and vertical integration of as many operations as possible in the long run. To reiterate, the sea change in government policies in the form of liberalisation and globalisation has altered the environment in the garment industry. It has now become possible for textile mills to look at spinning, weaving and processing separately in order to increase exports. Organisations at the unit level have to undergo major restructuring. Decision to concentrate, on one hand, on high priced, high quality products for domestic market and high value-added items for export market on the other would lead to manufacturing mix.[4]

Many specific actions have been taken within the basic framework of the new economic policy to encourage the sector. Duties on synthetic raw materials were reduced as part of an across the board reduction of customs duties. Decrease in customs duty reduces the difference between international and domestic prices. Machinery imports have also been liberalised. Import of second-hand machinery with a minimum residual life of ten years is allowed. Thus, the domestic firms have access to anywhere in the world for spinning equipment for their production process.

A large number of Export Oriented Units (EOUs) have come up in recent times. Several independent export-oriented weaving and knitting units are also being established. Many of the modern units that have been set up in recent years are able to meet international quality demands. In general, firms pursue an international strategy to sell products and skills to markets with not many local competitors. Often firms customise the product and try to market it abroad.

Studies have shown that world trade in textiles and clothing is likely to increase substantially in the coming years. Goldman Sachs (2004) estimated that the world prices of textiles would be down by 30% in 5 years due to rapid rise in exports from a number of countries. WTO study (Nordas, 2004) points out that China and India have the comparative advantage in dominating world trade in textiles and clothing. As part of their international business strategy, textiles firms have started entering into foreign countries by way of joint ventures and alliances. For example, Malwa, an Indian firm, and the Woolmark Company, a European firm, have launched 'Indigo Wool' in the UK market recently. This

4. Bhavani T. A. (2002): "Small Scale Units in the Era of Globalisation", *Economic and Political Weekly*, Nov. 3.

product is soft to touch, has aesthetic appeal and so on. Malwa had been working with Jeans Care of UK to adopt a range of finishing techniques that bring out aesthetics and effects of wool and the indigo dye appearances in finished garments.

The total values and percentage annual change of garments exports from India in the post-WTO period are given in Table 7.3. The garments exports had grown at 7.31 percent during 1997–98 to 1998–99, but the growth rate declined to 4.86 percent during 1998–99 to 1999–2000. Subsequently, the yearly export growth has been negative in 2000–01. However, the export growth has become remarkable from the year 2003–04 onwards.

Table 7.3 Indian Garments Exports in the Post-WTO Period (Million US$)

Year	Exports	Percentage change over previous year
1996–97	4762.2	+6.69
1997–98	4910.3	+3.11
1998–99	5269.4	+7.31
1999–2000	5525.4	+4.86
2000–01	5300.9	–4.06
2003–04	10,100.2	+4.98

Source: Report of Apparel Export Promotion Council of India, 2004.

Case: Century Polysters

Century Polysters, B. K. Birla group company, manufactures polyester partially oriented yarn (POY), polyester chips and nylon tyre cord fabric (NTCF). The production of Century polyesters takes place mainly at Pune, Mahad and Bharuch in India. Margins were under high pressure due to volatility in raw material prices and competition from low priced imports.

Profit margins in Century Polyester operation can be improved with the reduction in excise duty and stable raw material prices. But profit margins in NTCF were affected because of increase in caprolactam prices, low priced Chinese imports and appreciation of the rupee. However, Century's special interest in nylon textile yarn could increase its market share.

To cope with the increasing competition, the company is trying its level best to increase its operational efficiencies, value addition and product mix. They are focusing on energy conservation and modernisation. To increase its generative capacity, the company has installed 2 diesel generating sets of 6 MW each at Pune. The NTCF capacity expansion of about 7500 tonnes per annum is on the verge of completion. Earlier, most of the NTCF demand was met by Chinese imports due to less production rate in India. Estimated investment for all these schemes is about Rs 280 crore.

Questions

1. What were the major problems century polysters had to overcome?
2. Why did they go for capacity expansion of NTCF?

Three factors appear to constitute the recipe of success for new units in this industry while facing the challenges of globalisation, namely:[5]

(a) Location: The right location for well-developed infrastructure especially power, and access to raw material and labour;
(b) Appropriate plant selection: Import liberalisation has enabled capital goods imports from all over the world. Though Indian machines are less expensive, they ultimately increase costs in many cases such as spinning, since their delivery periods are long;
(c) Commercial skill: Given the high content of raw material (which is agro-based) in the output, the commercial judgment in timing and selection of raw materials is crucial.

In a nutshell, globalisation and liberalisation policies have led the Indian textiles industry to grow from the status of small-scale industry to a large-scale one in the organised sector. Liberalising imports of modern textiles machinery and the rationalisation of import duty structure have made the industry more technology-oriented and competitive. The textiles industry today is driven by two sets of forces i.e., (i) pressures to globally integrate and (ii) pressures to be locally responsive.

SWOT Analysis

The SWOT analysis of textiles industry in India is given in Chart 7.1.

Chart 7.1 SWOT Analysis of Textiles Industry in India

Strength	Weakness	Opportunity	Threat
(a) Traditional Export Item of India (b) Near Perfect Competition in the Industry	80 per cent units are very small and tiny, in which the cost of production would be high compared to large units. Small units can't achieve economies of scale	Export demand is likely to increase with the removal of Quantitative Restrictions by all member countries of WTO in 2005 as per the agreement on Textiles and Clothing	Competition from countries like Bangladesh and Vietnam. Garments export growth rate in India has slowed down in recent years.

The SWOT chart reveals that the textiles industry consists of many small units, though the sector has been contributing substantially to India's exports value. On the other hand, world export demand for textiles has increased with the implementation of the Agreement on Textiles and Clothing (ATC) in the year 2005. However, the exporters would face increased competition from other countries like Bangladesh and Vietnam. Those who focus on export markets and leverage the opportunity would emerge as winners.

SECTION 3: ELECTRONICS INDUSTRY

Analysis of electronics industry has been carried out and the implications of economic reforms have been discussed in this section.

5. Bhavani T. A., (2002): "Small Scale Units in the Era of Globalisation", *Economic and Political Weekly*, July 20.

Market Structure

The electronics industry constitutes nearly 8 per cent of the manufacturing sector in India. It is one of the fast growing and labour intensive industries in the country. Total employment in the industry had increased from 1,30,000 persons in 1981 to 3,45,000 persons in 2000 (Guide to Electronics Industry in India, Government of India 2002, Page 120). In the industry, numerous small-scale units are engaged in the manual assembly of imported kits/components of goods like tape recorders. They have already been hit by the presence of multinationals, such as Sony, after the removal of restrictions on imports.

The electronics industry comprises six categories, namely, (i) consumer electronics, (ii) instrumentation and industrial electronics, (iii) data processing systems and other office equipment, (iv) communication and broadcasting equipment (v) strategic electronics and (vi) electronic components. Of all the segments, consumer electronics contributes a major proportion of the industry's production followed by the components segment. Instrumentation and industrial electronics, data processing system, communication and broadcasting equipment accounted for about 14 per cent each in the total production of the industry. The growth of the electronics industry is primarily due to the phenomenal expansion of the consumer electronics segment, especially the television (TV) and audio systems during 1980s and personal computers during 1990s.

At the industry level, around 13–15 per cent of the domestic production is being exported. At the segment level, the data processing system occupies the lead position with export accounting for almost 45 per cent of its production. Electronic components occupy the second place, with 19 per cent of production being exported. Exports from other segments are much lower, in percentage terms. As regards the industry structure, there are about 3500 units engaged in electronics production. Of these, 97 are public sectors units, 625 are in the organised private sector, and more than 2800 are registered small-scale units. In addition, there are numerous unregistered smaller units engaged in the assembly of consumer electronics, instruments and electronic components. The top 200 units, including 50 small-scale units, account for nearly 73 per cent of the industry's production. Thus, there has been a competitive market structure for a majority of the industry's products.

The small-scale sector accounts for nearly 35 per cent of the production and 48 per cent of the employment of the electronics industry in India. A majority of these units are mostly involved in the production of consumer electronics, computers and components. Some of the consumer electronics products that have been produced by the sector are televisions, tape recorders and calculators. The manufacturing process, in many cases, consists of manual assembly of imported (mainly) components. Even in the components segment, small-scale units are confined to simple assembly-oriented components that require lower investments in plant and machinery. Some of the components that are typically produced in the small-scale sector are mechanical TV tuners, audiotape deck mechanism, micro-motors, magnetic heads, loudspeakers and their parts, transformers and Printed Circuit Broads (PCB). Some small-scale units also undertake contract work for one or two large-scale units as the latter want to reduce labour costs and avoid unionised workforce.

Recent Developments

The Indian electronics industry is undergoing transformation due to the new economic policy of the 1990s and the rapid technological developments in the field.[6] As a part of the new economic policy,

6. Bhavani T. A., (2002): Small Scale Units in the Era of Globalisation, *Economic and Political Weekly*, July 20.

the government has liberalised a wide spectrum of investment, trade and fiscal policies relating to the industry. With the de-licensing of the entire consumer electronics industry and the removal of restrictions on foreign trade and investments, most of the important global firms like Thomson and Sony have entered the Indian industry either directly or through collaborations with the local firms. Those multinational firms have brought in popular global brands and they offer the consumers a wider choice in terms of product features, quality and competitive prices. In addition, import of all the components, raw materials and capital goods relating to the industry have been made free and the duties on the items are reduced (The Hindu Survey of Indian Industry, 2000). Import duties were rationalised by fixing duties on raw materials at 35 per cent, for processed parts at 50 per cent, for components and peripherals at 80 per cent and for final products at 90 to 150 per cent in early 1990s. Government has reduced duty rates on select items in the recent past. These changes have not only intensified the competition in the domestic market, but are also expected to transform the domestic industry on the pattern of the international electronics industry.[7]

The changes brought by the globalisation have created a new set of products that are fast replacing the old ones. For instance, in case of consumer electronics, new products (like CD systems, both in audio and video lines) have replaced the old products. The technological developments necessitate the use of costly and complex automated manufacturing, testing facilities and highly skilled personnel. Labour is becoming less important and capital and technology are becoming increasingly more important factors of production in the electronics industry. As a result, large firms dominate the established markets, though small-scale firms have a scope in new and rural markets.

The technological changes brought by the globalisation have also made various firms of the industry interdependent and have transformed electronics into a global industry. In past, the functions of research and development, design, manufacturing, sourcing, distribution and end user application were carried out in sequence, or rather independently from one another. However, the present trend is for the integration and interdependence of all these functions. Materials, parts and subsystems for the manufacture of electronic equipment are sourced worldwide. This trend is forcing firms across the world to opt for strategic alliances, joint ventures, equity participation and marketing arrangements.[6]

To sum up, in the electronics industry, the role of SSIs has been increasing. Generally, the small enterprises in the industry are involved in the manual assembly for low-end consumer electronics with the help of few tools and instruments. However, the entry of global players in the wake of globalisation and liberalisation, along with rapid technological developments in the sector, may considerably change the product composition and structure of the industry. Competition in the industry is going to intensify and it is likely to transform the Indian electronics industry along the lines of the global scenario. The changes have made the process of manual assembly of lower-end products by the small-scale units no longer feasible. The survival of Indian electronic firms now depends critically on developing or acquiring and adopting the latest technologies. Given the high costs of technological development and short-product cycles, Indian firms are required to go in for collaboration with other firms both for acquiring technology and for marketing their products. These aspects demand that the Indian small-scale sector needs to effect not simply a marginal change, but a total transformation in the production process, such as a shift away from manual assembly to automation.

SWOT Analysis

Details of SWOT analysis for the electronics industry in India has been presented in Chart 7.2.

7. Bhavani T. A., (2002): Small Scale Units in the Era of Globalisation, *Economic and Political Weekly*, July 20.

Chart 7.2 SWOT Analysis of Electronics Industry in India

Strength	Weakness	Opportunity	Threat
Labour-intensive industry, which suits the requirements of abundant labour resource in India	Transformation from manual assembly to automation may reduce the employment opportunities	Domestic firms get motivated to achieve international competitiveness due to trade liberalisation	Survival of Small Scale Industries

According to the SWOT chart, the electronic industry in India has been undergoing transformation due to trade liberalisation. The small-scale industrial units face challenges due to the competition in the market. Only the firms, which achieve international competitiveness, can survive in the days to come.

SECTION 4: AUTOMOBILE INDUSTRY

The business environment and the trends in the automobile industry have been discussed in the context of three distinct phases, namely, (i) regime of licensing (ii) partial liberalisation (iii) full liberalisation.

Policy Thrust and Phases

The arguments for globalisation and market-oriented policies are relevant to the automobile industry. The policy changes include exposing domestic producers to both internal and external competition, which can lead to: (i) better utilisation of capacity and (ii) cost reduction. Enhancement in efficiency, along with openness, policies implemented by other countries helps enlarge the size of the external market to compensate for any shortfall in domestic demand.

It can be seen that the Indian automobile industry has gone through three distinct phases. The phases are elaborated subsequently.

(i) The Early Regime of Licensing Until 1983

The early regime was governed by regulations where imports, collaborations, and equity ventures were severely restricted by the government. Capacity expansion was also restricted and the government issued the required licences. Technology transfer from foreign companies was subject to government approvals. All these factors had an impact on the supply as well as the prices of the vehicles. The prices were very high during this period.

(ii) Partial Liberalisation of Rules in Mid 1980s

The partial liberalisation of rules by the government in the mid 1980s led to the entry of Maruti and the proliferation of Two Wheelers and Light Commercial Vehicles (LCVs) into India. The decision to allow foreign collaborations in all automotive segments was a milestone in the history of the Indian automobile sector. Capacity constraints became a matter of past and the auto industry was allowed to attain greater flexibility in their operations as a result of exemption from MRTP notification procedures and with the freedom for importing technology and capital goods. The entry of multinational companies into the automobile sector led to its substantial growth. Suzuki Motor Company of Japan in collaboration with Maruti Udyog Limited led the sector to its tremendous growth. In numerical terms, there had been a rise in the sales of car from 112,550 (including jeeps) in 1980 to 345,157 in 1990 registering a three-fold increase within a decade. The government also encouraged the company through fiscal concessions by lowering import and excise duties. The company was also forced to adopt a phased manufacturing programme whereby it had to increase the indigenous content in the production process gradually. The advent of the company had significant effects in terms of quality and price also. They pioneered the concept of an affordable family car, and cashed in on demand. Thus, the actual boom in the car market started when Maruti Udyog Limited entered the industry in 1984 with its small and fuel-efficient family car models.

(iii) The Phase Dealing with Economic Reforms of 1990s

The recent measures of liberalisation have led to a further increase in the domestic as well as foreign investment in the automobile sector. Until the liberalisation policies of the 1990s, Maruti Udyog Limited had a free run in the Indian automobile market with very little competition. But the scenario changed considerably with the introduction of the Structural Adjustment Programme. Entry of new players increased the competition in the joint ventures in the country, with each player targeting to manufacture between 20,000 to 150,000 cars per annum. In fact, for the first time, the automobile sector had become competitive.

The policy changes were with respect to industrial licensing, foreign investment and technology, fiscal, and foreign policy environments. As a result, government regulations or direct controls in the sector has become substantially of lower degree compared to other developing countries in Asia. The sector witnessed frequent release of new models over the recent years. The primary beneficiary have been the consumers who are now reaping the advantage of enhanced choice, better technology and decreased relative prices.

Salient Features of Liberalisation Policies pertaining to Automobile sector

(i) Industrial Policy Production licensing was done away with for all types of automotive vehicles, except motorcars, in July 1991. Production licensing for cars was abolished in April 1993. For all de-licensed industries, no approval is required from the central government. Only a memorandum of information is required to be filed with the Secretariat of Industrial Approvals (SIA), which is only meant for statistical purposes.

(ii) Foreign Investment Automatic approval for foreign equity stake has now been allowed in segments like commercial vehicle, public transport vehicles including automotive commercial three-wheelers, jeep type vehicles, industrial locomotives, automotive two-wheelers and three-wheelers, automotive components/spares and ancillaries. For approval of projects in the car segment, a further condition of dividend balancing has been imposed (i.e., outflow on account of dividend payments has to be balanced by the foreign exchange earning through export over a period of time). Dividend balancing is spread over seven years from the commencement of production. Balancing is not required beyond the seven-year period.

(iii) Foreign Technology Agreements There is automatic permission for technology purchases of up to a lump sum payment of Rs 10 million.

(iv) Engaging Foreign Technicians No permission is now needed for hiring foreign technicians or foreign testing of indigenously developed technologies. Payment through foreign exchange transactions can be made according to the guidelines, without problems.

(v) EXIM Policy Capital goods, components, parts and consumables for the manufacture of vehicles can be freely imported. The Government of India has removed the quantitative restrictions on imports of hundreds of items. Second-hand cars import has been permitted, but not with a left hand side steering.

(vi) Fiscal and Monetary Policies Indian Rupee has been made convertible on current account. This simplified procedures for imports and exports. Since the import of automobiles and capital goods like radiators requires large amount of foreign exchange, companies can greatly benefit from the relaxed regime. Example: Tata Motors import capital goods from countries like Japan to manufacture Indica and Indigo cars.

SWOT Analysis

Economic reforms have had a positive effect on both demand and supply of automobiles. Many foreign companies have invested in this sector, including major companies worldwide. There has been a phenomenal growth rate in the passenger car and Light Commercial Vehicle segments. Sales of both the segments have grown at the rate of over 20 per cent annually. Overall, the automotive boom that started in the mid-80s got a further boost. The SWOT analysis of the sector is presented in Chart 7.3.

Chart 7.3 SWOT Analysis of Automobile Industry in India

Strength	Weakness	Opportunity	Threat
Decline in prices and more number of models for consumers	(i) Dominance of MNCs over domestic firms (ii) Dependent on imports for capital goods like radiators	Consumers sovereignty and big firms reap the benefits	Small players producing automotive components face challenges

The SWOT chart reveals that the multinational corporations try to dominate Indian automobile industry with the liberalisation in trade and investment. However, the policy changes have helped the consumers to get new models at an affordable price. The firms in the sector are dependent on imports for machineries and components.

Cases*

1. Ashok Leyland

Ashok Leyland is one of the largest manufacturer of commercial vehicles in India. They also makes vehicles for defence and other special applications, engines for industrial purpose, gensets and ferrous castings.

They were the first to introduce compressed natural gas (CNG) buses in Delhi. It is of great demand now. They are also likely to bag more gains from the rising exports of auto and auto ancillaries. Ashok

* These cases were prepared solely as the basis for class discussion. They are not intended to serve as illustrations of effective or ineffective management.

Leyland's traditional strength is built around its skilled manpower, which is capable of producing quality products at a competitive cost.

The entry of global companies like General Motors, Ford, Honda, Toyota etc., in the Indian market has propelled Indian manufacturers to facilitate work on global production, quality and delivery systems. Ashok Leyland is also forced to achieve international competitiveness to survive.

The company is now focusing on maximum effective utilisation of resources. They have initiated cost saving measures in the operations side, including a voluntary retirement scheme. They are focusing on consumer-centric approach. They are trying to give much attention for commercial vehicles and expand their product range in the top and low weight segments. They are also likely to invest more in these segments for product upgradation to suit the requirements of various export markets.

Question

Ashok Leyland has to achieve international competitiveness. Why?

2. Bajaj Auto

Bajaj Auto is considered to be the second largest manufacturer of motorcycles in India.

Their profits was soaring high due to the company's special stress on changing its organisational structure, products and models, its approach to markets and consumer preferences, R&D, engineering, product design and speed to market and nationalizing of costs. Thus they could achieve 69% growth in export of two wheelers, and 66% increase in the export of all the vehicles.

The company's R&D strategy is a combination of in-house and collaborative efforts. Their collaboration with Kawasaki, for joint design and development of new vehicles, is notable.

Bajaj had done very well in three-wheeler market. This market comprises three and six-seater passenger vehicles and goods carriers. In the three-seater passenger vehicle category, their market share increased to 91.8% in 2003–04.

Their increased sales volumes, better product mix, better operational efficiency etc., increased their profit margins. The company's focus on R&D, their target on marketing and advertisement etc. has contributed a lot to the company growth.

Question

Discuss the performance of Bajaj Auto and the factors contributed for the success?

3. Hero Honda

Hero Honda is considered to be the single largest manufacturer of two-wheelers in the world market. Their best selling model, *Splendour*, is the world's largest selling motor cycle brand at present.

The domestic motorcycle market has expanded in the past few years due to easy availability of loans and fall in interest rates.

However, the company faces huge challenges. The motorcycle market in India has become extremely competitive with the technology evolving constantly. Motorcycle manufacturers have been launching a variety of models across all segments and product launches are often accompanied by heavy discounts. The company will find it increasingly difficult to withstand this onslaught, without cutting prices, a difficult proposition given that the input costs are rising. Competition is also expected to intensify with the entry of foreign companies.

But the future is not that gloomy for Hero Honda. It is the market leader by a wide margin and has a very good distribution network. The company also has a large cash hoard to face competition.

Question

Do you think that the Hero Honda would remain as market leader in the motorcycle market?

4. RAMBUS IT Academy

Rambus Network Academy is one of the leading trainers in Kerala in India in the field of hardware, networking and security. The organisation is located at Chalakudy, Thrissur District, Kerala, and has ten divisions in different parts of Kerala. The organisation had a humble start in 1999, as a PC and Laptop service centre. Later, the same year, an Education division was also started, aiming to provide training courses in hardware and networking. Initially, the division was started as a low profile project, but now it is set with enough infrastructure to support various levels of training programmes in the field of hardware, networking and security.

The organisation was established by Mr. Jeevan P.V. and Mr. Abhilash T. in the year 1999, during the boom in the Information Technology industry, to leverage the opportunities in the sector, based on the new business. Though started as a service centre the organisation had a set plan for innovation and entry into IT Education. With the increase in demand for IT professionals in the area of hardware and networking, the founders decided to build an infrastructure which was capable of generating experts, able to withstand day-to-day challenges that come in this industry. Thus RAMBUS NETWORK ACADEMY was established. The organisation is undertaking hardware and networking courses, interior designing and career oriented short term computer courses. To simplify the management of the entire organisation, the responsibilities and duties are divided into various levels of management. The hierarchy includes departments based on the training area, which also has a Head of the department. To uphold the manpower and their efficiency, there is a Human Resource Department.

The Rambus Network Academy is, in association with the Continuing Education Cell, Govt. of Kerala, operating in Polytechnics of Kerala. Continuing Education Cell (CEC) is a Kerala government. project, operating through polytechnics, and providing certifications for courses in almost all engineering subjects. Currently, the organisation has off campus training in eight polytechnics, in collaboration with the CEC.

The institution provides a training standard that provides sufficient knowledge to the student for appearing in Global Certification Examinations such as A+, Net+, Linux+, RHCE, MCSE, CCNA, CCNP, etc. With a team of ‘Globally certified’ faculties, the entire training programme is conducted. We happily announce that till date, the organisation could successfully train more than 5000 students.

The organisation is heading forward to achieve its dream project of establishing its divisions throughout the country now, to leverage the opportunities arising from the new business environment and IT industry. Along with all these, the organisation is planning to start its new business project in the field of Advertisement, Construction and Real Estate. At present, they are drawing the business plan and formulating strategy to venture into Real Estate, Advertising, etc., based on the positive trends in the sectors. There are thousands of Non-Resident Indians investing in housing and real estate through builders in Kerala because of two reasons. (a) Income Tax exemption that they enjoy when they have NRI Status and would not get when they settle back in the home country. To avoid interest tax etc., they invest heavily in real estate. (b) The majority of Keralite Non-residents in Gulf countries have no time to construct their own houses, while working in Gulf.

Future endeavours include extending the business enterprise into other states. The organisation is committed to provide the best of all services.

Questions

1. Do you think that Rambus academy has grown because of the time advantage or the business plan?
2. Do you agree with their diversification plans?

Chapter Summary

The points discussed in this chapter can be summarised as follows:

(i) As a result of liberalisation in trade relations with other countries, the units in the electronics and textiles industries are going through a phase of compulsory modernisation and reforms. The changes are inducing some units to innovation processes, but the units, which are not economically strong, are facing the problem of sickness.

(ii) There are 3 major challenges faced by industries in India, namely:
  (a) Growing pressure from the import liberalisation programme;
  (b) Growing competition due to increased foreign direct investment; and
  (c) Growing complexity of issues.

(iii) Some of the changes made in the government policies have also affected industries. For example, the policy framework governing inward FDI was substantially liberalised under the automatic route.

(iv) Unless industrial units continuously upgrade their technologies, it will be difficult for them to withstand international competition arising from trade liberalisation and openness of the economy.

(v) The textiles exports from India is likely to be benefited due to the removal of restrictions as per the implementation of the Agreement on Textiles and Clothing, by many member countries of WTO that has taken place in 2005.

Review Questions

1. Discuss the competitive business environment that arises as an outcome of the implementation of globalisation and liberalisation policies.
2. Briefly analyse the structure and profile of electronics industry in India.
3. Elucidate the salient features of liberalisation policies pertaining to automobile sector.

Class/Field Exercise

Do an analysis of the Market Structure based on factors affecting the market structure. Students can use statistical tools such as Herfendile Index, Concentration Ratio etc., that they have already studied in other courses if required.

1. Market Structure of IT Industry with reference to computer hardware industry – Analysis based on the developments in Indian and in the world economy.
2. Industry Analysis – Mobile Handset Industry in selected countries – Companies, Market Share – Past, Present and Future, New Product Innovations etc.
3. Passenger Car Industry in India US and China – Companies, Market Structure: Past, Present and Future Brands, Innovations and Recent Developments, detailed study on a selected company.
4. Textile Industry in Bangladesh, India and China – Companies, Market Structure and Market Shares in India, Leading Textiles Exporters from India. Study and prepare a business plan and to face challenges. Study on a selected brand – Demand Analysis (factors affecting domestic demand etc.).

5. Consumer Electronics Industry in selected countries – Local companies, foreign companies, market share analysis, main importers, duty structure and rates on components and parts and goods. Study about a company and its strategies.

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Chapter 8

Industry Analysis—FMCG, Chemicals and Pharmaceutical Sectors

Learning Objectives

- to analyse the business environment in FMCG, chemicals and pharmaceutical sectors
- to understand the impact of liberalisation and globalisation

Chapter Structure

Introduction

The structural adjustment programme and the trade liberalisation policies in India are supposed to have significant impact on the industrial sector. The measures such as removal of quantitative restrictions on imports, reduction of customs duty rates and removal of restrictions on foreign direct investment are expected to expose the industrial sector to a greater market competition. In this chapter, an attempt has been made to analyse the impact of liberalisation on select industries in India, i.e., (i) Fast Moving Consumer Goods (FMCG), (ii) Chemicals, and (iii) Pharmaceuticals. Collectively these industries contribute to more than 25 per cent of the industrial output in India. The choice of industries for analysis is based on the (i) size of industry (ii) vulnerability of industry to policy measures, (iii) share of production to the total production in the industrial sector in terms of value added and (iv) the importance of the industry in global context. Sub-sectors of the selected industries have also been covered, wherever possible. For example, in the case of FMCG sector, various product categories (tea and coffee, coconut oil, cheese, poultry, cigarettes, alcoholic beverages, butter, milk food for babies and oral hygiene products) have been considered. Similarly, three sub-sectors of chemical industry have been taken up for discussion. The impact of economic reforms on domestic industries has been analysed in a descriptive framework based on the available literature dealing with trade, industry and ministerial reports of respective industries. A brief SWOT (Strength, Weakness, Opportunity and Threat) analysis has been performed in case of each of the industries. Further, the industry has been analysed from the perspective of both the domestic and multinational firms.

SECTION 1: BUSINESS ENVIRONMENT AND CURRENT ISSUES

Removal of Quantitative Restrictions on Imports

Article XI of the General Agreement on Tariffs and Trade 1994 stipulates that no prohibitions or restrictions (other than tariffs), through quotas, import or export licences or other measures, shall be maintained by members of the WTO. However, under provisions of Article XVIII-B of GATT, India maintained quantitative restrictions on import of items in respect of 2400 tariff lines in the HS (Harmonised System) codes. In May 1997, India put forward a plan for the elimination of these restrictions on imports over a period of 9 years, which was considered at consultations held in the committee on Balance of Payments Restrictions in June-July 1997. While the plan in general received the support of developing countries, developed countries felt that the phase-out period still was too long and many of the items proposed for phase out belonged to the later years of the plan. Although India agreed to reduce the period to 7 years, it was not acceptable to the developed countries (EXIM Policy Document, Ministry of Commerce, Government of India 2000–01).

Developed countries, including the United States, initiated dispute settlement proceedings against India and sought consultations under Article XXII of GATT. Through the consultations that followed, India reached at agreements with most of the countries. The US, however, filed a dispute against India (This aspect has been also cited in chapter 5). A panel was constituted by WTO on November 18, 1997 to examine the US allegations that the continued maintenance of QRs (Quantitative Restrictions) on imports by India was inconsistent with its obligations under the WTO agreement.

Article XVIII: B of WTO, which is invoked by India, recognises that members whose economies can only support lower standards of living and are in the early stages of development may apply quantitative restrictions for better balance of payments position. Those countries are free to deviate temporarily from the provisions of the other Articles of the Agreement as provided in Sections A, B and C. Paragraph 9 of Section B provides that such member countries may control the general level of imports by restricting the quantity or value of merchandise to be imported, provided the import restriction shall not exceed those necessary:

(a) to forestall the threat of (or to stop) a serious decline in its monetary reserves; or
(b) in the case of a contracting country with continuing deficit in the balance of payment position.

The provisions also stipulate that a member has to announce publicly the time-schedules for the elimination of QRs maintained for balance of payments purpose. A member taking recourse to Article XVIII: B is also required to have periodic consultations with the Committee on Balance of Payments Restrictions in the WTO. India presented a case for the removal of QRs over 9 years and subsequently reduced it to 7 years as cited earlier. As even 7-year phase-out period was not acceptable to developed countries including the United States, WTO initiated dispute settlement proceedings against India. Before April 1, 2000 when the first phase-out of QRs began, there were 685 tariff lines in the Special Import License list and 700 items in the restricted list. 44 items could only be imported through canalising agencies such as Indian Oil Corporation. On April 1, 2000 QRs on 714 tariff lines were removed (the restricted list was reduced to 444 and the special import category to 230 and the canalised list to 41 items). In the second stage of the phase out on April 1, 2001, remaining QRs on imports of 715 tariff lines were taken away.[1] These points have been enumerated in the chapter on WTO.

TRIMs and TRIPs

There are important issues related to WTO such as Trade Related Investment Measures (TRIMs), Trade Related Intellectual Property Rights (TRIPs) and the stipulation of stringent sanitary and environment standards. In case of TRIMs, the Uruguay Round had identified all clauses that are inconsistent with the GATT provisions. Subsequently, WTO set a time target for the member countries to remove the restrictions pertaining to TRIMs. Accordingly, for example, the clause relating to minimum proportion of local input to be used in the production of domestic as well as multinational units (in a given country) had to be removed. As a result of the implementation of the agreement on TRIMs, input supplying Indian units like the auto component units either face the risk of losing their market share or have to compete in open markets for their share, which requires considerable improvement in the competitiveness of the units, especially the small-scale units.[2]

The agreement on TRIPS is of special significance to the chemical and pharmaceutical industries, as some units have been producing patented products through new processes. Those units could do so, till now, under the Indian Patent Act 1970 that mainly takes into account the process patent for seven years. But with India changing its patent act so as to recognise product patents with a long period of protection (20 years) as per the agreement on TRIPs, it would not be possible in future. This aspect makes Indian industry dependent on multinational corporations, as they are the prime producers of a majority of products. In such a scenario, small-scale units become vulnerable, as they do not have the required resources and capabilities either for innovation or for purchase of technologies from multinationals.

Major changes in the past few decades, both in the basic sciences and in applied fields like technology, have altered the manufacturing processes as well as the input and output structure. Mechanical devices were initially replaced by electrical, then by electronic and very recently they have given way to computerised machines. Unless Indian industrial units continuously upgrade their technologies, it will be difficult for them to withstand international competition arising from trade liberalisation and openness of the economy.

1. Justin Paul, International Business, Prentice Hall, Third Edition.
2. Sourced from www.wto.org

Trips (Trade Related Intellectual Property Rights)

The agreement on the aspects of Trade Related Intellectual Property Rights [TRIPS] of the WTO, which came into effect on January 1, 1995, is to date the most comprehensive multilateral agreement on intellectual property. The contribution of WTO agreement related to TRIPS, aimed at industrial development of a country, is substantial. Granting of patent monopoly on the consideration of disclosure of invention enables competitors in the field to manufacture new or improved products or effect improvements in the process of manufacturing the existing products. But for a patent system, much of the technological information would have remained secret.[3]

Protection of industrial design encourages people to devote their talent and energy in developing new product design. This is particularly so in the case of consumer products including toys, garment, furniture and so on. Protection of trademarks enables consumers to obtain the products of the right quality, which they are accustomed to get through identification trademark. If trademark cannot be protected from infringement, the market will be flooded with shoddy and spurious goods. The printing, publishing and entertainment units (belonging to the film and recording industry) are significantly dependent on copyright protection. The manufacture of any kind of machinery or machine, which is based on industrial drawings, enjoys copyright protection.[4]

WTO and TRIPS set the minimum level of protection for intellectual property that every member country must provide to a right holder. TRIPS, thus, tends to add obligations on matters where the pre-existing conventions were absolutely silent or inadequate. Significantly, intellectual property rights have been recognised as vital to free trade. All countries that are part of GATT/WTO have to comply with the TRIPS text. Under TRIPS, India, as a developing country, has got herself under the purview of WTO commitments after January 1, 2000. The general goals of the TRIPS are contained in the preamble of the agreement, which reproduces the basic objectives of Uruguay round negotiations objectives. These objectives include promotion of effective and adequate protection of intellectual property rights by ensuring that measures and procedures to enforce IPR do not themselves become barriers to legitimate trade.

The requirements of WTO related to patents, current laws, transition status and the likely impact on industrial sector have been compiled and given in Chart 8.1. WTO requirements insist that both process and product patents must be available in all fields of technology. But, Indian Patent Act allows only process patents for food, medicine, drugs and chemicals. Though India has agreed to accept the product applications, it remains a legal issue as of now. Similarly, WTO has specified the duration of patents as 20 years. As shown in the chart, in India, duration of patent has been five and fourteen years for process and product categories respectively. The domestic industry will have to wait for amendment to Indian patents laws.

Chart 8.1 Patent Related Requirements of WTO

The WTO Requirements	The Indian Law (before 2005)	Status
Both process and product patents must be available in all fields of technology	Indian Patents Act, 1970, allows process patents only for food, medicine, drugs and chemicals	Government has started giving patents for products in India (Product patents)

(Contd.)

3. Arun Goyal, WTO in the New Millennium, Academy of Business Studies.
4. Krishna Rao, WTO: Text and Cases, Excel Books.

Duration of patents must be 20 years	Duration of process patent is 5 years from date of sealing or 7 years from date of filing. Duration of product patents is 14 years	Government has accepted WTO rule

Source: Compiled from Focus WTO, Journal of Indian Institute of Foreign Trade, October, 2000.

Subsequent part of the chapter deals with the impact analysis of trade liberalisation on industrial sector.

SECTION 2: FAST MOVING CONSUMER GOODS (FMCG) INDUSTRY[5]

The FMCG industry has been one of the dominant Indian industries as it is characterised by large volume of sales. Generally, FMCG refers to consumer non-durable goods required for daily or frequent use. It is a Rs 800 billion industry and hence, it is important to domestic as well as multinational firms. The FMCG industry consists mainly of sub segments relating to personal care, oral care, household products and so on.

The FMCG industry is considered to have the maximum impact of the QR removal in 2000 and 2001, because many of the items were either in the restricted list or special import license list. However, competition is not new to this sector. With the implementation of liberalisation programmes, several multinational corporations have set shops in India.

Since most of the goods in the FMCG sector have been subjected to the removal of quantitative restrictions on imports recently (in the year 2000), the approach of impact analysis has been constrained by the availability of a few reports only. Most of the observations are hunches (intuitive based) of industrial consultants.

For multinational corporations, it has now become easier to import those products into India, which could not be freely imported due to the QRs earlier. Such products would now be sold at cheaper rates due to the economies of scale involved. Moreover, many of the brands, which had their presence in the grey market and were sold at exorbitant rates, are now sold at normal retail outlets at much cheaper rates due to the import liberalisation. This is likely to create a market for imported products. This is an important factor that may work against the domestic players.[6]

However, the consumers shall have more choice if the Indian market gets flooded with imported goods. Though the mere removal of Quantitative Restrictions will not mark the demise of domestic industry, it is likely to affect the consumer goods and small-scale industries more severely. Most of the imports shall be carried out by big retail outlets, which basically cater to the upper segment of the market. The other market segments, however, may not be aware of the availability of the product. It shall take a great promotional effort to lure customers away from certain product categories like food and beverages regarding which the Indian consumer is both very sceptical and hygiene conscious. Some researchers have argued that there will only be a marginal increase in import demand as a consequence of removal of Quantitative Restrictions on imports (Mehta, 2000).[7]

5. This section is based on an article co-authored by Justin Paul, Sudeep Ghose etc.
6. Nayar (2001), Opening up and Openner of Indian Economy, EPW, Sep. 15.
7. Mehta (2000), Eco and Poli-Weekly.

Custom duties have a major impact on the quantity that actually gets imported into the country as domestic players ask for protection against foreign competition. It may be mentioned here that the WTO has also permitted 'bound rates' (the rate upto which the government can impose custom duty). The basic customs duty rates of FMCG products for three years in India have been presented in Table 8.1. The customs duty rates on sugar confectionary, chocolate with cocoa, chewing gum, malted foods, condensed milk, ice cream, dairy products other than milk powder, biscuits, waffles and detergents were 35 per cent in 2000–01 and 2001–02. But, government reduced customs duty on these items in 2002 from 35 per cent to 30 per cent. At the same time, the customs duty on tea and coffee was raised from 35 per cent to 70 and to 100 per cent in 2000–01 and 2001–02 respectively. Duty on infant foods and skimmed milk powders remained untouched.[8]

Table 8.1 Customs Duty Structure of FMCG Products (Post-QR Removal)

Beverages & Foods products	2000–01	2001–02	2002–03
Sugar confectionery	35	35	30
Chocolate etc. with cocoa	35	35	30
Chewing gum	35	35	30
Instant coffee/tea	35	35	30
Coffee & Tea	35	70	100
Malted foods	35	35	30
Condensed milk	35	35	30
Ice-cream	35	35	30
Infant foods	15	15	15
Dairy products other than milk powder	35	35	30
Skimmed milk powders	0	0	0
Biscuits in retail packs upto 100 gms costing < Rs 5	35	35	30
Biscuits	35	35	30
Waffles and Wafers having chocolate	35	35	30
Jams, jellies, sauces, juices, soups	35	35	30
Cereal food products/Noodles	35	35	30
Bottled Mineral Water	35	35	30
Aerated Waters	35	35	30
Personal/household care products:	*2000–01*	*2001–02*	*2002–03*
Cosmetics/toiletries	35	35	30
Toothpowder	35	35	30
Toothpaste	35	35	30
Hair Oils	35	35	30
Toilet Soap	35	35	30
Washing Soap	35	35	30
Soaps, Detergents	35	35	30

Source: Compiled from Union Budget 2002, 2001, Ministry of Finance, Government of India.

8. The Economic Times, 1st March, 2001.

Impact on Product Categories

The impact of the removal of Quantitative Restrictions on imports of various product categories of FMCG industry is analysed in this sub-section. The following product categories have been covered for impact analysis.

(i) Tea and Coffee
(ii) Coconut Oil
(iii) Cheese and Butter
(iv) Poultry
(v) Cigarettes
(vi) Alcoholic beverages
(vii) Milk food for babies
(viii) Oral Hygiene products

Tea and Coffee

After the QR removal, tea and coffee were allowed to be imported at a rate of 70 per cent customs duty from April 1, 2001. Though this provided a shield to the domestic tea and coffee industry, cheaper varieties were available from some countries (like cheaper imports from Sri Lanka due to the SAARC agreements). Hence, the Government of India increased the import duty to 100% in the year 2002–03 with the intention of protecting domestic industry. Tea is a part of the normal staple diet of the Indian consumers and they develop a taste for a particular brand. In other words, the brand loyalty in this segment is high and hence, mere availability of a foreign brand cannot ensure a switchover. Therefore, the impact is likely to be felt only in the niche segments. The Government's reduction of the excise duty on tea from Rupees 2 per kilogram in the Union Budget-2002 would benefit manufacturers in India to offset the adverse impact of QR removal.[9]

Till about five years ago, coffee planters were subjected to the norms of the coffee board. Hence, it is only recently that this sector has actually started to develop on its own. Moreover, the coffee industry continues to be levied with an AIT (Agricultural Income Tax) of 60% and there is an additional burden of excise duty and sales tax on instant coffee. On the whole, the coffee industry may continue to face immense competition from global players.

Coconut Oil

The coconut oil market is currently going through a phase of surplus supply and reducing trend in per capita consumption. Copra growing areas are largely in South India. The surge of palm oil imports from Malaysia and Indonesia has skewed the pattern of consumption of edible oil from coconut and groundnut oils to palm oil. This has led to an over supply situation of coconut oil. The market is witnessing a price level of Rs 30,000/- per tonne, which is at its nine year low. After the removal of QRs, consumers are getting benefited due to the decline in prices. On the other hand, the producers are forced to sell coconut at a price, less than the average cost of production. At present, import duty is 100 per cent if necessary, the government can increase it upto the 'bound rate' of WTO.

9. Prepared, based on Union Budget Document, Government of India, 2002.

Cheese and Butter

The cheese market in India has a market size of Rs 300 crore with major producers being Amul, Britannia, Verka, Vijaya and newer brands like Laughing Cow, Happy Cow and Kraft. The import duty is 35 per cent and there is a demand from the domestic industry to keep the tariff rates on milk products at 60%, which is the WTO permitted bound rate. However, in the short run, the impact on the domestic players may not be significant as the market may expand due to the advertising and promotional campaigns of firms including that of the MNCs. At the same time, cost and quality competitiveness of the foreign players might actually cause a brand switch phenomenon and induce higher demand for imported cheese in the long run.

Over the years, domestic players like Amul and Britannia, have established a name for themselves. With the advent of goods in their product category, like Le Bonn, their consumers are provided with a wider choice. To further elaborate, processed cheese is mainly an "urban phenomenon" with the rural sector opting for homemade *paneer*. International players enjoy economies of scale in the manufacture of cheese. The quality conscious urban consumers are expected to shift towards the foreign brand without the price consideration.

The butter market size is about 55,000 tonnes per annum. The growth observed has been 8 to 10 per cent. The QRs on the international butter brands have been removed, but an import duty of 40 per cent has been maintained. It may be noted that European and American countries provide export subsidies even to the extent of 50 per cent. This fact may turn out to be a significant deterrent for Indian firms. The consumption of butter is basically concentrated in the urban market, which has actually seen the presence of the above said brands in its big retail stores. The question is whether the import duty of 40% is enough to offset the subsidies received by the foreign players. The butter industry is likely to face severe competition in the near future (The Financial Express, April 1, 2000).

Poultry Products

The market size of poultry industry is Rs 11,000 crores. The customs duty rate on imports was 100%, along with the QRs before the year 2000. In other words, the industry was well protected. In 2000, mutton imports were put under the Open General List (OGL) followed by the case of chicken in 2001. One use of imported poultry can be by the restaurants irrespective of cost considerations. Packaged and branded imports can make a dent in this segment.

Cigarettes

Foreign brands like Marlboro, Dunhill, 555, Benson & Hedges have flooded the markets after the QR removal. These can be imported at a normal custom rate of 35 per cent. On the other hand, the domestic cigarette industry is reeling under the pressure of high excise duties. One Benson & Hedges cigarette is available at Rs 3.50 as compared to the Indian Tobacco Company manufactured Gold Flake Kings at Rs 3.00. With the price gap narrowing, the cigarette industry shall be severely affected. Before 2001, cigarette was on the restricted list. With the removal of import restrictions, the lower end of the market including Beedi manufacturers have been troubled by cheaper imports of brands like Lara and Aziz from countries like China, Bangladesh and Sri Lanka (Report of The Economic Times Intelligence Group, The Economic Times-2nd April 2001). The domestic industry has been demanding a reduction in excise duty, but the government has not reduced the duty so far. Another important aspect in case of this product is that during QR regime, there used to be huge revenue loss to the government due to smuggling.

Alcoholic Beverages

Though QRs have been removed, customs duty of 220% was imposed in 2000. However, in 2002, the customs duty on imported liquor was reduced to 182 per cent.

Also, the government is not imposing any countervailing duties. At the same time, the states have been given a free hand to impose an additional duty. Punjab and Maharashtra imposed an additional duty of Rs 540 and Rs 1800 per case respectively. This indicates that the domestic players are protected against the foreign players. The foreign players have to adhere to (i) labelling norms in different Indian languages (as is the case with the domestic producers) and (ii) the norms of Bureau of Indian Standards.

According to the Economic Times Intelligence Team, the retail outlet driven market is expected to increase to 1.5 lakh cases from the present 90,000 cases per annum (The Economic Times, April 1, 2000). The scotch segment, which was growing at the rate of 12% per annum, is expected to grow at the rate of 18–20% per annum, which suggests that the effect will be mainly on the niche segment of the alcohol market. However, the domestic market may also be affected in future when the duties come down. The lower and the medium end of the market may be challenged by brands from Poland, Slovakia and Czheck Republic which could affect the domestic brands.

Chocolates

There is an intensifying competition in the segment, brought on by the dismantling of the quantitative restrictions on food products. The QR phase-out has, so far, had a limited impact on the domestic chocolate industry, because of the high import duties and the substantial price difference at which imported products have been available on the retail shelves. But it may only be a matter of time for some of the dominant global players to decide to set up a manufacturing base in India. Mars, one of the largest chocolate manufacturers in the world, has been reported to be contemplating setting up a base in India. Though the entry of new players will undoubtedly expand the market itself, in the near future, escalating competition is bound to push up promotional outlays for the two players, Cadbury and Nestle, who lead the market. This has prompted both the firms to consider the option of drawing more actively from their parents' portfolio in order to broaden their market base. However, even if one assumes that both these firms act in this direction, the new brands would certainly require higher marketing and advertising support in the initial phase than the mature brands.

Milk Food for Babies

There are only two global players in India—Nestle and Heinz—and the major brands are Cerelac, Farex and Lactogen. Both the companies are multinationals and will benefit from the QR removal, as they would be able to import a wider range of products from their parent companies. Meanwhile, other MNCs keen on entering the market will have a rough ride because of the sensitive nature of the baby care market. Moreover, the demand is concentrated in the urban sectors and hence, the market as such is not very large. Nevertheless, advent of new products will increase the size of the market, even if only Nestle or Heinz brings them in. And since the lifestyle has started undergoing changes, over a period the concept of such products would percolate to the middle and lower income groups of the society as well.

Oral Hygiene Products

In this sector, almost all the top major firms, Colgate Palmolive, Gillette, HLL and SmithKline Beecham Consumer Health Care have already established their bases in India, and hence, there is unlikely to be any major impact. From the point of view of foreign companies, although the removal of QRs would provide them easy access to the Indian market, there are two major limiting factors, namely

(a) A customs duty of 35% has to be paid; and
(b) Oral hygiene market is very sensitive to the quality of the product

Hence, mere availability does not ensure sales. It also has to be supplemented with major promotional efforts, which all the major firms have been practising.

SWOT Analysis

The details of SWOT analysis of the FMCG sector are provided in Chart 8.2.

Chart 8.2 SWOT Analysis of FMCG Sector

Strength	Weakness	Opportunity	Threat
(a) Competition forces the firm not to increase the price.	Irrational domestic tax structure encourages imports.	Excise and Customs Duty rates have been slashed. More level-playing field for producers and importers.	Local unorganised players face challenges with the trade liberalisation policies.
(b) Provide employment directly and indirectly.			

From the chart, it can be observed that the Fast Moving Consumer Goods sector is characterised by the vast and extensive product range offered by each of the players in the market. In view of the above, the removal of QRs will also affect two primary drivers in the FMCG sector in the near future. They are:

(a) Distribution Chain
(b) Organised Retail Sector.

The freeing of QRs may enable the MNCs, already well entrenched in India, to use their appropriate networks to import and distribute their products. Also, Indian companies with extensive distribution infrastructure are likely to tie up with foreign firms and try to target Indian consumers for these products. The organised retail market, which is growing phenomenally in the country, is also going to be largely benefited. The advantage for it is that it get opportunities to look at the entire world as its souring base. The Indian industry has for long been exhorted to look at the world as a market to boost export earnings. The retailers can now have the option of exploring low cost production centres, with already created capacities, anywhere in the world.

SECTION 3: CHEMICAL INDUSTRIES

Chemical industries have been key to the economic development process of a country. In terms of raw material and finished goods imports, these industries show higher volume. However, significance of this sector in terms of export growth is also noteworthy.

Focal Issues

As a result of liberalisation in trade with other countries, the units in the industries are going through a phase of compulsory modernisation and reforms. The changes are inducing some units to innovation processes, but the units, which are not economically strong, face the problem of sickness.

Some of the changes made in the government policies also have affected chemical industries. For example, the policy framework governing inward FDI was substantially liberalised under the automatic route. As an effect of the rules laid down by WTO globally, all the industries are currently going through a phase of reforms and adoption of innovative measures. Chemical industry is not an exception to this phenomenon.

The deceleration in the industry has been due to a number of factors such as (i) normal business and investment cycles, (ii) lack of both domestic as well as external demand, (iii) inherent adjustment lags due to industrial restructuring through mergers and acquisitions and (iv) delay in establishing appropriate institutional and regulatory frameworks in certain key sectors.

The impact of globalisation policies with reference to trade liberalisation on three sub-sectors of chemical industry, namely petroleum, fertilizer and plastics, has been taken up subsequently.

Petroleum Industry

The Administered Price Mechanism (APM) for petroleum and diesel was abolished with effect from April 1, 2002. The pricing of Aviation Turbine Fuel (ATF) had already been deregulated from April 1, 2001. The APM was a complex cross-subsidised system under which some petroleum products like kerosene and diesel were highly subsidised, while the prices of some products like petrol were fixed at a level higher than the import parity price. While it was expected to be self-balancing over a period of time, domestic prices of petroleum products were partially insulated from volatile international crude prices in the short-term.

The APM worked satisfactorily in dampening the pass-through of fluctuations in international prices to domestic inflation. At the same time, lack of incentives for resource generation and technological upgradation resulted in widespread distortions affecting both industrial and consumer segments. The Oil Pool Account that was in operation since 1975 supported the APM. Oil pool deficits are outstandings payable to the oil companies by the Oil Co-ordination Committee (OCC). The oil pool went on deficit from 1989–90 onwards. The continued deficit rendered the public sector units in this sector non-viable. It made them to borrow heavily from the financial system in order to maintain supply lines.

With the dismantling of the APM, the oil companies are expected to set the prices of petrol and diesel in accordance with market forces, while prices for items under Public Distribution System (PDS), Kerosene and domestic Liquid Petroleum Gas (LPG), will continue to be subsidised. These subsidies are being phased out in 3 to 5 years. The cost of these subsidies would be borne out of the Consolidated Fund of India although the government is expected to collect taxes on petroleum products to roughly offset the subsidies. Oil marketing firms will have flexibility to revise product prices. However, oil companies would put a regulator in place to guard against cartels and other monopolistic practices.

Another aspect has been that mergers of the Public Sector Undertakings (PSUs) were carried out in order to improve the viability and competitiveness of stand-alone refining companies. Chennai Petrochemicals Limited and Bongaigaon Refinery and Petrochemicals Limited were made subsidiaries of Indian Oil Corporation Limited. Similarly, Kochi Refinery Limited and Numaligarh Refineries Limited were made subsidiaries of Bharat Petroleum Corporation Limited.

Fertiliser Industry

Fertiliser companies produce 30,722 thousand tonnes annually, but there is a substantial need of more than 3,540 thousand tonnes of imports per annum. Therefore, the industry has to take some innovative steps, which involve a high degree of modernisation to increase production, thereby saving valuable foreign currency. The exports towards South East Asia and West Asia have been adversely affected due to the rise in competition from China. There is a high level of subsidisation of fertilisers for farmers. (For example, urea comes under Essential Commodities Act and, therefore, its price and distribution are determined by the government). This leads to low profit margins for manufacturers.

Plastic Industry

Plastic industries constitute a major part of chemical industries. Plastic was placed on the Open General License (OGL) list in April 2000. Plastic products are of three kinds: Poly Vinyl Chloride (PVC), moulded items and extruded items. The basic import duty on plastics is 35 per cent, the surcharge on basic customs duty is 3.5 per cent, the additional duty is 16 per cent and the special additional duty is 4 per cent, making the total duty 58.5 per cent. For any kind of plastic industry, the raw material—polymer—is crucial. The import duty on polymers is same as on plastics. Domestic manufacturers have priced polymers at par with the import price, inclusive of import duty. Naphtha is converted into polymers such as PVC, polyethylene and polypropylene. Reliance is the largest manufacturer of polymers in the country followed by IPCL, GAIL and Haldia Petrochemicals. Reliance sets the price and others follow suit. The price of polymers manufactured in Korea or Kuwait is between $600 and $ 900 per tonne, whereas the corresponding price in India is $1,200 (The Hindu Annual Survey of Industries, 2000).

There is reasonable evidence of China flooding the Indian market with plastic goods. China mass produces the goods on a scale not possible in India. Because of the large-scale production of plastic items, the cost of goods produced in China, such as lighter (plastic) pens, is one-fourth of production cost in India. China and Nepal have a trade agreement which allows free movement of goods across the border. 'Made in China' goods are passed off at customs in India as 'made in Nepal'. This includes plastic products and plastic woven fabric like packing material.

The reasons why the plastic industry units in India are not in a position to compete with China are: (a) High import duty on raw material; (b) Lack of cheap credit; (c) Lack of power; and (d) Inspector rule. Also, part of the problem is Chinese goods smuggled through Nepal. Until recently, the incidence of duty on goods imported from Nepal was from the 4 per cent special additional duty and from the 16 per cent Counter Veiling Duty (CVD). Now the special additional duty has been removed as part of the free trade pact with the country. According to industry association sources, 90 per cent of the goods from Nepal are illegal and this illegal entry may become a major menace for the industry.

Any Chinese item with 10 to 20 per cent value addition can be brought in with a payment of 16 per cent CVD. The only way to check this is by insisting on 50 per cent additional duty in the case of third country origin goods, which is the international norm. Another severe problem experienced in this industry is the inspector rule which impacts cost. Furthermore, the plastic industry faces a threat from the unorganised sector, which pays neither electricity bills nor taxes.

Finally, small-scale units in the industry have to practice innovation. Some units have already adopted global quality practices as a strategy for success.

SWOT Analysis of Chemical Industries

The SWOT analysis of Chemical industries is presented in Chart 8.3.

Chart 8.3 SWOT Analysis of Chemical Industry in India

Strength	Weakness	Opportunity	Threat
Innovative steps taken by some of the companies	High cost of production in India	Focus on R&D will pay dividend in the form of patents	Imports from countries like China

SWOT analysis reveals that in this era of innovation-driven growth, focus needs to be on research-oriented growth strategy along with a combination of several other factors, namely (i) market-oriented product mix, (ii) increased thrust on marketing, (iii) stringent cost-control measures and (iv) growth in exports. With very high reliability of process design and stable operations, chemical industries can excel.

Case: Atul Products

Atul Products is a leading manufacturer and exporter of agro chemicals, drugs, cresol derivatives, dyes, dye intermediates and epoxy resins. It operates through six divisions in India and enjoys a good global network of associates and subsidiaries.

The management is making efforts to reduce its overhead costs to meet the challenge. The company is trying to reduce the interest amount by accessing low-cost funds, preparing high-cost loans, raising loans in foreign currency and by utilising more concessional export credit from banks.

The dye market experienced fierce competition from China and other Asian countries. Withdrawal of the quota regime in textile trade by other countries will open both avenues of enhanced profitability indirectly.

Atul is now focusing on its in-house R&D for development of environmentally-sound processes for manufacturing high-value fine chemicals, high-performance agro-chemicals and speciality dyes and dye intermediaries. The company is trying to modernise a number of existing processes to improve productivity, yield and quality and enhance solvent recovery. It is now focusing on its ability to deliver good value and superior customer-relationship management.

Source: Data collected from Company's Annual Report and website.

Case: Nirma

Nirma is an Ahmedabad-based soaps and detergent company. They have a broad product portfolio, with salt and soda ash to soap and detergent manufacturing and marketing.

The company was established in 1969 and its early operations were small in scale. They adopted the strategy of low pricing and low margins to beat the giants in the FMCG sector. The company also concentrated on widening its distribution network. Their sales were pushed up mainly through word of mouth. As the products' fame spread, agents from across the country became willing to operate on the tiny margins that Nirma offered. The company's strategy was to reach rural area through television medium in 1980s. They operated in the small-scale sector and thus saved enormously on excise duty that multinationals had to pay for every kilogram of detergent produced. They advertised in Doordarshan, not in cable TV channels.

The company has saved much on various expenditure heads like staff cost, power and fuel. The debt-servicing burden has also decreased by 21% to Rs 8.6 crore. Nirma has already created a brand associated with cheap products.

The company also faces intense competition from hundreds of small-scale soap makers. Presently, the company has 14,000 workforce and a turnover of Rs 2500 crore. Nirma faces stiff competition these days. However, Nirma has ventured into other sectors like education and run its institutions with the determination to serve the society and create goodwill.

Source: Data collected from Company's Annual Report and website.

SECTION 4: PHARMACEUTICAL INDUSTRY

In this section, the pharmaceutical industry has been analysed, particularly, based on the WTO agreement Trade Related Intellectual Property Rights (TRIPS).

Industry Structure and Aspects Related to Globalisation

India produces nearly 8.5 per cent of the world's drug requirements in terms of volume. (It ranks amongst the top fifteen drug manufacturing countries in the world). The industry produces a wide range of bulk drugs and holds a prominent position in the world in the manufacture and export of basic drugs. Currently, the Indian pharmaceutical industry is a vibrant, high technology-based and growth-oriented industry. Consequently, it attracts attention from the world over for its immense potential to produce high quality drugs and pharmaceutical formulations. The industry is one of the R&D intensive industries. The process of globalisation brings both new opportunities and new prospects to the pharma industry. The industry meets around 70 per cent of the country's demand for bulk drugs, drug intermediates, chemicals, tablets, capsules and orals. The industry is characterised by:

(a) Very intense competition from about 24,000 firms—large, big, medium and small fighting for their own place.
(b) Continuous drug discovery and rapid introduction of new products.
(c) The seemingly ever-increasing and almost never-ending government regulations and policy changes.
(d) Price controls, which are stiff and profits that are eroding
(e) Rigorous control on formulations and the absence of international patent protection resulting in little or no product differentiation.

(f) Increasing health awareness among the people and importance given to mediclaim.
(g) Increasing dominance of trade associations and their constant demand for increase in trade margins.

The Indian drug industry had been protected from foreign competition for two decades. And, yet, it is one of the most competitive industry in the world. Indian drug exports has grown by 35% annually over the past decade ((Dubey, 1999).[10]

Patent protection for pharmaceuticals raises the following distinct issues:

(i) Impact on Public Health

Some say, patenting drugs as per the WTO requirements raises costs, puts them out of the reach of the poor (applicable to most of the people in the country) and therefore, damages public health. Others argue that it encourages the introduction of new drugs, either directly, by encouraging invention in the country (in India) or through newly invented imports that are protected, or through foreign investment in production (and possibly research) in India. (India's size might make the prospect of this aspect more attractive as compared to other small countries.)

(ii) Impact on Indian Pharmaceutical Industry

The small players, who have been making copies, fear that they will not have sufficient capital or technology to invent new drugs that can be patented. As a result, they feel that the market will be polarised in favour of foreign multinationals. Larger firms, on the other hand, are in full support of patents, which they hope will attract foreign investment, and thereby stimulate joint ventures and research. The government is keen to implement the TRIPS agreement though it has faced resistance from local drug manufacturers and consumers. According to the government, once the crutches of weak patent law are removed, it can successfully negotiate with research-based international companies to boost export earnings, create more employment and benefit from the transfer of technology.

The developing countries have no other option but to fulfil the obligations, which they unwittingly undertook to perform during the Uruguay round. Under the WTO-led product patent regime, which India implemented, the mandate for the pharmaceutical industry is to focus on innovation and research. Protection of intellectual property is vital for encouraging and sustaining any innovation and research. The catch lies in understanding the protection and using it to one's advantage.

Deregulation and patent protection are considered necessary factors for boosting research and development because they allow companies to recover the costs. But their immediate impact could be social upheaval, due to an increase in the price of essential drugs. Lifting of price controls could have a more serious impact on drug consumers. According to a recent study by the Indian Drug Manufacturers Association, in the next 10 years, patents of most of the world's top 10 drugs will expire and the market for generic drugs will correspondingly increase (Proceedings of the Annual Conference of Association of Indian Management Schools, Noida, 2002). With well-established capabilities in the manufacture of bulk drugs, India can meet the challenge from the 'hard' patent regime by invading western markets with generic drugs. Indian firms have already established an international niche. Like, Ranbaxy is the world's second largest manufacturer of Cefaclor (the world's largest selling antibiotic at US$1billion a year). Therefore, strengthened "patent protection" is expected to encourage foreign direct investment

10. Dubey D. P., (1999), Globalisation and Indian Pharmaceutical Industry, Revolutionary Democracy, Vol 5, No. 1.

in India (Dubey, 1999).[11] An environment hospitable to foreign innovative technology sets in motion a range of other dynamics such as licensing, co-marketing and joint ventures; all of which in turn generate multiplier effects. Patent protection could improve the quality of medical care in India as the country progresses from a copying culture to one that induces local innovation.

However, the extent to which a new trade related patent regime would have direct impact in stimulating R&D in India remains open to debate. The indigenous capability will be hit hard. The Indian pharmaceutical companies know very well that the transition from the era of process patents to product patents will lead to severe market imperfection in the next few years and a number of companies will dwindle drastically. The infrastructure created by local industry will remain unutilised and local production will be confined to making age-old drugs, denying the benefits of new drugs and innovation. Today, while India is under pressure to provide market access to foreign companies, the country may not be in a position to export its drugs to western markets due to non-tariff barriers in the form of social and environmental regulations. Such non-tariff barriers may undermine India's comparative advantage of having lower price structure for the pharmaceutical products. As a case, recently, the European Union threatened to impose countervailing duties on Indian drug exports because they were cheaper than locally produced drugs therein.

The global pharmaceutical industry is a knowledge industry to which the case of India cannot be an exception. Indian units have survived so far without developing new molecules. But with the advent of the new patent regime, the strategies will have to change. Indian pharmaceutical industry, apart from pursuing novel synthetic routes to known molecules, must pursue basic research for patent-worthy inventions comprising new molecules. For these few new molecules, patents will lead to monopoly, as no other company will launch the same molecule.

The patents for almost all the drugs have already been filed; therefore for all practical purposes nothing is going to change. For most of the diseases, there are already known cures, therefore product patenting would not drastically change things. Situation will probably change drastically only for those companies which come out with breakthrough blockbuster molecules, which happens only once in twenty years or so (IIMB Management Review, Feature on TRIPS, September 2001).

Industry Trends

The industry trends have been outlined below.

(a) Increased Focus on R&D

Major firms such as Ranbaxy, Dr Reddy's Labs., Cipla, Nicholas Piramal and Wockhardt, are aggressively investing in R&D. Dr Reddy's Labs and Ranbaxy have already discovered a New Chemical Entity (NCE).

(b) Marketing Tie-ups

Domestic players and MNCs have entered into marketing arrangements to increase market penetration and further strengthen their position in respective therapeutic segments. For example, Ranbaxy has tied up with Cipla, Glaxo and Hoechst Marion Roussell (HMR) for products in specific therapeutic segments and HMR has tied up with Nicholas Piramal.

11. Dubey (1999), Globalisation and Indian Pharmaceutical Industry, Revolutionary Democracy, Vol 5, No. 1.

(c) Product Rationalisation/Brand Acquisition/Firm Acquisition

Most of the top pharmaceutical companies are consolidating their position in the domestic market either through product rationalisation (e.g. Glaxo) or brand or company acquisitions. HMR, Glaxo, Wockhardt and Ranbaxy have cut down their product portfolio in order to be more focused. Similarly companies, such as Sun Pharmaceuticals, Nicholas Piramal and Dr Reddy's Labs, have opted for brand/firm acquisitions to increase market penetration.

(d) Upgrading Manufacturing Facilities

Most of the above mentioned companies have already procured it upgraded their manufacturing facilities and either already have the approval or have procured it from the international agencies. The said approval is the basic requirement for access to the highly regulated developed markets of Europe and the US. (Example, approval from Food & Drug Authority in the United States).

The firms are setting up subsidiaries abroad or having strategic alliances to exploit the tremendous opportunities in the generics market, which is expected to grow in the next 5 to 10 years. They have got product registration/ Abbreviated New Drug Application (ANDAs) worldwide. A recent estimate suggests that only 15% of the Indian drug market has been covered by patents. The remaining 85% of the market would continue to be exposed to the full impact of generic [i.e. non-brand name drugs] competition, to which patented products will ultimately also contribute to when their patents expire. Moreover, as the TRIPS Agreement does not allow for backdating, drugs already in the market will be exempt from patenting (Dubey, 1999).[12]

With a high rate of population growth, it is expected that drugs requirement will tremendously increase in India in the days to come. India contributes 16.1 per cent of the world population. And, Indian firms enjoy price advantage as they produce quality products at nearly 1/10th of the price of a foreign firm. The multinational pharmaceutical companies in India enjoy a market share of around 35 per cent while the share of Indian companies is nearly 65 per cent.

SWOT Analysis

Details of the SWOT analysis are given in the following Chart 8.4.

Chart 8.4 SWOT Analysis of Pharmaceutical Industry in India

Strength	Weakness	Opportunity	Threat
Cost Competitiveness, Rich Biodiversity, Well developed Industry with strong manufacturing base, Well established network of laboratories and R&D infrastructure, Access to pool of highly trained scientists	Low investments in innovative R&D, Lack of resources for New Drug Discovery Research, Lack of strong linkages between industry and acadmia Production of spurious and low quality drugs tarnishes the image	Significant export potential, Contract manufacturing arrangements with MNCs.	Product patent regime poses serious challenge to domestic industry unless it invests in R&D. Drug Price Control Order (DPCO) puts ceilings on product prices, which prevents firms from generating surplus for investment.

12. *Ibid.*

According to SWOT Analysis, Indian pharmaceutical industry is characterised by efficiency through cost structure and good manufacturing base. However, R& D efforts are yet to become comparable to international levels. It has good export potential, which is, however, complicated with patent regime, imposed by WTO.

Case 1: Cipla

Cipla is one of the biggest manufacturers of bulk drugs and formulations.

The company has introduced several formulations and active pharmaceutical ingredients (APIs). It commissioned the second phase of its manufacturing operations in Goa and has entered into a research alliance for biopharmaceutical products with a Bangalore-based biotech company.

Cipla exports a wide range of APIs and formulations to over 150 countries. Cipla has entered into new arrangements with leading US generic companies for the supply of a wide range of finished dosage formulations. They have obtained approvals from USFDA, MHRA of UK, PIC of Germany and WHO, for most of their drugs. Its overall profitability was due to the optimisation of resources and implementation of rigorous cost control measures.

Cipla focuses on technological excellence and innovation to improve its performance both in domestic and international markets. The company has already accepted the growing importance of strategic alliances for research, manufacture and marketing, in the changing business environment.

Question

Discuss the rationale for Cipla's focus on exports and strategic alliances?

Case 2: Nicholas Piramal

Nicholas Piramal India is a giant in the Indian pharmaceutical market.

Nicholas Piramal had a different growth strategy as it started as a small player with big dreams. The strategy was organic growth coupled with acquisitions. Piramal acquired nine entities and integrated them quickly into the parent company to deliver higher growth from the acquired portfolio.

Nicholas Piramal is also focusing on exports market. It has decided to partner with innovator companies in global markets, rather than compete or patent litigate against them. Building on this base, the company has built an export model that delivers the 'India advantage' to the global firms. It plans to provide end-to-end outsourcing solutions across the pharmaceutical life cycle, from custom-made synthesis and bulk intermediates to formulations. It has established four process development groups at multiple locations in India and has also set up a 100% subsidiary in the US for closer customer reach. Nicholas Piramal believes that the future growth driver will be exports, ably supported by a strong domestic market.

Question

What are the growth strategies formulated by Nicholas Piramal to explore the opportunities?

Case 3: Dabur India

Dabur India is one of the biggest manufacturer of natural, herbal and ayurvedic products, healthcare and personal products, and food products.

It could cut its raw material expenditure to 50% by purchasing the raw materials through e-sourcing. Dabur reduced its stock at the stockists' end, and entered into a 10-year IT outsourcing-cum-consulting contract with Accenture. Their new advertisement campaign has helped them a lot.

In order to reduce its interest outgo, it has managed to get low cost debt rather than high cost debt.

Dabur has already entered the global market. As part of the business strategy, it has acquired Redrock, a UAE-based company, and renamed it as Dabur International. Dabur International's joint venture in Bangladesh, which has a manufacturing unit in Dhaka, became operational in 2003–04. They have already set up a joint venture in Pakistan and a manufacturing unit in Nigeria.

The company's international business, including exports from India, contributed 9.6% to the total sales. Dabur's FMCG business is expected to do well with increasing demand.

Question

Why does Dabur go global as business strategy?

Review Questions

1. Analyse the impact of liberalisation and globalisation on chemicals and pharmaceuticals sectors.
2. Critically examine the impact of removal of quantitative restrictions on imports on FMCG sector.
3. Carry out SWOT analysis of chemical industries.

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Part Annexure

Industry Analysis—Market Structure of Consumer Electronics Sector in Japan

Dr Justin Paul, Christian Tigges and Pavel Chernaev[1]

Introduction

The popular perception is that Japanese consumer electronics industry is characterised by few large, dominant corporations. However, there are small domestic firms as well as foreign companies operating within the Japanese market. The foreign firms include Samsung, Philips and LG. Smaller Japanese firms in the consumer electronics industry in Japan are Casio, Hitachi, Denon, NEC, TDK, JVC, Roland, Fujitsu, Canon, Fujifilm, Rohm, Plextor, Korg, Pioneer, Kyocera, Konica Minolta, Maxell, Mitsubishi, Technics, Ricoh, Pentax, Olympus, Nintendo, Sanyo, Epson, Nikon and Yamaha. An attempt has been made to hypothesise that Japanese consumer electronic industry falls in the oligopolistic market structure. This hypothesis has been tested in this study with the four-firm concentration ratio estimated by the authors.

Review of Literature

If competition within the Japanese consumer electronics industry were limited, Japanese firms could presumably earn higher profit margins. However, little evidence exists that the profitability of Japanese firms is higher. On the contrary, Japanese firms revealed to have lower profitability than firms from other advanced nations, especially the United States (Porter, Sakaibara, 2003). We, however, believe that this fact may partly be attributed to higher costs for production factors such as high labour costs and extensive R&D budgets; it also reflects the fact that market share and innovation are valued more than short-term profits by many Japanese companies.

Given the innovation-driven dynamics of the consumer electronics market, technology leaders would be able to reap short-term excess profits; however, a study conducted by Yamawaki found that over a period from 1964–1982, short-run excess profits and losses regressed at a comparable pace in Japan and the United States. Furthermore, Odagiri and Yamawaki (1990) were unable to show any significant difference in the persistence of profitability in Japan, Canada, France and the United States for the same period.

However, in the Japanese domestic market, competition is seldom a matter of pricing alone. Market share is rather determined by other features such as design, functionality, features and advertising, despite continuous efforts by foreign companies such as Samsung and LG to erode price levels and gain a foot in the Japanese markets. Unlike Japanese manufacturers who take pride in keeping their production and research facilities in a high-wage country like Japan, foreign competitors increasingly shift production to less developed nations such as China.

Price stability within the domestic market in Japan is significantly higher than in other Western nations, and especially the United States (Display Search, 2007) which supports our assessment that the industry is still characterised by strongly oligopolistic structures. As lowering prices would lead to deteriorating margins for all Japanese producers in the domestic markets, it appears that, true to the predictions of Game Theory, with respect to the oligopoly market structure, the Japanese domestic markets are arbitrarily kept at stable pricing levels.

1. The authors are with Nagoya University of Commerce & Business, Japan and European Business School, Germany at the time of this write-up.

While there is a high amount of differentiated products in the market, the degree of differentiation between companies is marginal with some firms trying to earn a brand premium in the high-end sector of the market. The high degree of domestic competition is mainly due to the tendency of Japanese manufacturers to imitate direct competitors (Abegglen and Stalk, 1985; Cooper, 1995; Porter, Takeuchi and Sakakibara, 2000). In addition, technology diffusion within the industry is extremely rapid, therefore eliminating any chances of access profits as shown by Cohen, Goto, Nagata, Nelson and Walsh (Cohen, Goto, Nagata, 2001) who measured imitation lag of Japanese companies to be 1.98 years compared to 2.80 years in the US domestic market. In addition corporate expansion strategies such as internal growth (Miyagawa, Wakabayashi and Uchida, 1996), foreign investment (Head, Ries and Swenson, 1995), diversification and new business development (Porter, Takeuchi and Sakakibara, 2000) are all rapidly adopted by all major industry players leading to a situation where Japanese firms enter all market segments simultaneously and all offer a complete product portfolio, at times even without establishing competitive advantages through differentiation or niche targeting (Porter, Sakaibara, 2003).

Research Methodology

This study has been carried out based on corporate data and research reports. While examining many corporations which deal in the wider field of general electronics, the scope of this analysis is deliberately limited to the consumer electronics markets in an attempt to differentiate a distinct market for which competitors could clearly be identified and analysed based on corporate data. Throughout this write-up, the term consumer electronics therefore implies the manufacture of audio and video playback and record equipment as well as music devices, game consoles and home appliances. We assume the video segment to consist of televisions, video recorders (VCRs), DVD players/recorders, integrated television recorders, camcorders, digital cameras and set-top boxes. Similarly, we have defined the audio sector to be comprised of audio home systems, CD players/recorders, minidisks, radios and portable audio systems. Games consoles include all hand-held and plug-in consoles.

Concentration ratio (CR) has been estimated to analyse the market structure and to test the hypothesis. CR measures the degree by which an industry is dominated by a few large firms. These give the percentage of total industry sales of 4, 8 or 12 largest firms in the industry an Industry in which the four-firm concentration ratio is close to 100 is clearly oligopolistic, and industries in which this ratio is higher than 50 percent is also likely to be oligopolistic.

Market Structure Analysis

Historic Structure

The Japanese corporate development is traditionally characterised by tight-knit conglomerate structures, called keiretsu. Held together either by extensive cross-shareholdings along a supply chain or by affiliation to a common banking house, these structures have for the most part created oligopolistic structures in all leading industries in the Japanese domestic and export market. A strong role of the government throughout the 1960s and 1970s further shielded companies from competition and foreign investment. The consumer electronics industry, too, was heavily influenced by government sponsored investment and support leading to the creation of internationally dominant corporations such as Panasonic, formerly Matsushita, and Sony. On the other hand, sophisticated Japanese consumer demand necessitated continuous innovation and competition within the domestic market, which would eventually allow Japanese consumer electronics companies to become successful outside of Japan as well. Following the collapse of the keiretsu system in Japan after the 1980s, government regulation was reduced in the consumer electronics industry and more and more foreign competitors were granted access to the mature domestic Japanese market.

Firms Size and Market Structure

The Japanese consumer electronics industry is characterised by few large, dominant corporations. Based on market share and revenue, four-firm concentration ratio was estimated to see whether the consumer electronics industry in Japan falls in the category of oligopolistic industry. The estimated four-firm concentration ratio was 52 (52%) i.e., 0.52 out of 1, which shows that the industry is likely to be oligopolistic.

Market Share Estimates based on Corporate Data (Consumer Electronics Industry in Japan)

Corporation	Market Share
Panasonic	18 %
Sony	15 %
Toshiba	12%
Sharp	7%
Others	48 %
Overall Market Volume	**US$ 17.9 billion**

Source: Data Monitor Report on Global Consumer Electronics, 2007.

Entry and Exit Barriers

The consumer electronics industry in Japan is characterised by high entry barriers created by lack of know-how, patents and high initial investment. While the emergence of budget products from China and Korea has shown that basic manufacturing skills can be transferred easily, entry barriers are posed by continuous R&D development which necessitates sufficiently skilled labour as well as distribution networks and marketing capabilities. As consumers become increasingly brand conscious with regard to video and entertainment products, branding and high brand loyalty also pose significant entry barriers. On a domestic level Japanese employment regulations and foreign direct investment guidelines pose high exit barriers for potentially unsuccessful competitors on the domestic level (Porter, Sakakibara, 2001).

Control over Supply

For most of the industry's history, Japanese manufactures have had a considerable amount of control over the Japanese domestic market as well as the international market with only Philips as the main rival from Western Europe. The emergence of new consumer electronic powerhouses such as Samsung and LG in South Korea and Haier in China, which have made considerable inroads in the international markets as well as in Japan, has diminished the influence of Japanese manufacturers with regard to supply control.

Future Outlook

It is worth noting that both the statistical data provided by the concentration ratio and the review of literature validate the hypothesis that still after considerable reform, the Japanese consumer electronics industry is largely oligopolistic. The domestic Japanese market especially shows considerable signs of pricing power and price control between corporations. Despite fierce competition on the domestic level, Korean and Chinese manufacturers as well as European competitors have so far been unable to gain significant market share. This may partly be due to the market power of domestic firms; however, the considerable bias of Japanese consumers towards foreign and especially Korean consumer electronics goods has been a factor that should not be neglected. We nevertheless believe, that in the future, foreign competitors will increasingly be able to gain some market share in the domestic Japanese market as the production in foreign companies matures. The continuous deterioration of trade barriers will therefore in the future lead to a moderate decrease in oligopolistic power. Also, changes in Japanese spending patterns may lead consumers to be more price-conscious. Following the liberalisation of the Japanese labour market by Koizumi, a significant amount of Japanese workers has lost the traditional lifetime employment but rather is forced to work on a part-time basis (Mulgan, George, 2002). This has created a new social group with considerable less disposable income and the constant fear of not maintaining employment. This group might eventually be perceptive to lower price offerings by foreign competitors.

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PART Four

Economic Policies

Chapter 9

Privatisation: Problems and Prospects

Learning Objectives

- to understand the meaning of the term 'privatisation' and its methods
- to learn the rationale for privatisation and the problems
- to analyse the disinvestments scenario in India
- to compare the privatisation programmes in the UK with that of India
- to analyse the case of privatisation of VSNL & airline industry

Chapter Structure

Section 1: **Privatisation – Modes, Reasons and Problems**

Section 2: **Disinvestment – Indian Scenario**

Section 3: **Difficulties in the Process**

Section 4: **Privatisation in UK**

Section 5: **Cases (i) Privatisation of VSNL**

(ii) Privatisation of Airports and Airlines

Introduction

Today, the pace of economic change is far rapid than at any point in the history of mankind. With each passing moment, the economies of the world are getting further integrated and interlinked. The term 'global village' is no longer a myth, but a reality which we need to live with.

The world over, there are shifts towards lesser government involvement in the field of business. The famous quote "The business of government is not to be in business" by John Moore seems to hold relevance these days, because of the privatisation wave across the countries.

In this context, let us discuss the essence of the term 'Privatisation', the modalities of how it is carried out and tried to analyse the pros and cons of the whole exercise. The purpose is to understand the issue and critically examine if increased private enterprise leads to any desired improvements. An attempt has also been made to study the mother of all privatisation schemes the world over, that of the Conservative government led by Ms Margaret Thatcher in the UK in 1980s, which has acquired legendary status and is the inspiration for similar exercises being adopted the world over. In this chapter, we analyse two case studies **(1) Privatisation of VSNL and (2) Privatisation of Airline Industry in India.**

SECTION 1: PRIVATISATION: MODES, REASONS AND PROBLEMS

According to the World Bank, privatisation *"is the transfer of ownership of State-Owned Enterprises (SOEs) to the private sector by sale (full or partial) of going concerns or by sale of assets following their liquidation."*

Privatisation is a very broad term, which can be defined in the simplest form as the process of transferring assets or service delivery from the government to the private sector. Since it is so broad, privatisation runs from leaving very little government involvement in the market to sometimes creating partnerships between the government and private players.

Over the past few years, the Indian government has been working towards privatisation of some state-owned enterprises in order to help diversify the economy. However, this effort has continued to attract criticism, particularly from the Left parties, who seem to believe that India should not privatise. The questions to ask, therefore, are what privatisation is and what are the benefits and costs of privatisation.

The strategy of economic reform introduced in 1991–92 in India was based on a combination of measures aimed at economic stabilisation as well as structural reform. Over the last decade, the Indian economy has demonstrated resilience and closer integration with the world economy. The country has moved into the 21st century with a strong desire to become competitive in a global arena.

Modes of Privatisation

A firm can be privatised through the following modes:

(i) Sale of enterprise
(ii) Lease of entity (with short-term purpose)
(iii) Joint ventures
(iv) Public share offers (Example, Initial Public Offer)

The modes and methods of privatisation adopted by governments vary and include the following:

1. Strategic sale by auction method;
2. Offer of shares through a public offering, both domestic and global, which may or may not involve a change in ownership/management (IPO and ADR/GDR).

The most preferred option of governments for privatisation so far has been via the strategic sale by auction method. The companies that have witnessed strategic sale in India in the recent past include Modern Foods, BALCO, CMC, VSNL, IBP, ITDC hotels, Maruti and HZL. In a strategic sale, there is the transfer of a block of shares by government to the strategic partner together and sometimes with the transfer of management control of the company to the strategic partner. The strategic sale method of disinvestment enables governments to receive a higher value for the shares transferred by it, as the strategic partner pays a premium for acquiring management control of the target company. This method of disinvestment has been successfully used in Great Britain during the privatisation drive under the Thatcher-led regime. China has also used this method for selling shares of State-Owned Enterprises (SOEs).

In a strategic sale deal, prospective and interested investors are invited by the government to put in their Expressions of Interest (EOIs). Government scrutinises the EOIs to shortlist the Qualified Interested Parties (QIPs) who meet the pre-determined net worth criteria. Therefore, the authorities ensure an unbiased selection process wherein shortlisted QIPs are allowed to conduct detailed due diligence of the Public Sector Undertaking (PSU), including site visits, and management meets in order to satisfy themselves on the fundamentals of the PSU. The disinvestment process culminates in a bidding process by auction where the QIP that puts in the highest bid would be eligible for the transfer of shares and controlling interest of the PSU concerned.

Shares are transferred by the government to the strategic partner through execution of a share purchase agreement. For the purpose of effective management control of the target company, government and the strategic partner execute a shareholders agreement that grants them rights on certain critical items of business at the general meetings of members as well as the meetings of the board of directors. Ordinarily, QIPs are given sufficient opportunity to put across their points and concerns.

In India, the route of strategic sale method has been the preferred choice over that of public offerings. This is on account of the perception that the Indian capital markets is not as well-developed as those of the developed world, thereby preventing government from getting the full value for the sale and disinvestment. However, the route of disinvestments, by way of domestic offerings and parallel global offerings in well developed markets in the US and Europe, have also been initiated by the government.[1]

Reasons for Privatisation

There are varied objectives for the governments to divest the PSUs. More often, these include some or all of the following reasons mentioned below. However, one of these reasons could be the main factor to trigger the privatisation process.

(i) To Reduce the Burden on Government

The government has to think about alternative sources of funds, if fiscal deficit and balance of payment become burden for the economy. In such situations, the government has two options:

- To raise taxes: However, the public are either unwilling or unable to pay for these taxes. Moreover, this in any case would cripple productive economic activity.

1. CAI Xueqin, Jean, KANDALLA Venkatanath, TAN Min-Ching “Privatisation in India: Progress, Issues and Recommendations”, Economic and Political Weekly, Oct. 7, 2003.

- To seek alternative sources of funding: For example in UK, a private railway infrastructure company announced a capital investment programme in track upgrade and renewal worth US$ 60 billion over 10 years entirely funded by the private sector.

(ii) To Strengthen Competition and Efficiency

Increased efficiency derived through the competition is the goal of privatisation. This is beneficial to the consumer not only because of cheaper products but because it leads to:

- Greater choice
- Better services and products

More investment in technology and research might also occur under privatisation. This is because of the increased competition that makes the quality of service more important.

It is worth noting here that the full benefits of privatisation accrue only when corporate culture changes—floating on the stock exchange won't bring efficiency and improved service of itself.

(iii) To Improve Public Finances

In order to service public sector debt, which often run up over many decades, the raising of revenue through sale receipts and post-privatisation corporate taxation on the profit of the company prove to be a major impetus to reform. *In one famous example, a major loss making UK firm, which was being subsidized to the tune of US $1.6 billion per annum a year prior to privatisation, was generating a positive corporate tax revenue contribution of over US$1 billion per annum to the public purse within two years of privatisation.*

(iv) To Fund Infrastructure Growth

In both developed and developing countries, upgrading and expanding infrastructure has greatly benefited from the privatisation process. Private capital has been brought to upgrade energy and telecom networks, build new schools and create new transport networks. In some countries, private sector investors provide service to build port, bridges etc. under private-public partnership.

(v) Accountability to Shareholders

Companies are also encouraged to act for the interest of shareholders after privatisation, i.e., privatisation increases shareholder accountability.

Take the example of Modern Foods Ltd. Within a month after privatisation, the company had been referred to the Board of Industrial and Financial Reconstruction (BIFR). At the time of privatisation, people knew that based on its past performance (loss), Modern Food was fast approaching BIFR. Hindustan Lever took measures to financially restructure the company and bring it out of BIFR at its own expense. Had Modern Foods remained a government company, the taxpayer would have paid for financial restructuring of the company, perhaps followed by another restructuring a couple of years later, again at the taxpayers' expense, as is usual in the public sector.

(vi) To Reduce Unnecessary Interference

One of the greatest benefits of democratic government is that the government is responsive to public demand and concerns. In some cases, this system gets abused by special interest groups for their own interests. Privatisation has the advantage of reducing the interference of the government and political parties in business.

(vii) More Disciplined Labour Force

In privatised industries, there are fewer strikes because unions have less power. Days lost through strike cause the organisation to operate less efficiently than is possible because it means that we are not making full use of all our labour resources. Strikes can also be very costly (both implicit and financial cost). In this context, privatisation is a good thing because it leads to increased efficiency and greater profitability, but in some cases the privatised industries could be 'under staffed' with one person doing the work of three.

Problems of Privatisation

It is often debated about the disadvantages of privatisation. The important points cited against privatisation are discussed in this section.

(i) Ownership to a Privileged Few

There has been a lot of debate against privatising profit-making companies. The taxpayer could suffer while public assets get sold off. Ownership would be transferred from public hands to the hands of a privileged few. However, many see that widespread shareholdership through listing encourages public ownership. The argument is that people feel like owners if they own a few hundred shares in a company.

(ii) Labourers would be at the Mercy of the Owner

Privatisation has weakened union power. The workers are forced to accept the package offered by the owners. They are also less protected from the possibility of dismissal and unemployment.

As the firms in private sector are known for capital-intensive technology use, it is likely to have an effect on the number of unemployed. This means that the state has to support more people and is, therefore, more expensive. Private firms are not keen to employ more people.

(iii) Price and Ignorance Factors

In certain cases, if the privatisation creates a monopoly, the consumer may lose out because companies would try to make a profit rather than provide a service. There can be a lack of provision to remote areas. For instance, if the postal service were privatised it could lead, for example, to less regular collections from remote rural areas, simply because it is not cost-effective.

(iv) Lack of Social Responsibility

The private sector is driven more by a profit motive than the public sector, which sees its aim as more of a social guardian providing employment and security to all. Failure of the private sector to fully account for non-commercial costs and benefits (e.g. Social, environmental) unlike the PSUs is an often quoted argument against the privatisation exercise.

(v) Loss of Experienced Managerial Expertise

Private sector normally prefers to employ youngsters and do not take initiative to protect them once they become aged. Experience has shown that the privatisation process is often accompanied by increased restructuring in management. Loss of senior management expertise can potentially undermine the whole process. The loss of managerial skills, of the senior people due to voluntary retirement etc, can have negative implications on the performance of the company in a competitive deregulated market place.

SECTION 2: DISINVESTMENT: INDIAN SCENARIO

This section is an attempt to give a brief overview of the disinvestment process in India with regards to the rationale behind it, a brief summary of the major disinvested Public Sector Undertakings (PSUs) and the current disinvestment scenario in India.

Background

The state sector was built up in India after Independence because the government wanted to build socialism in India. Thus, the state took on the task of building the infrastructure and basic inputs. To ensure the demand for the products made in India did not dip, the state erected huge walls of protection around the Indian economy. Many sectors of the economy originally left to the state sector can now be taken over by the private sector—it has the capacity to run them. The state can concentrate on jobs that the state alone can do, such as governance. This is the essential logic of privatisation.

Privatisation and Disinvestment

Privatisation process leads to change in management with change in ownership. Change in management is not a necessary condition in the process of Disinvestment. Disinvestment refers to dilution of the stake of the government to a level where there is no change in control that results in the transfer of management.

Rationale for Disinvestment

Because of the current revenue expenditure on items such as interest payments, wages and salaries of government employee and subsidiaries, the government is left with hardly any surplus for capital expenditure on social and physical infrastructure. On the other hand, the government should be spending on basic education, primary health and family welfare. At the same time, huge amounts of resources are blocked in several non-strategic sectors.[2]

Not only this—the continued existence of the PSUs is forcing the government to commit further resources for the sustenance of many non-viable units. To top it all, there is a huge amount of debt,

2. Narjess Boubakri, "The Aftermarket Performance of Privatization Offerings in Developing Countries", September, 2001, The Economist.

which needs to be serviced and reduced. This makes disinvestment of the government stake in the PSUs absolutely imperative.

The primary objectives for privatising the PSUs are, therefore, as follows (According to the statement made by Ministry of Disinvestment, Government of India in 2000–01):

- Releasing the large amount of public resources locked up in non-strategic PSUs for redeployment in areas that are much higher on the social priority such as basic health, family welfare, primary education and social and essential infrastructure
- Reducing the public debt that is threatening to assume unmanageable proportions
- Transferring the commercial risk, to which the taxpayers' money locked up in the public sector is exposed, to the private sector wherever the private sector is willing and able to step in

The benefits expected to be achieved through disinvestment are:

- Disinvestment would expose the privatised companies to market discipline, thereby forcing them to become more efficient and survive on their own financial strength. They would be able to respond to the market forces much faster and cater to their business needs in a more professional manner. It would also facilitate in freeing the PSUs from government control and introduction of corporate governance norms in the privatised companies.
- Disinvestment would result in wider distribution of wealth through offering of shares of privatised companies to small investors and employees.
- Disinvestment would have a beneficial effect on the capital market. The increase in floating stock would give the market more depth and liquidity.
- In many areas, e.g., the telecom and insurance sectors, the end of public sector monopoly would bring relief to consumers by way of more choices, and cheaper and better quality of products and services—as has already started happening.

Disinvestment Procedure

The procedure for carrying out the disinvestment, according to the rules laid down by the Govt. of India, is as follows:[3]

Proposals for disinvestment in any PSU are placed for consideration of the Cabinet Committee on Disinvestment (CCD). An Advisor is appointed to invite Expressions of Interest (EOI) from parties. The prospective bidders undertake due diligence of the PSU. Concurrently, the task of valuation of the PSU is undertaken. There are four methods used to arrive at the reserve price of a PSU. These are discounted cash flow method, balance sheet method and asset valuation method. The share purchase agreement and shareholders' agreement are sent to the prospective bidders for inviting the final binding bids (Technical and Financial). The bids received are placed before the CCD for the final approval. The CCD then approves the final buyer. After the transaction is completed, all papers and documents relating to it are turned over to the Controller and Auditor General of India (CAG), to enable the CAG to undertake an evaluation of the disinvestment, for placing it in Parliament and releasing it to the public.

3. Department of Disinvestment, India: www.divest.nic.in

Disinvestment Scene

Table 9.1 Actual Disinvestment from April 1991 Onwards and Methodologies Adopted

Year	No. of Cos. in which Equity Sold	Target Receipts (Rs cr)	Actual Receipts	Methodology
1991–92	47	2500	3038	Minority shares sold by auction method in bundles of "very good", "good", and "average" companies.
1992–93	35	2500	1913	Bundling of shares abandoned. Shares sold separately for each company by auction method.
1993–94	07	3500	Nil	Equity of 7 companies sold by open auction but proceeds received in 1994–95.
1994–95	13	4000	4843	Sale through auction method, in which NRIs and other persons legally permitted to buy, hold or sell equity, allowed to participate.
1995–96	04	7000	362	Equities of 4 companies auctioned.
1996–97	01	5000	380	GDR (VSNL) in international market.
1997–98	01	4800	902	GDR (MTNL) in international market.
1998–99	05	5000	5371	GDR (VSNL) Domestic offerings with the participation of FIIs (e.g. GAIL). Cross purchase by 3 Oil sector companies i.e. GAIL, ONGC and Indian Oil Corporation.
1999–2000	02	10000	1829	GDR-GAIL, VSNL domestic issue, BALCO restructuring.
2000–01	04	10000	1870	Strategic sale of BALCO, LJMC, KRL (CRL), CPCL (MRL).
2001–02	10	12000	3436	Strategic sale of CMC-51%, HTL 74%, VSNL 25%, IBP 33.58%, PPL 74% and other modes: ITDC, HCI, STC, MMTC.
2002–03	06	12000	3348	Strategic sale of JESSOP 72%, HZL 26%, MFIL 26%, IPCL 25% and other modes: HCI, ITDC and Maruti.
2003–04	09	13200	15547	Maruti-IPO (27.5%), Jessop & Co. Ltd. (Strategic sale-72%), HZL (Call Option of SP-18.92%), Public Offers – IPCL (28.95%), CMC (26%), IBP (26%), DRDG (20%), GAIL (10%), ONGC (10%), ICI (9.2%)
2004–05	01	4000	2684	NTPC (IPO) (5.25%)

Source: Compiled from the Ministry of Disinvestment Data, Government of India. Information on some companies were collected from the website www.divest.nic.in

Some of the cases of Privatisation in India in the recent years are given in the Table 9.2.

Table 9.2 Privatisation in Recent Years

Period	Company	Bidder	Amount (Rs Cr)
Jan 2000	Modern Food Ind Ltd (MFIL)	HLL	105.40
Jun 2000	Lagan Jute Machinery Co Ltd (LJMC)	Murlidhar Ratanlal Exports	4.00
Feb '01	Bharat Aluminium Co Ltd (BALCO)	Sterlite Industries	551.50
Mar '01	Kochi Refineries	Bharat Petroleum Corp	659.10
Mar '01	Chennai Petroleum Corp	Indian Oil Corp	509.30
Mar '01	Bongaingaon Refineries	Indian Oil Corp	148.80
Oct '01	CMC Ltd	Tata Sons	152.00
Oct '01	HTL	Himachal Futuristic Comm	55.00
Nov '01	Hotel Ashok Bangalore	Bharat Hotels	4.10
Nov '01	Hotel Ashok, Madurai	Sanguchakra Hotels	5.50
Nov '01	Hotel Ashok, Bodh Gaya	Lotus Nikko Hotels	2.00
Nov '01	Hotel Ashok, Hassan	Malnad Hotels & Resorts	2.50
Nov '01	Temple Bay Ashok Beach Resort	G R Thanga Maligai	6.80
Nov '01	Hotel Ashok, Agra	Mohan Singh	3.90
Nov '01	Juhu Centaur Hotel	Tulip Hospitality Services	153.00
Nov '01	Rajgir Property of Hotel Corp of India	Inpac Travels India	6.50
Jan '02	Hotel Qutab	Sushil Gupta	35.70
Jan '02	Hotel Lodhi	Silverlink Holdings	76.20
Jan '02	Hotel Laxmi Vilas	Bharat Hotels	7.50
Feb '02	Hotel Centaur, Mumbai	A L Batra Group	83.00
Feb '02	VSNL	Pantone Finvest (Tata Group)	1439.20
Feb '02	IBP Ltd. (IBP)	Indian Oil Corp	1153.70
Feb '02	Jessop and Company Limited	Ruia Cotex	18.20
Feb '02	Paradeep Phosphates Limited (PPL)	Zuari Maroc	151.7
Feb '02	Modern Food Ind Ltd (MFIL)	HLL	44.00
Apr '02	Hindustan Zinc Limited (HZL)	Sterlite Group	445.00
May '02	IPCL	Reliance Petroinvestments	1409.80
May '02	Maruti Udyog Limited (MUL)	Suzuki Motors Co	1000.00
May '02	Kovalam Ashok Beach Resort	M Far Hotels	43.70
May '02	Hotel Manali Ashok	Auto Impex	4.00
May '02	Hotel Aurangabad Ashok	Loksangam Hotels & Resorts	17.40
May '02	Hotel Airport Ashok, Kolkata	Bright Enterprises	20.00
July '02	Hotel Khajuraho Ashok	Bharat Hotels	2.20
July '02	Hotel Varanasi Ashok	Consortium of Ramnath Hotels (P)	9.10
July '02	Hotel Kanishka	Nehru Palace Hotels	96.00
July '02	Hotel Indraprastha	Moral Trading & Investment	45.00
July '02	Chandigarh Project	Taj GVK Hotels & Resorts	17.30

Source: Compiled from the data released by Government of India (www.divest.nic.in).

Cases

Lagan Jute Machinery Company Limited (LJMC)

LJMC is a jute manufacturing company. It started making loss from 1996–97 onwards and the turnover was on a decline. LJMC was approved for privatisation in the year 1997 and the company was later privatised in 2000 through sale of 74% stake to a strategic partner, M/s Murlidhar Ratanlal Exports Ltd.

The performance of LJMC, post-privatisation (July–Sep. 2000), compared to pre-privatisation period (i.e. April–June 2000) is given below:

Particulars	Pre-privatisation Period (April–June 2000)	Post-privatisation Period (July–September 2000)
Gross turnover	Rs 6 million	Rs 24 million
Profit/Loss	Incurred loss	Showed profit
Orders booked	Rs 12 million	Rs 15 million
Export of spares	Rs 0.5 million	Rs 1.6 million

LJMC is on the path of revival after privatisation without drastic problems.

Bharat Aluminium Company Ltd. (BALCO)

BALCO is a fully integrated aluminium producing company set up in 1965. The government of India had 100% stake in BALCO prior to disinvestment. In 1998, the disinvestment commission recommended 51% disinvestment in favour of a strategic buyer along with transfer of management. Sterlite Industries acquired the stake in March 2001 for Rs 551.50 cr.

CMC Limited

The company, incorporated in 1975, is mainly involved in hardware maintenance, systems engineering, system design, development, consultancy and networking. The government held 83.31% equity prior to disinvestment. Tata sons acquired 51% for Rs 152 crore in Feb 2001 although the CCD had set the reserve price at Rs 108.88 crore.

IBP Limited (IBP)

The company is engaged in the retail marketing of petroleum products, manufacture and marketing of industrial explosives and cryo-Vessels for industrial and biological applications. Government of India (GOI) finalised the strategic sale of 33.58% of IBP's equity out of its holdings of 59.58% for a price of Rs 1153.68 crore i.e., Rs 1551.00 per share at a P/E ratio of 63. It was sold to Indian Oil Corporation (IOC).

Videsh Sanchar Nigam Limited (VSNL)

Government sold 25% equity share holding out of its total holding of 52.97% in VSNL, in 2002. The total paid-up capital of VSNL was Rs 285 crore, the government holding being Rs 151 crore. Rs 71.25 crore of this equity was sold to M/s Panatone (Tata Group) at a price of Rs 1439 crore. The government in the process received approximately Rs 3689 crore. Thus, the government had sold its shares at a price of Rs 202 per share. The market price of VSNL shares as on 01.02.2002 was Ea.158/-.

Indian Petrochemicals Corporation Ltd. (IPCL)

The company is involved in production of chemicals and petrochemicals with focus on polymers. The paid-up capital was Rs 249.05 crore of which the Government of India shareholding was Rs 148.80 crore (59.75%). It was decided to offer 25% equity to a strategic buyer along with transfer of management control. Bids were received from Reliance Petro investments, IOC and Nirma Chemical Works Ltd. Consequently, the 26% equity was sold off to Reliance Group for an amount of Rs 1491 crore which translates in a P/E ratio of 23.

SECTION 3: DIFFICULTIES IN THE PROCESS OF PRIVATISATION

Following can be some of the difficulties and impediments in the process of implementation of privatisation policies.

Political System

One explanation for the slow pace of privatisation is the failure of the government to force the coalition parties in power to push through change. Not only are there differences between the ruling coalition government and major opposition parties, but also among different government entities.

A sustained and credible reform process needs a long-term policy framework that the government is committed to. There are few assurances that commitments made by a government will be honored by successive governments. A political party that introduces some reforms could just as quickly oppose them when it is no longer in power.

Union Power

One of the side effects of privatisation is the large potential layoff of employees, in a bid to increase efficiency. The fear of massive lay-offs has led to strong demonstrations against privatisation. There are instances of strikes organised by trade unions and political parties held across the country against the government's policy of liberalisation and privatisation.

Social Institutions

Strong social institutions are needed to help those put out of jobs as a result of privatisation. Reforms in India have focused largely on the trade, fiscal and industrial problems. Little attention has been paid to developing institutions such as social welfare, education, health, and so on.

Corruption

In many instances, privatisation has been criticised stating that it has gone hand-in-hand with widespread corruption and insider dealings, particularly in cases of privatisation through asset sales and vouchers.

This is because asset sales are often not done in a non-transparent fashion, with poor publicity of any impending sale. The scope for discretionary behavior is great and personal contacts can be a great advantage. Joseph Stiglitz once admitted that it was "difficult to prevent corruption and other problems in privatising monopolies".[4]

Misuse of Power by New Owners

The protest against privatisation has been fuelled by the perceived misuse of power by new owners of the privatised entities. Their actions could be driven by their own interests at the expense of the company. This issue had surfaced following the acquisition of VSNL (in the international telephony business) by the Tata group. Tata subsequently invested more than Rs 1200 crore of surplus cash of VSNL into its sister company Tata Tele Services, the returns of which were considered uncertain.

Private Monopoly Creation

Given the thin capital markets and the paucity of private Indian companies with the financial strength to purchase PSUs, this has meant that asset sales to private owners have been largely to the big family concerns. This has the effect of enlarging Indian conglomerates in the economy. Although they may not be in the same sector as the PSU they are buying, it could lead to monopoly/oligopoly.

In addition, there have been instances when the sale of the government's stake in a public company to a private company has provided it with monopoly power. One recent example was the purchase of IPCL (Indian Petrochemical Corporation Ltd) by Reliance, which led to an almost total monopoly in some of the most critical inputs in the petroleum industry.

SECTION 4: PRIVATISATION IN UK

The privatisation programme carried out by the Margaret Thatcher government in the UK has been a trend-setter and benchmark for all programmes of its kind pursued by the various governments around the world today. An attempt has been made to analyse the motives behind the British exercise, the results and the lessons that we have to learn based on their experience that transformed the British economy.

Motives

The successive Conservative governments of UK after 1979 pursued policies of privatisation of public sector units. Explanations of the government's motives for launching the privatisation programmes can be classified broadly into ideological, economic and managerial motives. A compilation of quotations would facilitate an examination of these categories.

Ideological

"We have also embarked on the long and complete process of returning state-owned enterprises to private ownership.... Legislation has been passed or is under way to denationalize many concerns. We are restructuring corporations...with a view to returning them to private ownership as soon as we can". Margaret Thatcher, February 1981.

4. Andrius Bogdanovičius, Policy Analyst, LFMI, "The Free Market", 2000 No. 2.

Economic[5]

The primary objective of the government's privatisation programme has been to reduce the power of the monopolistic firm and to encourage competition. As the programme moves ahead, maximizing competition will become the most important goal.

Managerial

"There has been an absence of radical thinking and a too ready acceptance of present practices. The privatisation programme holds substantial advantage for the management of the industries, their employees, the consumer and the taxpayer"—John Moore, 1983.

History of Privatisation in UK

Until the mid-seventies, the traditional government's response to poor performance of the economy was to proceed through macro-economic management of the demand. By the middle of the 1970s, the government had come to accept that the country could no longer be managed by providing simultaneously for growth, price stability and full employment.[6]

The period 1980–96 saw more than 50 cases of privatisation of UK organisations with total market capitalisation at current prices of over £45 billion. Examples include British Petroleum, British Aerospace, Britoil, Associated British Ports, British Telecom, Unipart, British Leyland and Trucks, and Istel; in some of these, the government still holds some shares (representing a minority holding). Several transfers have been total in nature and at one go (e.g., British Gas and British Airports Authority). Most have been public sales, but some have been in the nature of private sales, including management buy-outs. The UK divested in some very large companies that generated £27 million in sales revenue until 1990. As a result, the share of gross domestic product (GDP) held by public enterprises dropped by 6.5 per cent. However, the programme made wide use of employee share ownership and emphasised on broad share ownership in general.

This characteristic was particularly prominent when British Telecom was sold for £3.7 billion. It was the largest flotation of any kind until that year and the company came to have the largest number of shareholders of any company in the world. Privatisation has also helped many British industries to compete successfully in world markets. It made possible the emergence of a better quality of management such as in British Airways and British Telecom.

It has succeeded in the UK largely due to the political commitment of the government in power and the will to succeed and political consensus on the need to privatise some of the public sector industries.

Lessons

The main lessons from Britain's privatisation experiment are; first, the programme gives incentives to cut costs and improve services. Second, privatisation can assist the extension of shareholding if it is done through public issue at capital market and provide valuable funds to 'cash-strapped' governments. However, privatisation is not a solution. It works best when markets are opened up for competition.

5. The Economist, "All Yours", July 17th 2003.
6. Jacqueline Rose, "Privatisation of the State", January 18, 2003, The Economist.

The privatisation process continues to be an organic one with new sales mechanisms and industry structure.

Cases*

1. Case: Privatisation of VSNL

The government policy in India on privatisation had evolved from selling minority shares in 1991–92 to an emphasis on strategic sales during late 1990s. After partial disinvestment through sale of shares, VSNL, public sector Internet service provider, underwent a strategic sale to the Tata Group in April 2002. Subsequent to the sale, the government holding became 26% and the Tata Group's 45%. The sale was followed by VSNL's decision to invest Rs 1,200 crore in Tata Teleservices Limited (TTL), a wholly-owned subsidiary of the Tata Group. This led to concerns regarding the appropriateness of the decision, since it involved a cash outflow of Rs 1200 crore to a fledging private company in the telecom sector. VSNL was a cash rich organisation and was seen as having the potential to make forays into the global marketplace. Its monopoly in international long distance (ILD) voice until 2002 and Internet until 1998 had ensured that VSNL was a profitable enterprise. With WTO imposed stipulations, its monopoly, first over the Internet and then in ILD had been declared as no longer valid.

The Bidding Process

Companies, interested in participating in bid were required to have a net worth of Rs 2,500 crore.

The bid was open to international parties but did not draw any interest because of the 49% cap of foreign direct investments in the telecom sector. Among the domestic players, the initial 7-8 players who showed interest were narrowed down to Reliance and the Tata Group by the time the bidding process began.

The Reliance Group bid Rs 1,347 crore, losing out to the Tata Group bid of Rs 1439 crore. The Tata bid for the 25% stake worked out to Rs 202 per share as against the then prevailing market value of Rs 168 per share. The total realisation from VSNL was expected to fetch the government Rs 3,689.25 crore after provisioning in Rs 1,887 crore as dividend and Rs 363 crore as dividend tax.

The TTL (Tata Tele Limited)

After the acquisition, the VSNL board (under Tata management) decided to invest Rs 1,200 crore in TTL. The Tatas justified the decision as being part of the effort to extend VSNL's activities to the basic services customer. But this action led to controversy in the political circle.

The Union Communications Minister objected to the decision. To him, it was unethical that the Tata Group was using up cash reserves of VSNL to fund its own subsidiary. In the Minister's perspective, TTL was a new company that was yet to prove itself. If VSNL wanted investment in basic services, BSNL and MTNL could provide better opportunities.

Legally though, the Tata group was well within its rights to make the move. According to the Companies Act, strategic partners were free to utilise cash reserves of public sector units. However,

*The case studies in this chapter has been co-authored by Dr. Justin Paul with Dr. Festi Lova. These are not intended to serve as endorsement of data. Authors prepared these cases as the basis for class discussion, and not to illustrate effective or ineffective management.

the VSNL board's decision was questionable to the extent that the government nominee's dissenting voice was overruled when the proposal for the investment was passed in the board.

Key Issues

In case of VSNL, the government had been receiving Rs 10.4 crore (104 million) as dividends (average of eight years upto 2000) from VSNL. The sale of 25% stock resulted in an inflow of Rs 3,689 crore (including the special dividends) leading to an earning of Rs 368.9 crore in perpetuity (as interest on 10% deposit annually). Viewed from this perspective, the privatisation has led to a better expenditure management. It may be argued that by the privatisation process, the government had lost claim on its assets or shareholding. But this may be compensated by the higher cash returns generated from the sale. Moreover, service quality and prices, and efficiency might improve for the consumers and citizens.

Public Issue versus Strategic Sale

Before the year 2000, the government was selling minority shares in VSNL. The price to earnings ratio was 6.0 at that time. The strategic sale gave a much higher price to earnings ratio of 11.0. This was an indication of the market expectation of better performance under a private management. However, it is not always true that strategic sale alone leads to better valuations. In the case of British Telecom's (BT) privatisation that was done through sale of shares to the public, the government made significant changes in the board membership to indicate the greater business orientation the future BT was likely to have. In the absence of such changes, VSNL's share prices could not gain from IT/telecom boom. A more proactive approach to managing VSNL even before privatisation would have increased the valuation of VSNL.

Valuations

Critics of the present process of disinvestment have pointed out that many valuable PSUs have been sold below their actual value. They also point out that a short-term perspective of reducing the fiscal deficit should not drive the process of privatisation. The claim of privatisation boosting share prices of PSUs had also been proved wrong by the case of VSNL. The advisers and professionals who assist the process of disinvestment should be people with knowledge and integrity. Otherwise, it could lead to improper evaluation of the PSU and its bidding process.

Government's Role

Even after a strategic sale, it is the government's responsibility as a shareholder to ensure that such enterprises are allowed to function smoothly without interference from politicians.

The TTL controversy highlights the difficulties it faces in doing so. The government's role in privatised PSUs could continue to be significant.

The privatisation of VSNL can be seen as an example of public expenditure accountability through a realisation of higher return on the government's asset formation. The supporters of privatisation consider it as a step towards the provision of better quality communication services at the most competitive prices.

Questions

1. Why did the new Board of VSNL decide to invest Rs 1200 crore in TTL?
2. Privatisation of VSNL helped Indians. Yes/No. Justify.

2. Case: Privatisation of Airports and Airline Industry

Privatisation of airports could led to better operations and lower costs of aircraft carriers. All the airports were fully owned by the government in India till recently. Under the new public-private partnership scheme, more and more airports have been set up in semi urban India. The Cochin International Airport was a project that was inaugurated in 1999, involving a partnership between the government and the people (mainly NRIs), which functions outside the domain of the Airports Authority of India. It has led to one of the most efficient airports in the country and mainly serves the huge expatriate population travelling to and from Kerala. The company has made profit and broken even, paying a dividend to its shareholders. This could be an ideal showcase project for future investments in the airport sector.[7]

The competition among airports would allow airline operators to negotiate their landing prices, which would be a great aid for low cost airlines in cutting their charges, as in the case of mature markets of the West, which presented low cost airlines like Ryan-Air, Jet Blue (considered to be the hottest airlines in the American Skies), South West Airlines and so on.

Similarly, the state-owned domestic and international carriers, the Indian Airlines and the Air India dominated the airline market till recently in India. The air ticket prices were not affordable to ordinary citizens. Although the government had plans to divest its stake in Air India and Indian Airlines initially, it did not happen due to opposition from media and politicians. However, giving into the pressure of liberalisation, private airlines were allowed to operate in domestic routes as a first step. Due to the new entrants like Jet Airways, the state-owned airlines started losing their market share as they lacked technology upgradation and product offerings. Ministry of Civil Aviation in India has already adopted many schemes for the growth and expansion of air transport. They have made new aviation policy, which incorporated the construction of private sector airports, reconstruction of public sector airports and purchase of new aircraft, which help the carriers to compete with the private players. The policy would also accommodate to provide additional slots for foreign airlines at Indian airports and attract foreign direct investment (FDI).

The Indian government has opened up their skies to the private Indian aircraft, which helps them to offer their services internationally. As part of this policy, some of the private airlines, including Air Sahara, are able to run international flights. This '*open skies policy*' and the entry of low cost carriers, have brought about a boom like never before for the airline industry.

In general, the airline industry has absolutely no control over some of the biggest expense heads including fixed costs (in terms of leases and taxes) and variable costs (fuel and landing charges). Aviation Turbine Fuel (ATF) constitutes close to 40% of an airline's operating cost in India. This is almost twice that of airlines in the West. The reason for high price of ATF in India is the huge customs and excise duty levied on the fuel. Aviation turbine fuel is currently a monopoly of IOC (Indian Oil Corporation), BPCL (Bharat Petroleum Corporation Ltd.), and HPCL (Hindustan Petroleum Corporation Ltd.). The government plans to allow private players to supply ATF, so that the competition in the market will help to reduce cost.

Although India boasts of more than 400 airports, just 62 of them are in active use, and Mumbai and Delhi airports alone account for over 40% of the total air traffic in India. Traffic is growing both on major routes (between metros) and 'feeder routes' (between smaller cities) within the country. The facilities at Indian airports are woefully short. The poor infrastructure at Indian airports, including less space for parking bays, maintenance hanger, check in counter space etc., is really pathetic. Two of

7. Team SCMS, Case of CIAL, SCMS Journal of Indian Management, July–Sept. 2005.

the principles of low-cost flying-quick turnarounds and increased aircraft utilization are very difficult to implement in India because of the poor airport infrastructure. According to Ernest & Young industrial consultants, India needs $10 billion (Rs 44,000 crore) in investments to upgrade their airports.

Here comes the importance of privatisation and liberalisation. Privatisation helps more and more airports to spring up in India, which ultimately leads to better facilities at airports. It helps to bring up more and more low-cost private airlines into this highly competitive field. Reduction of import duties imposed, will help these airlines much, in lowering their fare also.

According to consultancy centre for Asia-Pacific Aviation (CAPA), domestic passenger traffic could grow at a much faster rate in the coming years. By 2010, there could be 60 million Indians travelling by air, resulting in an industry that's Rs 30,000 crores or $7 billion big, according to CAPA. Air Deccan, a private Indian airline, was able to draw more and more public attention by the introduction of their low-cost domestic airlines. Vijaya Mallaya's '*Kingfisher Airlines*', Nulsi Wadia's (Bombay Dyeing) '*Go Airline*', 'Spice Jet', '*Royal* Airways', '*Air India Express*'….. thus goes the long list of low-cost airlines. Most of the private airlines offer differentiated products and competitive fares on first cum first serve basis, which has also worked as source for inspiration to public sector airlines like Indian Airlines to reduce their prices.

Question

Discuss the business environment in Airline industry.

Courtesy: 1. *Business Today, Feb 13, 2005 `Indian Aviation's take off' by Kushan Mitra.*
2. *'I' Business Magazine, Jan 2005 issue 'skywards at rock bottom prices' by Rohan Randery.*
3. *Business Today, Jan 30, 2005 'Low drag flying' by Venkatesh Babu.*

Review Questions

1. What are the methods of privatisation?
2. Discuss the process of 'strategic sales' method of privatisation.
3. List out the reasons for privatisation.
4. Critically examine the problems and prospects of privatisation.
5. Explain the disinvestments procedure and debate on the advantages and disadvantages of disinvestments with illustrations.
6. Compare the privatisation programmes in UK and India.
7. Have you learnt any lessons based on the case of VSNL privatisation?
8. 'Private Sector is preferable to Public Sector'. Yes/No. Justify.

Objective Type Questions

1. According to World Bank, privatisation "is the transfer of ownership of ____________ to the ____________ by sale of going concerns, or by sale (full or partial) of assets following their liquidation.
2. The most preferred option of governments for privatisation so far has been via ____________.
3. The strategic sale method of disinvestment enables governments to receive a higher value for shares transferred by it, as the strategic partner pays a ____________ for acquiring management control of the garget company.

4. In strategic sale method, government scrutinizes __________ to shortlist the Qualified Interested Parties (QIPs), who meet the predetermined criteria.
5. For the purpose of effective management control of the target company in strategic sale method, the government and the strategic partner execute a __________, that grants them rights on certain critical items of business at the general meetings of members.
6. Strategic sale method is the preferred choice in India over the public offering method because __________ are perceived to be not as well developed as those in developed world, thereby preventing government from getting the full value for the sale and disinvestment.
7. In case of Modern Foods Limited, the company had been referred to __________ within months of privatisation.
8. Disinvestment refers to the __________ of the government, where there is no change in control that results in the transfer of management.
9. Disinvestment exposes __________ to market discipline, thereby forcing them to become more efficient and survive on their own financial strength.
10. Proposals for disinvestment in any PSU are placed for consideration with __________.
11. Government sold 26% equity share holding out of its total holding of 59.75% in IPCL to __________.
12. The issue of misuse of power by new owners surfaced following the acquisition of __________ by Tata Group.
13. The purchase of __________ by __________ led to an almost total monopoly in some of the most critical inputs in the petrochemical industry.
14. The privatisation programme carried out by the __________ in the UK has been a trend setter and a benchmark for all the projections of its kind, pursued by the various governments around the world.
15. The explanations of the conservative government's (UK, 1979) motives for launching the privatisation can be classified into ideological, __________, managerial and __________ motives.
16. Two examples of emergence of a better quality of management after the privatisation in UK: __________, __________.
17. The sale was followed by VSNL's decision to invest Rs 1200 crore in __________, a wholly owned subsidiary of the Tata Group.
18. By eliminating __________ and getting reservation system free, Air Deccan was able to cut short its airfare.
19. In a strategic deal, the prospective and interested investors are invited by the government to put in their __________.
20. Privatisation is beneficial to the consumer since __________ is an obvious outcome of privatisation.
21. Privatisation has the advantage of __________ the interference of government and political parties in business.
22. One of the major disadvantages of privatisation is weakened __________. The workers are forced to accept any pay package offered by the owners.
23. Failure of the private sector to fully account for __________ and __________ causes is often quoted as an argument against the privatisation exercise.
24. Change in management is not a necessary condition in the process of __________.
25. The continued existence of the PSUs is forcing the government to commit further resources for many non-viable units. In such a situation, __________ of the government stake in PSUs is absolutely imperative.
26. Proposals for disinvestment in any PSU are placed for consideration of the __________.

27. After the CCD approves the final buyer, all documents are sent to ________, who does the evaluation and sends it to the Parliament.
28. A sustainable and credible reform process needs a strong ________ system and a ________ framework.
29. The fear of ________ has lead to strong demonstrations against ________.
30. Privatisation in India has been criticised because most of the buying firms are ________.
31. After the acquisition of VSNL, the VSNL board decided to invest Rs 1200 crore in a Tata subsidiary. According to Companies Act, ________ were allowed to utilize the cash reserves of PSUs.
32. Even after a ________, it is the government's role to ensure that enterprises are allowed to function independently.
33. Government of India had gone for ________ in case of disinvestment of some PSUs.

Test Your Understanding

True or False

1. A firm can be privatised through strategic sale by auction method.
2. Government of India had gone for public issue of shares in the case of disinvestment of some PSUs like GAIL and NTPC.
3. The period 1980–96 saw more than 50 cases of privatisation in UK.
4. The disinvestment of BALCO took place in February-March 2001 and sterlite industries became the single largest private stake holder in the process.

Class/Field Exercise

Visit the website of Department of Disinvestment of two emerging countries and prepare a presentation on the trends and pattern of privatisation during last 10 years in those countries. Government of India's website is given below: http://www.divest.nic.in/

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Answers

Objective Type Questions

1. State-Owned-Enterprises (SOEs), private sector
2. Strategic sale by auction method
3. premium
4. Expressions of Interest (EOIs)
5. shareholders agreement
6. Indian capital markets
7. Board of Industrial and Financial Reconstruction (BIFR)
8. dilution of stake
9. privatised companies
10. Cabinet Committee on Disinvestment (CCD)
11 Reliance Petro Investments (Reliance Group)
12. VSNL
13. IPCL, Reliance Group
14. Margaret Thatcher government
15. economic, political
16. British Airways, British Telecom
17. Tata Teleservices Limited (TTL)
18. middlemen
19. Expressions of Interest (EOI)
20. increased efficiency
21. reducing
22. union power
23. social, environmental
24. disinvestment
25. disinvestment
26. Cabinet Committee on Disinvestment (CCD)
27. Controller and Auditor General of India (CAG)
28. political and long-term policy
29. massive lay-offs, privatisation
30. large Corporate house
31. strategic partners
32. strategic sale
33. public issue of shares

True or False

1. True 2. True 3. True 4. True

Chapter 10

Fiscal Policy, Union Budget and Taxation

Learning Objectives

- to understand the mechanism of fiscal policy implementation
- to learn the structure of union budget
- to know the procedure for calculating the fiscal deficit
- to assess the taxation system and the reforms undertaken

Chapter Structure

Section 1: Fiscal Policy

Section 2: Union Budget

Section 3: Reforms Undertaken and to be Undertaken

Section 4: Taxes

Section 5: Role of Government

Case: Indus-[Budget Game]

SECTION 1: FISCAL POLICY

The policy of the government pertaining to public revenue, public expenditure and public debt is known as Fiscal Policy. Government Revenue can be classified as tax and non-tax revenue. Government expenditure refers to plan and non-plan expenditure. Fiscal policy can play an important role in stimulating the rate of growth of an economy. The appropriate design of fiscal policy is important for all countries since tax and expenditure policies are geared towards encouraging savings and investment and the efficient use of policy can help stimulate economic growth. However, fiscal policy can hurt prospects for economic growth if government machinery runs up successive high budget deficits.

The objective of fiscal policy can be specified as follows:

1. To strike a balance between government revenue, expenditure and borrowings.
2. To attain best possible level of economic development.
3. To achieve full employment.
4. To reduce inequality of income and wealth.

The tools of fiscal policy have been given below.

Tools of Fiscal Policy
- Taxation
- Public Expenditure
- Public Debt
- Deficit Financing
- Budget Announcement

Economic reforms in India started in a slow, and limited way in the eighties and gathered momentum in the nineties. These reforms have by and large focused on removing the economic distortions created by earlier policies such as controls on economic activity and excessively complicated taxes. As a result of these reforms, India had achieved a growth rate of over 6.1% per annum over the last decade of the 20th century. Despite this, India remains as one of the poorest countries in the world. The fiscal problem, arising from an excess of unproductive expenditure, increases the vulnerability of the poor (and the economy as a whole) to adverse shocks.

Low per capita income poses challenge for a country. The need of the hour is to accelerate economic growth in the 21st century so as to eliminate poverty and unemployment. It is possible to accelerate growth to 7% and maintain it for two decades and thus generate full employment, and attain 100% literacy. To ensure environmental sustainability and quality of life, population growth will have to be contained.

The government has to focus attention on some of its most basic responsibilities such as the provision of public goods (roads, police, courts, regulatory systems), primary education, and public health (water & sanitation).

The fiscal situation had deteriorated during the eighties and culminated in the balance of payment crises of 1991 in India. Though the deterioration that preceded the crisis was reversed quickly, the fiscal deficit remains at a high level. In the long-term, high level of fiscal deficit is not sustainable. The fiscal problem needs to be tackled on by the Central and state governments if high growth is to be achieved and sustained. This chapter lays out the agenda for fiscal reform, outlines the structure of union budget and covers the important announcements of the yearly budget exercises (see the website of the book for Update on Budget and powerpoint file on highlights of latest budget).

The institutions of governance are basic to efficient growth at high levels. The quality of institutions of governance needs to be improved. This requires a fresh and unbiased review of their roles and functions. In some cases, old institutions (such as Panchayats and Co-operatives) have to be strengthened and given new roles. The State can decentralise powers and functions to the local level so as to improve productivity of expenditures.

SECTION 2: UNION BUDGET

The policy of the government to promote economic growth and avoid undesirable effects on the economy through taxation, government expenditure and debt management is called as Fiscal Policy. The implementation of fiscal policy is through annual 'Union Budget' exercise. The budget depicts a complete picture of the estimated receipts and expenditure of the government for the ensuing financial year.

Union Budget is an important event which has great significance for the entire nation and is normally introduced in the last week of February every year.[1] The budget is prepared and presented by Finance Minister before the Parliament. The Finance Bill of the budget has to be passed in the Parliament to approve the tax proposals and an appropriation Bill has to be cleared to authorise expenditure.

In the budget, a distinction is made between Revenue Account and Capital Account. Revenue Account can be classified into Revenue Receipts and Revenue Expenditure. Similarly, Capital Account is classified as capital receipts and capital expenditure. In simple words, the government proposes its plan to raise resources through annual budget and this is divided into two accounts (a) Revenue Receipts (b) Capital Receipts.

Receipts which involve no disposal of assets or incurring of liabilities are Revenue receipts. The Revenue receipts include direct taxes like corporation tax, income tax, wealth tax, gift tax, and so on, and indirect taxes like customs duty, excise duty, sales tax etc. The non-tax revenue like net income by public sector undertakings are also accounted under 'Revenue Receipts'. On the other hand, the money raised through borrowings by government or sale of government property etc., constitute capital receipts. i.e., Capital Receipts include government's market borrowings, provident fund, small savings etc. and the external assistance like loans, grants, etc.

Likewise, 'Revenue Expenditure' are those which neither add to the government's assets nor reduce the liabilities. Salaries of Government employees, purchase of stationery, maintenance of public utilities etc. are part of revenue expenditure. 'Capital Expenditure' refers to items that involves acquisition of assets, eg., investment in railways, roads, bridges, power projects and irrigation works.

When the total expenditure exceeds the total receipts, we call it as Budget Deficit. The excess of the total expenditure over the 'Revenue Receipts' are financed by borrowings of the Government which are classified under 'Domestic Capital Receipts' and 'External Capital Receipts'. The market borrowings, small savings, provident funds etc., come under domestic capital receipts. The loans and other assistance received from international agencies come under external capital receipts.

In other words, one can say that the greater part of budgetary gap is resorted through 'Deficit Financing'. The tools of 'Deficit Finance' are (i) borrowings by Central government against treasury bills (ii) withdrawal of accumulated cash balances of the government from the Reserve Bank (iii) issuance of new currency by the government. The deficit financing should be within manageable limit as excessive use of 'created money' may fuel inflationary tendencies. It is worthnoting that some amount of deficit financing is prevalent in developed countries also.[2]

1. http://indiabudget.nic.in
2. www.economist.com

Budget at a Glance and Fiscal Deficit

Fiscal deficit as a term is used in the Union Budget exercise. Fiscal deficit is the sum of the amount the Central government borrows and the overall budget deficit in order to meet the excess expenditure over receipts during a financial year. It can also be defined as 'Budgetary Deficit' plus the borrowings of the government.[3] On the other hand, revenue deficit measures the gap between Government's tax and non-tax receipts and expenditure on revenue account. The following Table 10.1 (titled Budget at a Glance) would give you clear idea about how these figures can be calculated.

Table 10.1 Budget at a Glance (Rs in Crores)

	Classification	Yearly Estimate
1.	Revenue Receipts out of which	84,209
	(a) Tax Revenue	62,739
	(b) Non-Tax Revenue	22,470
2.	Capital Receipts out of which	42,800
	(a) Recovery of Loans	6,655
	(b) Other receipts	3,500
	(c) Borrowings and other liabilities	32,645
3.	**Total Receipts (1 + 2)**	**1,27,009**
4.	Revenue Expenditure	1,01,839
5.	Capital Expenditure	29,484
6.	**Total Expenditure (4 + 5)**	**1,31,323**
7.	**Budgetary Deficit (6 – 3)**	**4,314**
8.	**Revenue Deficit (4 – 1)**	**17,630**
9.	**Fiscal Deficit (7 + 2c)**	**36,959**

SECTION 3: REFORMS UNDERTAKEN AND TO BE UNDERTAKEN

In the context of the overall tax system, import and export duties and taxation of inputs into production are recognised by tax experts as the most distorting forms of taxation. The argument is that such taxes reduce the efficiency and productivity of the economy by diverting resources. A reduction in import duties and the introduction of Value Added Tax (VAT) have, therefore, been important measures for improving the efficiency of the tax system. With the reduction in the peak rate to 12.5% on non-agricultural items, the number of basic customs duty rates have come down to 5.

In the direct tax area, efforts have been taken to simplify the tax system, reduce the maximum tax rate and broaden the tax base. The corporate tax rate, which ranged between 51.75% to 57.5% for different types of companies in 1991, was unified and brought down to 35%.[4] The reduction in rates and administrative improvements have resulted in broadening the base of direct taxes and a rise in the direct tax to GDP ratio.

In 1990, import duties were 300% or more for several items and above 200% for many other items. Peak rates* were progressively reduced during the nineties to reach 40% in 1999–2000 and 15% in 2004–05 and to 12.5% in 2006.

3. Fiscal deficit, monthly theme letter, South Indian Bank students Econo. Forum.
4. www.asiamoney.com
*Peak Custom Duty rate means the mode of customs duty rates.

Subsidies

Both revenue and fiscal deficits rose during the eighties in India. By the end of the eighties, the fiscal deficit had become a major underlying cause of the economic crisis which was to follow. Hence, it was necessary to eliminate wasteful expenditures and target subsidies more carefully.

Any subsidy on a good or service might distort the consumption and production of that good or service. Thus, for instance, a power subsidy might result in wasteful consumption of power and distorts the entire structure of production and investment in power. Hence, most subsidies can be considered as non-merit subsidies.

Changing circumstances have led to growth in the public distribution system (PDS) over the years. In an open economy with free access to the productive capacity of the world economy, the primary purpose of a PDS is to supplement the income of the poor. It is essential to improve the targeting of PDS to those who need it the most, namely those below the poverty line. A start in this direction has been made by removing actual income tax payers from PDS.[5]

User Charges and Investment Financing

Many public infrastructure services have been priced on the assumption that the government will underwrite whatever losses are incurred. It would be ideal to move to cost-based pricing of infrastructure services to generate sufficient resources for quality production. It is also critical for generating finances for the required investment to reach and sustain an economic growth rate of 7 to 8 per cent. Higher infrastructure growth is in the long-term interests of the common man, both as a consumer and a producer.

Budgetary Reform

The budget systems and operations can be restructured to take account of developments over the last 50 years. Government expenditures can be clearly separated from government investment. The concept of revenue and capital expenditure approximately captures these concepts.

A system of half yearly budgeting could be introduced. Computerised & standardised accounting systems can facilitate better management information systems in the public sector.

Tax Reforms

Reduction of the revenue deficit requires a rise in tax: GDP ratio on a sustained basis. This is possible only if the overall tax system is efficient and equitable. As taxes affect every facet of economic activity, they also have considerable power to channelise resources into socially-unproductive channels. It is, therefore, necessary to take an integrated view of the tax system.

5. www.imf.org

SECTION 4: TAXES

Value Added Tax (VAT)

VAT is a tax collected on the sale/production of goods and services and it replaced the sales tax at state level in India. At central level, CENVAT (central value Added Tax) replaced Central exise.

- The move from a traditional excise tax to a Value Added Tax in India has taken almost two decades. Already nearly 130 countries have switched over to VAT. The essential features of such a tax are the following:
  - It is comprehensive and universal; so that every producer pays VAT duty on his total output of goods and services. Wholesalers (large) would act as pass through agents (to complete the VAT chain).
  - Tax already paid on all inputs used in the production of the goods or services whether they are "consumables" or services is deductible from the final output at the time of fixing the tax.
  - There is a standard VAT exemption (value limit) for small producers or suppliers based on administrative considerations as is common across the world.

However, whenever VAT is mentioned, it is referred to mean state level tax level tax (VAT that replaced the sales TAX)

Customs Duty

Customs duty rate refers to the duty paid by an importer on items being brought or shipped from abroad.

Customs duty rates in India remain among the highest in the world, although it has been brought down in the recent past. Most developing countries have customs duty rates in the range of 5% to 20%, while developed countries have even lower rates. However, South Asian duty rates have been much higher. Given the limited capacity of less developed countries and their need for revenues, somewhat higher rates of customs duty have historically been justified.

Personal Income Tax

Income tax is an example for direct tax, to be paid by individuals earning income exceeding the government fixed level.

Though the income tax rate of 30% on personal income in India is quite reasonable, it applies at relatively low levels of income.

Those who are working in Gulf countries are exempted from paying income tax.

Corporate Tax

Companies are requied to pay corporate tax being calculated, based on their profit. Tax rate veries from country to country.

In India, the peak rate of corporate tax has recently been brought down to 30% to equate it with the personal income tax rate. With the increasing globalisation of the economy, there will be need for a comprehensive review of the income tax system to take into account greater movements of capital and labour in and out of the country. New developments like e-commerce would also have to be accounted for. The need of the hour is to restructure these elements of the tax laws to put them on par with the best systems in the world.

Service Tax

Tax to be paid by the consumers for availing certain category of services is known as service tax.

Services now account for the largest share at above 50 per cent in the country's GDP, whereas the primary and the secondary sectors contribute the rest. But even after successive expansion of service sector, revenue from service tax constituted barely 0.5% of the GDP and accounted for only 4% of the Union tax revenue. Efficiency in resource allocation suffers when certain sectors or activities remain untaxed while the tax burden falls on other sectors.

SECTION 5: ROLE OF GOVERNMENT

In the 1970s and 1980s, it was assumed that private entrepreneurs and firms were unwilling or unable to undertake investment in production of many goods and services. But they are very active in business these days and ready to invest huge amount. The role of government can, therefore, change from an investor and producer of goods & services to an enabler and facilitator of development.[6] However, it must continue to fund the provision of public goods and provide for the correction of externalities and the basic social safety net. The government should catalyse the building of public institutions and markets. The role of the government on taxation, expenditure etc., with reference to different sectors and services, have been outlined below one by one.

- It is well recognised that e-commerce presents some challenges for tax administration and governments finds it difficult to deal with e-commerce. With the physical location of both the buyer and the seller of the commodity in question irrelevant for the transaction, assigning tax liability would be hard. In addition, many goods (such as software) sold through e-commerce are directly downloaded and do not necessarily have a physical presence. The central government, with its reach throughout the country, may find it easier to tax e-commerce than state governments and local governments.
- Over the past two decades, many countries in Europe, America and Asia have gone through the process of bringing their fiscal deficits under control.[7] An Act, necessary for fiscal responsibility has recently been enacted. One of the objectives of the new Fiscal Responsibility Act is to bring the revenue deficit and primary deficit to nil within a defined time period. It also specifies the subsequent limits on these deficits, and the emergency situations in which these limits could be temporarily exceeded. Alternatively, limits could be put on total borrowing or fiscal deficit or on the debt-GDP ratio.

6. Sourced from www.adb.org
7. www.indiainbusiness.hic.in and modifieds

- Many of the administrative practices and methods in government offices have not changed since the colonial times. The need of the hour is to urgently introduce modern management practices in government departments.[8]
- The basic or fundamental function of the government can be divided in two categories: (a) providing public goods like defence, police, roads; and (b) promoting social welfare.
- Though economic growth creates job opportunities, poor can only benefit from these opportunities if they have access to basic facilities like housing, hospitals and education. Therefore, areas such as public health, primary education, legal system, public order, roads, knowledge and information, social welfare, old and disabled should be properly taken care of. The government has to mobilise resources to meet the expenses for all these activities by way of collecting taxes, both direct and indirect taxes.
- Normal decision processes in the government are slow and do not respond rapidly to the changing conditions. Government can create more autonomous organisations, which has complete managerial and decision-making powers, to avoid this problem.
- The voluntary retirement scheme in public sector undertakings can be strengthened. The rules of the VRS must ensure that the best employees do not leave.

Finance and Savings

The financial system plays a vital role in the economy by channelising funds from savings to investment. The health and efficiency of the financial system and the financial markets can, therefore, play an important role in sustainable growth prospects of the economy. It is noteworthy that financial services are a potential source of competitive advantage in the 21st century. This, however, requires an environment with international regulatory standards. Two specific points in this regard are:

- A number of saving instruments such as Provident Fund and 'Post Office and Small Saving Instruments' are used by the government as sources of funds. Because of system rigidities, interest rates on some of these instruments have barely changed. Interest rates on bank saving accounts are still controlled by the Reserve Bank in India.
- Replacement of the plethora of income tax deductions by a comprehensive exemption based on the net saving principle will ensure a supportive tax environment.[9] Once this is done, limits on employee or employer contributions will become unnecessary and can be abolished. It is sometimes forgotten that there are a large number of self-employed people in the country. They should also be entitled to similar tax benefits for retirement savings.[10]

8. Kelka Committee Report on Taxation, Government of India.
9. Todaro, Michael P., "Finance and Fiscal Policy for Development" Chapter 17, Economic Development, (pp 751–756), Pearson Education, 2003 Edition.
10. This case is a substantially modified and rewritten version of a caselette given by Prof. Jeffrey Straussman in a case study workshop conducted by him.

Case—Indus-[Budget Game]

Indus is a country that faces some difficult budget and defense policy choices. [Initially, participants should get divided into groups and, a few of them should act as the leaders of Indus, who decide how to allocate the country's budget for major government functions and resolve a number of national and defense policy issues. Each group should review the national functions of the government, determine proper roles, and allocate resources for macro-functions.]

Game Background and Country Description[10]

Indus is a large country with several hundred million people and faces several political, social, and economic security challenges. A variety of internal and external contingencies shape the domestic, foreign, and military security policy of the nation. Indus is currently experiencing rapid economic growth and becoming more productive as market-oriented reforms take hold. In the near future, Indus is expected to be a central player in the global economy. However, not everyone in Indus has benefited equally from the rapid economic growth. Unemployment is growing in the country as the government eliminates state subsidies from unproductive enterprises. As these problems grow an inevitable part of economic transformation—the government must decide on how much social protection should be provided to those left behind in the country's "economic miracle." Some of Indus's leadership also believe that the entire educational system needs to be re-examined if the country is to be truly competitive in the global environment. Meanwhile, inflation is a concern of Indus's leaders.

Indus also has national security policy issues to wrestle with. Some of the Indus's regional neighbours contest some of the territory that Indus believes is part of its historical legacy. More generally, the regional uncertainty is driven by racial, ethnic, religious and nationalistic forces. Political dissidents and even pockets of insurgency from those who refuse to accept the values expressed by Indus's leadership threaten domestic stability.

Given this environment, the leaders of Indus must establish firm priorities between defense and non-defense spendings and decide which programmes deserve the maximum resources.

Budget Preparation and National Priorities

Each group should now determine how important defense spending is compared to other national needs of Indus.

First, you should develop a display of government functions for Indus. Examples are:

Education *Health Care* *Agriculture* *Transportation*
National Security

Second, you should determine budget priorities by allocating 100 resource units to these functions. The 100 resource units represent the entire budget of Indus. Third, you should develop a plan on how to allocate a 10% increase and a 10% decrease in the budget.

Chapter Summary

This chapter has outlined some important aspects of the fiscal policy formulation in the 21st century. The tax reforms programme is considerably behind schedule. Fiscal imbalance is distorting central and state government expenditure patterns and growth. It was argued that tax reform measures would improve the allocation of resources, thereby improving growth prospects and increasing the tax base and collections. Higher tax collections would ease the fiscal pressure on state and central governments.

The rapid development of e-commerce, while inevitable and welcome in its own right, has the potential of eroding the tax base of state governments. Given the anticipated large growth in e-commerce, this problem is potentially of a serious nature. It was said that lower levels of government would find it hard to levy sales taxes. Since decentralisation of public expenditures would continue to be attractive, the role of fiscal transfers from the central to state governments is likely to become far more important in the future.

Review Questions

1. Discuss the meaning of the term 'Fiscal Policy'.
2. Distinguish between Budgetary Deficit and Fiscal Deficit.
3. Distinguish between 'Revenue receipts' as 'Capital receipts'.
4. Critically examine the 'tax reforms' and recent developments in the 'taxation' policy of the government in India.
5. Do you think introduction of 'VAT' will help the business community in India? What are the advantages of 'VAT'?

Objective Type Questions

1. ___________ is the sum of the amount the Central Government and the overall budget deficit in order to meet the excess expenditure over receipts during a financial year.
2. Fiscal deficit is the ___________ deficit plus govt. borrowings.
3. Revenue deficit measures the gap between ___________ on revenue account.
4. ___________ is the tax collected on the sales/production of goods and services, and it replaces the sales tax.
5. ___________ now account for the largest share at above 50% in the country's GDP, whereas the primary and secondary sectors contribute the rest.
6. One of the objectives of the ___________ is to bring revenue deficit and primary deficit to nil within a defined time-period.
7. The rules of the ___________ must ensure that the best employees do not leave.
8. A number of saving instruments such as ___________ and 'Post office and small saving investments' are used by the government as sources of funds.
9. The policy of the government pertaining to public revenue, public expenditure and public debt is known as ___________.
10. The objective of fiscal policy is to strike a balance between ___________, expenditure and borrowings.

11. In the budget, revenue account can be classified into __________ and __________.
12. When the total budgetary expenditure exceeds the total receipts, it is called __________.
13. The expenditure of the total over the revenue receipts are financed by govt. borrowings which are classified under __________ and __________.
14. Tools of fiscal policy are __________, public expenditure, __________, deficit financing and budget announcement.
15. Government revenue can be classified into __________ and __________ revenue.
16. The advent of __________ poses a new challenge for the government since in this case, the physical location of neither the buyer nor the seller is known.
17. Reduction of the __________ requires a rise in tax: GDP ratio on a sustained basis.
18. In an open economy with free access to the productive capacity of the world economy, __________ supplements the income of the poor.
19. In direct tax area, efforts are being made to simplify the tax system, reduce the __________ and broaden the __________.
20. The tools of fiscal policy are: __________, public expenditure, __________, deficit financing and budget announcements.

Class/Field Exercise

Visit the website of Ministry of Finance and gather the data and information on the latest Government Budget announcement and study the implications of the budget and make a class room presentation.

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11. Economic Survey, Government of India, 2004–05 and 2003–04.
12. Paul, Justin (2006): Impact of Union Budget-2006, Speech Delivered at IIM Indore (5th March, 2006) & SVIM Indore.

Answers

Objective Type Questions

1. Fiscal deficit
2. Budgetary
3. Government's tax and non-tax receipts and expenditure
4. VAT
5. Services
6. Fiscal Responsibility Act
7. VRS
8. Provident Fund
9. Fiscal Policy
10. govt. expenditure
11. Revenue receipts and revenue expenditure
12. Budget Deficit
13. Domestic Capital Receipts, External Capital Receipts
14. taxation, public debt
15. tax, non-tax
16. E-commerce
17. revenue deficit
18. Public distribution system (PDS)
19. maximum tax rate, tax base
20. taxation, public debt

Annexure

Exhibit 10.1 Trend of Fiscal Deficit in India (As per cent of GDP)

1990–01	6.6
1991–92	4.7
1992–93	4.8
1995–96	4.2
1996–97	4.1
1997–98	4.8
1998–99	5.1
1999–2000	5.4
2000–01	5.7
2001–02	6.2
2002–03	5.9
2003–04	4.6

Source: Economic Survey, Govt. of India, 2004–05.

Exhibit 10.2 Overall Balance of Payment Situation of India

(1990–1991 to 2003–2004)

(*Rs in Crore*)

Items	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-0	2000-1	2001-2	2002-3	2003-4(P)
Merchandise														
Exports, f.o.b.	33153	44923	54761	71146	84329	108481	121193	132703	144436	162753	205287	214351	254022	288769
Imports, c.i.f.	50086	51417	72000	83869	112749	146542	173754	190508	199914	240112	270663	274778	316450	365641
Trade Balance	–16934	–6494	–17239	–12723	–28420	–38061	–52561	–57805	–55478	–77359	–65376	–60427	–62428	–76872
Invisibles, net	–433	4259	4475	9089	17835	18415	36279	36922	38689	57028	48975	64161	82415	116510
Current Account	–17367	–2235	–12764	–3634	–10585	–19646	–16283	–20883	–16789	–20331	–16401	3734	19987	39638
Capital Account	12895	9509	11881	30412	28745	15597	40502	37536	35034	48101	44063	52858	62029	104287
Foreign Investment	184	340	1699	13282	15449	16312	21829	19961	10169	22501	31023	38809	27254	73461
External Assistance, Net	3965	7395	5748	5963	4798	3356	3998	3463	3484	3915	2079	5830	–11588	–12132
Commercial Borrowings, Net	4034	3807	–1095	1904	3238	4548	10004	14558	18557	1360	17553	–7495	–11415	–8455
Rupee Debt Service	–2140	–2785	–2335	–3302	–3090	–3106	–2542	–2784	–3308	–3059	–2763	–2458	–2303	–1758
NRI Deposits, Net	2756	1008	6097	3780	539	3821	11894	4325	4060	6709	10567	13127	14414	16800
Other Capital	4096	–256	1768	8786	7811	–9334	–4681	–1987	2072	16675	–14396	5045	45667	36371
Overall Balance	–4471	7274	–882	26779	18160	–4049	24220	16653	18245	27770	27662	56592	82016	143925
Monetary Movements	4471	–7274	882	–26779	–18160	4049	–24220	–16653	–18245	–27770	–27662	–56592	–82016	–143925
Reserves (Increase/ Decrease+)	2293	–9351	–2481	–27366	–14575	9798	–20759	–14367	–16593	–26648	–27547	–56592	–82016	–143925
IMF, Net	2178	2077	3363	587	–3585	–5749	–3461	–2286	–1652	–1122	–115	0	0	0
SDR Allocation	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Source: Economic Survey, Government of India, 2004–05.
See Reserve Bank website for updated information.

Exhibit 10.3 Tax Revenue of Centre and States (Direct and Indirect Taxes) in India (1975–1976 to 2003–2004)

(*Rs in Crore*)

Year	Total Tax Revenue (India)@			Central Taxes (Gross)			States' Share in Central Taxes		
	Direct	Indirect	Total	Direct	Indirect	Total	Direct	Indirect	Total
1975–76	2493	8689	11182	2205	5404	7609	742	857	1599
1976–77	2585	9747	12332	2320	5943	8263	662	1028	1690
1977–78	2680	10557	13237	2405	6453	8858	685	1113	1798
1978–79	2851	12677	15528	2528	7997	10525	717	1240	1957
1979–80	3096	14587	17683	2818	9156	11974	876	2530	3406
1980–81	3268	16576	19844	2997	10182	13179	1014	2777	3791
1981–82	4133	20009	24142	3786	12061	15847	1034	3240	4274
1982–83	4492	22750	27242	4139	13557	17696	1148	3492	4640
1983–84	4907	26618	31525	4498	16223	20721	1188	4057	5245
1984–85	5330	30484	35814	4798	18673	23471	1252	4525	5777
1985–86	6252	37015	43267	5620	23051	28671	1865	5625	7490
1986–87	6889	42649	49538	6236	26601	32837	2170	6306	8476
1987–88	7483	49494	56977	6752	30914	37666	2595	7002	9597
1988–89	9757	57168	66925	8830	35644	44474	2750	7919	10669
1989–90	11165	66528	77693	10003	41633	51636	3922	9310	13232
1990–91	12260	75462	87722	11030	46547	57577	4121	10414	14535
1991–92	16657	86541	103198	15353	52008	67361	5104	12093	17197
1992–93	19387	94779	114166	18140	56496	74636	6057	14465	20522
1993–94	21713	100248	121961	20299	55443	75742	7767	14473	22240
1994–95	28878	118971	147849	26973	65324	92297	8560	16283	24843
1995–96	35777	139482	175259	33564	77660	111224	11274	18011	29285
1996–97	41061	159995	201056	38898	90864	129762	13516	21545	35061
1997–98	50538	170121	220659	48282	90938	139220	21102	22446	43548
1998–99	49119	183898	233017	46601	97196	143797	14480	24665	39145
1999–00	60864	213719	274583	57960	113792	171752	16523	26958	43481
2000–01	71762	233558	305320	68305	120298	188603	18655	33290	51945
2001–02	73108	241427	314535	69197	117863	187060	21492	31906	53398
2002–03	86591	279802	366393	82445	139473	221918	NA	NA	57741
2003–04	100788	316587	417375	95714	155813	251527	25756	41602	67358

Source: www.indiabudget.nic.in

Chapter 11

Monetary Policy and Banking Sector Reforms

Learning Objectives

- to understand how monetary policy arises and tools of monetary policy
- to analyse monetary policy in the 21st century
- to learn about the link between monetary policy and banking
- to examine the central bank independence and monetary policy in India
- to compare monetary policies of different countries

Chapter Structure

Section 1: **Basic Concepts**

Section 2: **Monetary Policy in the 21st Century**

Section 3: **Monetary Policies in Various Countries**

Section 4: **Banking Sector Reforms**

SECTION 1: BASIC CONCEPTS

Monetary Policy is one of the two principle means (the other being fiscal policy) by which government authorities in an economy regularly influence the pace and direction of the overall economic activity, especially including not only the aggregate output and employment but also the general rate at which prices rise or fall. Governments carry out monetary policy, typically via central banks.

In this chapter, we discuss how the central bank influences the money supply by using different tools and how this mechanism works in controlling the trade-offs between inflation and real aspects of economic activity like output and employment. The focus is on the relevance of monetary policy in the 21st century. Owing to the recent developments in the theory and practice of monetary policy, we discuss the recent phenomenon of inflation in the Indian context. Finally, it also makes sense to discuss the various tools of monetary policy in the context of different countries and also describe how the central bank of India and that of other countries use these tools to implement monetary policy.

Monetary Policy Mechanism

Providing money for use in everyday transactions has been a common function of governments for over two thousand years. Over time, governments have created specialised central banks to which they have delegated this job.

The main objective of monetary policy in modern times has been to maintain stability of a country's general price level (prevent inflation or deflation). Other goals include maintaining balance in international trade, preserving stability in financial markets and fostering increased capital investment to enhance growth. Monetary policy, therefore, requires some "transmission mechanism" by which purely actions of the central bank influence the decisions of households and firms.

A bank holds reserves in proportion to its deposits. A bank's ability to provide loans depends on its ability to create deposits. The same holds true for the whole banking system. Credit need also varies with the levels of the economic activity.

Though some countries do not impose legal reserve requirements, their banks hold balances at the central bank to settle claims among themselves. Some countries also require their banks to use the central bank for net settlements.

Tools of Monetary Policy

The important tools of monetary policy are open market operations, reserve requirements, lending by Central Bank and Repo Rates.

Open Market Operations

Open market operations is the buying and selling of securities (normally Government Securities) by a central bank in the market in order to increase or decrease the outstanding supply of money. If the banking system as a whole has extra reserves, it will seek to buy such instruments, when available, as these are interest bearing instruments. The result will be the reduction in the interest rates.

An 'expansionary' open market operation creates downward pressure on short-term interest rates and a 'contractionary' open market operation creates upward pressure on short-term interest rates. Thus, a well functioning central bank following these procedures can control short-term interest rate.

Reserve Requirements (CRR and SLR)

A reserve requirement is a percentage indicating how much a bank needs to hold in reserves vis-a-vis its outstanding deposits. Lowering the reserve requirements has the same effect as expansionary open market operations, i.e. downward pressure on interest rates while raising the reserve requirements has contractionary effects. If central bank increase reserve requirements (Cash Reserve Ratio and Statutory Liquidity Ratio), bank's credit creation capacity will come down, i.e., banks would not be in a position to lend more money to the public in that situation. Cash Reserve Ratio is the rate at which banks are required to maintain their reserves with the central bank on fortnightly basis. Statutory Liquidity Ratio refers to the rate at which banks are required to maintain their reserves in government securities. The former is known as CRR and the latter as SLR.

Lending by Central Bank at Bank Rate

Central banks can also change supply of reserves by lending directly to some bank. In most countries that have reserve requirements, such direct lending to banks is normally on a small scale. In countries that have no reserve requirements, lending directly to banks is an important part of monetary policy, and this provides an alternative mechanism for controlling interest rates.

Setting the interest rate at which the central bank lends to the banks effectively establishes a floor for short term market rates. In some countries (e.g. Canada and New Zealand) the central bank confines the market rate on bills and similar short term instruments to trade within a narrow range by imposing both a floor and a ceiling: setting an interest rate at which it will lend to banks as well as a slightly lower interest rate at which it will pay banks on their holdings of reserve balances. In India, the rate is known as Bank Rate.

Repo Rates

Repos, short for repurchase agreements, are contracts for the sale and future repurchase of a financial asset, most often treasury securities. On the termination date, the seller repurchases the asset at the same price at which he sold it, and pays interest for the use of the funds. Although legally a sequential pair of sales, in effect a repo is a short-term interest-bearing loan against collateral. The annualised rate of interest paid on the loan is known as the repo rate. Repos are widely used in the over the counter market for investing surplus funds short term, or for borrowing short term against collateral. Dealers in securities use repos to manage their liquidity, finance their inventories, and speculate in various ways. The central bank uses repos to manage the aggregate reserves of the banking system.

SECTION 2: MONETARY POLICY IN THE 21ST CENTURY

One of the most obvious trends over the last two decades has been the gradual erosion of central bank power by market forces. Central banks are operating under tighter constraints as financial markets become more integrated and efficient, and as capital itself becomes more mobile and currencies more volatile. Now, more than ever, central banks need to ensure that they carry the markets with them if their policies are to have any chance of success.

Monetary Policy in Operation

Monetary policy sometimes works under conflicting goals, e.g. the desire to avoid inflation versus the desire to boost output and employment. It is necessary to establish what it can and can't do. For example, the central bank can fix the reserves or it can set the interest rates on any one class of debt instruments. It can also set the foreign exchange rate of its currency. But a central bank trading only in the securities market and making or taking payment by adjusting the supply of reserves can't directly set the volume of bank lending. It can only exert influence on these economic processes.[1]

Use of Money as an 'Intermediate' Target

The central bank can decide on the amount of 'money supply' in a given year, but cannot directly set the amount of money in the financial system; besides, it can't directly control the volume of bank credit. It tries to use money as an intermediate target by conducting monetary policy.

E-money and Falling Demand for Central Bank Money

Central banks face a new threat. Long-run factors, technological ones in particular, reduce the effectiveness of monetary policy. These new developments threaten to reduce the demand for central bank money (the monetary base) to a level where the central bank's leverage over the monetary system—its ability to influence interest rates, exchange rates, and the money supply—effectively disappears. As electronic substitutes for cash become more widely available.

Implications of a Declining Demand for Base Money

The declining demand for base money causes major problems for central bankers. First, as base money becomes less significant, it will gradually lose its effectiveness as a channel through which the central bank can influence the broader monetary system.

Secondly, the decline in the demand for base money would make prices and interest rates more vulnerable to external shocks and, in particular, to changes in the technological and other factors that influence the demand for currency.

[1]Dornbusch, Fisher and Startz, "Macro Economics", Tata McGraw-Hill, Ninth Edition.

Globalisation and the Monetary Policy

With the deregulation of financial markets and globalisation, the process of monetary policy formulation has acquired a much greater market orientation than ever before. This has been accompanied by several institutional changes in the monetary-fiscal interface to ensure that central banks possess autonomy.

The process of globalisation and liberalisation has necessitated widening of the mandate of central banks. For their policies to be effective, monetary authorities are required to modify the way in which they conduct monetary policy. Central banks in emerging markets also face similar issues. A special challenge in their case has been the need to calibrate the changes in the operating procedures of monetary policy with the pace of transition from an administered regime of interest rates to a market-based process.

Monetary Policy and Inflation

One of the most significant developments in the theory and practice of monetary policy in recent years has been inflation targeting.* The rationale for inflation targeting emerges as the joint consequence of two tools of monetary policy. It can be either open market operations or the interest rate the bank charges on advances. It is possible to express the policy chosen at any time in terms of the intended outcome of any single economic magnitude that monetary policy affects: inflation, output, employment or the economy's foreign balance. Maintaining price stability fosters greater output and employment in the long run. And in the short run, there is nothing monetary policy can do about either output or employment.

Central Bank Independence

Central bank independence relates to three areas viz. personnel matters; financial aspects; and conduct of policy.[2] Personnel independence refers to the extent to which the government distances itself from appointment and dismissal procedures of top central bank officials and the governing board. Financial independence relates to the freedom of the central bank to decide the extent to which government expenditure is either directly or indirectly financed via central bank credits. Policy independence is related to the flexibility given to the central bank in the formulation and execution of monetary policy.

Central Bank (Reserve Bank) Autonomy Over the Years

The Reserve Bank of India (RBI) was set up in March 1934, with the stated objective of monetary stability and operations on currency and credit system in India.

Shortly after Independence, the RBI was nationalised. The early years RBI was involved in promoting credit to agriculture and industry in pursuant to the overall objectives of the Five-Year Plans. An example of differences between the Government and RBI was the resignation of Governor Rama Rau in 1957.

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[2]www.fedralreserve.gov

*Inflation targeting refers to targeting the optimum level of prices in the economy.

During 1948 to 1969, the RBI matured into a full-fledged professionally managed central bank.[3] The mid-fifties saw the beginning of serious erosion of autonomy in the monetary policy function due to the emergence of the system of ad hoc treasury bills and automatic monetisation of fiscal deficit.

The third phase started with the nationalisation of major banks in 1969. Government became the owner of a number of banks, but the supervision of these banks was conducted by the RBI. High fiscal deficits persisted, which posed serious problems for prudent monetary management. The interest rates were administered and the Statutory Liquidity Ratio (SLR) requirements of the banking sector were periodically hiked. Recourse to the RBI credit was high, thus leading to high levels of monetisation. To neutralise the effect of monetisation on the price level, the RBI had to increase the Cash Reserve Ratio (CRR) requirements of the banking sector.

In the eighties, the RBI was ranked marginally below the median level of a list of about seventy central bank on the basis of autonomy. This represented a limited degree of statutory autonomy. The fourth phase started from 1990–91. Major changes in the monetary policy framework took place in many countries around this time. The relationship between the central bank and the government also took a new turn in many countries, resulting in the genesis of inflation targeting framework in a number of economies. The Indian economy in 1991 experienced a severe balance of payments crisis. The crisis was clearly fallout of the fiscal problem during the eighties. An agreement between the government and the RBI in September 1994 on the abolition of the ad hoc treasury bills was made effective from April 1997. The measure eliminated the automatic monetisation of government deficits. At the same time with the opening up of the economy, the operational framework of the RBI also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations.

Inflation in India has been moderate relative to other developing countries despite high fiscal deficit, and most inflationary episodes have been caused by supply-side factors. It has been pointed out by some experts that the RBI, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period. Significant achievements in financial reforms, including strengthening of the banking supervision capabilities of the RBI, have enhanced its credibility and independence.[4]

Monetary Policy in India

The conduct of monetary policy was guided by the objective of provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on the movements in the price level. Ensuring macroeconomic stability was a concurrent objective with intensified monitoring of price movements, in view of the hardening of international commodity prices, especially crude oil. Strong capital inflows posed a challenge for monetary management. The Reserve Bank responded with a policy mix of prepayment of external debt and liberalisation of foreign exchange transactions to maintain monetary conditions in line with the overall objectives. The monetary management with additional instruments in the context of the large volume of capital inflows led to the institution of a Market Stabilisation Scheme (MSS). Interest rates on nonresident deposits were gradually aligned with those prevailing in the international markets in view of the rapid expansion in banks' external liabilities.

[3]www.rbi.org

[4]Chandravarkar, Anand (2005): Towards an Independent Federal Reserve Bank, Economic and Political Weekly, Aug 27, Sep. 2, pp. 3837–3845.

These measures were reinforced by refinements in the Liquidity Adjustment Facility (LAF) scheme to strengthen the operating procedure of monetary policy. The Reserve Bank undertook parallel initiatives to improve the credit delivery system, especially in respect of agriculture and small and medium enterprises (SMEs). Let us understand the meanings of some of the tools used by the RBI.

Bank Rate

The **bank rate** is the rate at which banks borrow from the RBI. (See Reserve Bank Monthly Bulletin or website to check the current Bank Rate.) It is also defined as the rate of which Reserve Bank gives loans to banks by discounting bills. Any revision in bank rate by the RBI is a signal to banks to revise deposit rates as well as Prime Lending Rate (PLR). See **Exhibit 11.4** for details (Annexure).

Repo Rate

The **repo rate** is the rate at which the RBI borrows from the banks. This is also the floor rate at which overnight deals are struck. Besides lowering the cost of the funds, a lower repo rate will see the emergence of a short-term yield curve, since yields on a 91-day Treasury bill and repo rate will be the same. (Refer Reserve Bank website for updated rate.)

CRR and SLR

CRR is the cash reserve ratio, which is the percentage of net funds that commercial banks have to park fortnightly with the RBI to do business. Lowering of CRR means that more money comes into circulation. See **Exhibit 11.5** for details (Annexure).

In addition to the CRR requirement banks are supposed to maintain a certain percent of net deposits in government securities and similar instruments specified. This is known as Statutory Liquidity Ratio (SLR) which is 25% at present.

Monetary Policy Operations

Liquidity Management The Reserve Bank modulates market liquidity through a mix of repo operations. As capital flows persisted, the Reserve Bank's portfolio necessitated a switch from outright OMO to repo operations. In this context, the Reserve Bank appointed two groups, viz., a working group on instruments of sterilisation and an internal group on Liquidity Adjustment Facility to search for alternative instruments of sterilisation. On the basis of the recommendations of the Working Group on the Instruments of Sterilisation, the MSS was instituted in April 2004. The MSS, operationalised in April 2004, has emerged as a key instrument of liquidity management.

Interest Rate Policy The Reserve Bank continued to take policy initiatives to impart a greater degree of flexibility to the interest rate structure. In order to enhance transparency in pricing of loan products by banks, the April 2003 Monetary and Credit Policy Statement advised banks to announce their Benchmark Prime Lending Rates (BPLRs), taking into account the actual cost of funds, operating expenses and a minimum margin to cover the regulatory requirement of provisioning/capital charge and a profit margin. By 2004, almost all commercial banks had adopted the new system of BPLR.

Credit Delivery The Reserve Bank assigns the highest priority to nurturing a conducive credit culture among financial intermediaries, corporates and households. Credit delivery, in particular to agriculture, SMEs and infrastructure, is critical to sustain growth. In these sectors, the issue of availability of credit is often as important as the cost of credit, especially as the rates of interest on alternative sources of finance from the informal sector are prohibitively high. It is in this context that the Reserve Bank take initiatives to ensure flow of adequate bank credit at reasonable rates of interest.

SECTION 3: MONETARY POLICY IN VARIOUS COUNTRIES*

(A) Canada

The objectives of the monetary policy formulated by the Bank of Canada are solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.[5] Low inflation is essential to keeping the economy on the smoothest possible track for long-lasting growth. Monetary policy aims at avoiding inflationary "boom-and-bust" cycles that lead to painful recessions and rising unemployment.

Inflation Control Targeting has been a cornerstone of monetary policy in Canada over the past decade. In 1991, the Government of Canada and the Bank of Canada agreed to target inflation for a five-year period. The inflation rate in 1991 was 5.9 per cent as measured by the consumer price index. The initial goal was to reduce inflation to progressively lower levels. By December 1993, inflation had been reduced to two per cent. At that time, the government and the Bank of Canada agreed to extend the inflation-control target range one to three per cent. In May 2001, the one to three per cent target range was renewed to the end of 2006.

To achieve a rate of monetary expansion consistent with the target inflation range, the Bank of Canada uses its influence on short-term interest rates. If inflation is moving towards the top of the 1 to 3 per cent target range, it is usually a sign that demand in the economy for goods and services needs to be restrained through a rise in interest rates. If inflation is moving towards the bottom of the range, it is often a sign that demand is low and needs some support through a reduction in interest rates. The Bank of Canada carries out monetary policy mainly through changes in its target for the overnight rate. The Bank informs major financial institutions about the average interest rate it wants to see in the marketplace where they lend each other money for a day, or "overnight." When the bank changes the target for the overnight rate, this change usually affects other interest rates, including mortgage rates and prime rates charged by commercial banks, and may lead to the movement of the exchange rate of the Canadian dollar.

Through the Large Value Transfer System (LVTS), Canada's major financial institutions conduct large transactions with each other electronically. At the end of the day, the financial institutions need to settle business among themselves. One bank may have funds left over at the end of this process, while another bank may need money.

The Bank of Canada operates a system to make sure that trading in the overnight market stays within its "operating band". This band always has the target for the overnight rate at its centre. For example, if the operating band is 4.25 to 4.75 per cent, the target for the overnight rate would be 4.50 per cent.

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*Section 3 in this chapter was co-authored by Dr. Justin Paul, Pankaj Sachar, Niharika Chandalia and Sachin Aul, alumni of Indian Institute of Management.

5. www.bankofcanada.org

(B) China

Objectives

With the recovery of the global economy in the year 2004, the pressure of inflation built up in major economies. Some central banks chose to take fighting inflation as the main monetary policy objective. An array of macro control measures were gradually put in place in China, which have started to bear fruits. The unstable and unhealthy factors in the economy have been contained enabling the economy to carry on the momentum of rapid, efficient and vigorous growth. In the year 2004, China's GDP increased by 9.7 per cent over the same period of 2003.[6]

The policy aims at applying quantitative instruments to appropriately adjust liquidity in the financial system. It also aims at speeding up the development of financial markets to improve efficiencies of monetary policy transmission and to promote reform of financial institutions to enhance sustainable development of the financial sector. It also aims to maintain exchange rate stable at an adaptive and equilibrium level.

People Bank of China's Monetary Policy: Major Changes during Last Decade

The major changes made in the monetary policy in China during last decade are

- Flexible open market operations were conducted to adjust the market liquidity
- Reserve requirement ratio was raised
- Floating rates were applied to central bank lending and the system of differentiated reserve requirement ratio was adopted
- Market-based interest rate reform progressed steadily to ensure a more significant role of the market in resource allocation

Implications

The People's Bank of China instructs commercial banks to make sensible assessment of market risks and continue to provide normal working capital support for enterprises with marketable products, good efficiency and concrete contributions to employment, and for construction of projects conforming to the state industrial policies and market access requirements.[7] Indirect instruments are mainly used in the process of macro control so as to make the whole process more scientific, forward-looking and efficient.

Some sectors of the Chinese economy are becoming increasingly sensitive to interest rate movements. These include the rapidly expanding non-state enterprises, which have to base their investment decisions on financing costs and rates of return. The housing sector is becoming more sensitive to interest rate movements. The real estate market has flourished over the past few years on the back of the rising popularity of home mortgages, which grew to over 7% of total loans in 2004, despite being almost non-existent in 1998. China has made significant progress in building up its money market and deregulating interest rate controls over the past decade.

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[6]http://main.hangseng.com/eng/abo
[7]http://www.economist.com/agenda

(C) USA

The US monetary policy affects all kinds of economic and financial decisions people make in the country. Furthermore, because the US is the largest economy in the world, its monetary policy also has significant economic and financial effects on other countries.

The monetary policy is conducted by the Federal Reserve Bank, the nation's central bank, and it influences demand mainly by raising and lowering short-term interest rates.

Objectives

Monetary policy has two basic goals: To promote "maximum" sustainable output and employment and to promote "stable" prices. These goals are prescribed in a 1977 amendment to the Federal Reserve Act. Refer Exhibit 11.1 for the inflation rate trend in the USA.

Tools of US Monetary Policy

The following are the tools of the US Monetary policy:[8]

- Open market operations
- The discount rate
- Reserve requirements

Open Market Operations The major tool the Federal Reserve Bank uses to affect the supply of reserves in the banking system is open market operations under which the Fed buys and sells government securities in the open market.

Suppose, the Fed wants the funds rate to fall. So, it buys government securities from a bank and then pays for the securities by increasing that bank's reserves. As a result, the bank now has more reserves than it wants. So the bank can lend these unwanted reserves to another bank in the federal funds market. Thus, the Fed's open market purchase increases the supply of reserves to the banking system, and the federal funds rate falls. When the Fed wants the funds rate to rise, it does the reverse, that is, it sells government securities. The Fed receives payment in reserves from banks, which lowers the supply of reserves in the banking system, and the funds rate rises. Refer Exhibit 11.2 to understand the interest rate trend.

Reserve Requirements Reserve requirements are the amount of funds that a depository institution must hold in reserve against specified deposit liabilities. Within limits specified by law, Federal Reserve Bank has sole authority over changes in reserve requirements.

Discount Rate The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility—the discount window. The Federal Reserve Bank offer three discount window programs to banks—primary credit, secondary credit, and seasonal credit, each with its own interest rate. All discount window loans are fully secured.

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[8]http://nber.org

(D) England

Day-to-day operations of monetary policy in the UK is in the hands of the Bank of England. The bank sets the official repo rate on the basis of a detailed monthly assessment of trends in the economy and the associated balance of risks to cost and price inflation.

Objectives

Bank of England's core objective is to 'maintain the price level and value of the currency'. The bank pursues this primarily through the conduct of monetary policy. Above all, this involves maintaining price stability, as defined by the inflation target set by the government as a precondition for achieving a wider goal of economic growth and employment. Refer Exhibit 11.1 for the inflation rate trend in the UK.

Tools

The bank aims at meeting the inflation target by setting short-term interest rates. Interest rate decisions are taken by the Monetary Policy Committee (MPC) of the bank. Monetary policy operates by influencing the cost of money. The bank sets an interest rate for its own dealings with the market and then that rate affects the whole pattern of rates set by the commercial banks for their savers and borrowers. Refer Exhibit 11.2 for the interest rate trend.

This, in turn, affects spending and output in the economy, and eventually costs and prices. Broadly speaking, interest rates are set at a level to ensure that demand in the economy is in line with the productive capacity of the economy. If interest rates are set too low, demand may exceed supply and lead to the emergence of inflationary pressures; if they are set too high, output would be low and inflation is likely to decelerate.

Monetary Policy and the Exchange Rate

There is no official exchange rate target for the British economy. The UK has operated a free-floating exchange rate ever since they suspended their membership of the European exchange rate mechanism in September 1992. Although the Monetary Policy Committee has occasionally discussed the relative merits and demerits of intervening in the current foreign exchange markets to influence the external value of the pound, the Bank has not done so for over a decade.

Monetary Policy and Money Supply Targets

There are no specific targets for the growth of the money supply, although data on the growth of the stock of money provides useful information for the central bank on the strength of aggregate demand. Interest rates are not determined with reference to specific targets for the money supply. There are no supply-side controls on the growth of bank lending/credit, instead monetary policy in the UK is designed to control the growth in the demand for money through changing the cost of loans and influencing the incentive to save.

SECTION 4: BANKING SECTOR REFORMS

The banking sector reforms in 1990s in India were based on the report of the committee headed by Mr. M. Narasimhan in 1991. Major recommendations of the committee were as follows:[9]

1. There should be no bar to set up new banks in the private sector, provided they have the start-up capital and other requirements prescribed by the Reserve Bank of India.
2. The government should indicate that there would be no further nationalisation of banks and there should not be difference in the treatment of public and private sector banks.
3. The banking system should evolve towards a broad pattern consisting of three or four large banks, including the State Bank of India which could become international in character; eight to ten national banks with a network of branches throughout the country engaged in universal banking; local banks whose operations would be generally confined to a specified region and lastly, rural banks to cater to rural areas.
4. There should be an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions (FIs) a portion of their bad and doubtful debts at a discount, the level of discount being determined by independent auditors on the basis of clearly defined guidelines. The ARF, according to the Committee, should be provided with special powers for recovery, somewhat broader than those contained in Sections 29 to 32 of the State Financial Corporation Act, 1951. The capital of the ARF should be subscribed by the public sector banks and the financial institutions.
5. The banks and the financial institutions should be authorised to recover bad debts through special tribunals and based on the valuation given in respect of each asset by a panel of at least two independent auditors.
6. The public sector banks with profitable operations should be allowed to tap the capital market for enhancement of their share capital. Subscribers to such issues could be mutual funds, profitable public sector undertakings and the employees of the institutions besides the general public.
7. Branch licensing should be abolished and the option of opening branches or closing of branches other than rural branches, be left to the commercial judgment of the individual banks. Further, the internal organisation of the banks is best left to judgment of the management of the individual banks.
8. There should be phased reduction of CRR and SLR.
9. Banks should adhere to ascertain prescribed Capital Adequacy Ratio (CAR) and should attain CAR of 8 per cent by 1998.
10. A board for Financial Supervision should be set up to oversee the operations of the banks.
11. Banks should conform to prudential income recognition norms of provisioning against bad and doubtful debts and ensure transparency in maintaining balance sheet.
12. There should be speedy computerisation of the banking sector.

According to the Committee, foreign banks should be subjected to the same requirements as are applicable to the Indian Banks and the RBI policies should be more liberal in respect of allowing the foreign banks to open branches or subsidiaries. Joint ventures between foreign banks and Indian banks should also be permitted, particularly in regard to merchant banking, investment banking, leasing and other newer forms of financial services. Priority sector lending by banks should be reduced from 40 per cent to 10 per cent of their total credit.

[9]See Narasimhan Committee Report submitted to Ministry of Finance, Government of India in 1991.

The Committee had recommended phasing out of concessional interest rates. It was of the view that the structure of administered interest rates was "highly complex and rigid" and proposed that interest rates be further deregulated so as to reflect emerging market conditions. Premature moves to market-determined interest rates could, as experience abroad had shown, pose the danger of excessive bank lending at highly nominal rates to borrowers of dubious credit worthiness, the Committee observed.

Most of the recommendations of the Committee had been implemented. Meanwhile, keeping in view the changing global scenario after the setting up of the WTO and the need for more efficient, competitive and broad based banking sector, the government set up another committee, once again headed by Narasimhan.

Narasimhan Committee-II

The Narasimhan Committee, in its second report on banking sector reforms, submitted in April 1998 made a series of sweeping recommendations which is being used as a launching pad to take Indian banking into future.[10] The report covers an entire gamut of issues ranging from bank mergers and the creation of globalised banks to bank closures, recasting bank boards and revamping banking legislations.

The major recommendations of the Committee were as follows:

1. Merger of strong banks which have a multiplier effect on the industry. It has cautioned against merger of strong banks as this will adversely affect the asset quality of strong banks.
2. Concept of 'narrow banking' should be tried out to rehabilitate weak banks. If this is not successful, the issue of closure should be examined. Narrow banking, according to the Committee, implies that weak banks should not be permitted to invest their funds anywhere except in government securities as these were absolutely safe and risk free.
3. Two or three large Indian banks should be given international character.
4. Small, local banks should be confined to states or cluster of districts in order to serve local trade, small industry and agriculture.
5. The Committee has also commented on the government's role in public sector banks by observing that government ownership has become an instrument of management. Such micro management of banks is not conducive to enhancement of autonomy and flexibility.
6. Functions of boards and management need to be reviewed so that the boards remain responsible for enhancing shareholder value through formulation of corporate strategy.
7. There is a need to review minimum prescriptions for capital adequacy. In this regard, the Committee recommended that minimum CAR be raised to 10 per cent by 2002. Most of the banks have CAR of 11 per cent or higher.
8. There is a need to lay down prudential and disclosure norms and sound procedures for the purpose of supervision and regulation, the Committee recommended.
9. There should be an integration of NBFC's lending activities into the financial system.
10. Public sector banks need to speed up computerisation and focus on relationship banking.
11. Recruitment procedures, training and remuneration policies in public sector banks should be reviewed.

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10. Rakesh Mohan, Financial Sector Reforms in India, Economic and Political Weekly, 2005, March 19–25, pp. 1106–1121.

12. Threat of action by vigilance and other investigative authorities, even in the case of commercial decisions creates low morale. The Committee recommended this issue to be addressed in right earnest.
13. The Committee recommended professionalising and de-politicising of bank boards.
14. The Banking Service Recruitment Boards should be abolished.

The RBI has taken steps to implement many of the recommendations of Narasimhan Committee-II.[11] They had raised the Capital Adequacy Ratio (the minimum capital to risk-weighted-asset ratio) from 8 per cent to 9 per cent effective from the year-end March 31, 2000. With a view to further improve the quality of the asset portfolio and enhance the financial soundness of banks, income recognition and provisioning norms on government-guaranteed advances have been brought at par with those on, other advances. In a measure aimed at further strengthening the inherent strength of banks' balance sheets, provisioning requirements have been introduced for standard assets. Regarding government securities, the RBI has laid down that government-approved securities will have to provide a risk weight of 2.5 per cent. The government is planning to reduce its shareholding in nationalised banks from 51 to 33 per cent.

Banks have now to classify a minimum 75 per cent of their investment in approved securities as current investments.[12] This has been done with a view to adopt prudent accounting standards. It has also been decided that a bank's or a financial institution's investment in tier II bonds issued by other banks be subjected to a ceiling of 10 per cent of the bank's or financial institution's total capital. This was decided after observing a high level of cross holding of debt instruments relating to Tier II capital of banks among banks and financial institutions without there being any real accretion of capital to the financial system. According to the RBI guidelines, many banks have set up Asset Liability Management (ALM) systems. Similar guidelines have also been issued in respect of financial institutions. The purpose of ALM guidelines is mainly to strengthen the management information system within the banks and financial institutions so as to sensitise them about the market risk ahead of them.[13]

Reforms: Progress

The Narasimhan Committee-II defined a 'weak bank' as one whose accumulated losses and net NPAs exceed its net worth or whose adjusted operating profits (operating profit less income on recapitalisation bonds) was negative for three consecutive years. Based on these, the Verma Committee on Restructuring of Weak Banks set up by the RBI in February 1999 identified three banks as weak banks. The Verma Committee, which submitted its report in October 1999, had itself identified seven parameters covering three areas for classifying a bank as weak. These three areas are:

1. Solvency (capital adequacy ratio and coverage ratio)
2. Earning Capacity (return on assets and net interest margin)
3. Profitability (ratio of operating profit to average working funds, ratio of cost to income and ratio of staff cost to net interest income plus all other income).

The process of reforms in the banking sector has been progressing so as to enhance the efficiency and competitiveness of the sector. As a result of these reforms, two of the three identified weak public sector banks have turned around and started making profits. These are the UCO Bank and the United Bank of India.

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[11] RBI Annual Report 2003–04.
[12] Mittal B. M., Management of Operational Risk, Professional Banker, ICFAI, October 2005, pp. 37–43.
[13] Venkateswara, Rao, ALM—A tool for pricing Bank Products, IBA Bulletin, September 2004, pp. 14–17.

However, a major problem that still haunts the banking industry is the growing proportion of Non-performing Assets of banks which have reached an astronomical figure of about one lakh crore. Non- Performing Assets consist of assets under three categories: Sub standard, doubtful and loss. A sub standard asset is one which remains NPA for a period less than or equal to 12 months, while a doubtful asset is one which remains NPA for more than 12 months. A loss asset is one where the loss has been identified by the bank or internal/external auditors or the RBI inspection but the amount has not been written off.

Based on the recommendations of both the Narasimhan Committee (II) and the Verma Committee, the following measures have been taken to address the problems of the banking sector:

1. More and more Debt Recovery Tribunals and Appellate Tribunals have been set up to facilitate expeditious adjudication and recovery of banks and financial institutions dues. Accordingly, comprehensive amendments have been carried out in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 by issue of an Ordinance.
2. A Credit Information Bureau has been set up to curb the growth of fresh NPAs.
3. Changes in the legislative provisions have been made to accord necessary flexibility and autonomy to the Boards of banks to enable them to take decisions on corporate strategy and be responsible to the shareholders, customers, employees and the public at large.
4. More teeth have been provided to DRTs for recovery of bad debts. Also, in an all out effort to clean up the balance sheet of banks, the RBI formulated guidelines to facilitate recovery of loans of Rs 10 crore or less. In case of big borrowers of over Rs 10 crore, the government has empowered bank chiefs to crack the whip.
5. In order to reduce the staff cost of public sector banks, the government has also introduced Voluntary Retirement Scheme for the banking sector.
6. Transparent guidelines have been formulated for banks' investment in shares and financing of equities.
7. The Banking Service Recruitment Boards have been abolished. Accordingly, banks have been advised to frame their own recruitment strategies with the approval of the respective Boards to meet future requirements.
8. As many as 29 debt recovery tribunals and 5 appellate tribunals have been set up so far.
9. The Deposit Insurance Credit and Guarantee Corporation have been converted into the Bank Deposit Insurance Corporation to make it an effective instrument for dealing with depositors risks and distressed banks.
10. Banks have set up separate recovery departments.
11. Legal cells of banks are being strengthened.

Case

Prof Tom and Monetary Policy*

As Prof. Tom entered the class, he found a heavy silence. "What's the matter with the class?" the Prof. asked in a jovial tone. Confucious (because he was always confused), a student, as usual, showed

*Dr. Justin Paul, Prasoon Agarwal and Srickant Rajagopal co-authored this write-up.

an article on monetary policy to the Prof. "I can't figure out why all this fuss about interest rates and monetary policy," he asked Professor. Prof. Tom looked at the article in his usual manner. He rolled up his sleeves and said, "Ok, let's start with the basics. What is meant by interest rate and monetary policy? Interest rate is simply the cost of money. Just as we need to pay for our movie tickets, we need to pay for borrowing money. This is, what we call, cost of funds from the point of view of the borrower, and for the person lending the money, it is the price received, the yield on capital."

Raju, The Boy Lost In The Back Row (BLITBR), suddenly stood up, behaving as if he had found what he was looking for, and read out loud, "Despite the implementation of reforms, structural rigidities remained in interest rate structure, distorting the true market determined rates. Rates had been kept artificially high by offering high administered rates on small savings and provident fund. The gap between the short term and long term rates tended to remain high on account of this".

"Can't disagree with you, Raju. I get what you are leading at," the Prof. remarked.

It was then that Miss Dreamy Eyes (DE) decided to enter the discussion, "But sir, what does Reserve Bank has to do with interest rates and monetary policy? Why can't it just let interest rates move own their on?" Prof Bond Tom was now on song and explained, "Every industry requires finance for the establishment, expansion and working capital management. Bank credit is considered as the most important source of industrial finance in most of the countries. The dependence on bank for finance could vary according to the size of the companies, and on the availability of the credit at lower cost."

Confucious jumped up and chipped in, "Monetary policy aims to influence the overall level of monetary demand in the economy, so that it grows broadly in line with the economy's ability to produce goods and services." He was proud of finally understanding the linkage between interest rates, monetary policy and RBI. "This stops output from rising too quickly or to slowly. Interest rates are increased to moderate demand and inflation (increase in the general price level in an economy)".

Miss Dreamy Eyes was now in a fix, "What do interest rates have to do with demand?" The class was now in full swing. The Prof enjoyed the questions from his students. He calmly explained, "When interest rates are changed, demand can be affected in various ways. A change in the cost of borrowing affects spending decisions. Interest rates will affect the attractiveness of spending today, relative to spending tomorrow." "You mean that an increase in interest rates will make saving more attractive, and borrowing less so. This will tend to reduce current spending, by both consumers and firms," said Confucious. "Absolutely right!" the Prof exclaimed and added, "This spending includes both spending by consumers in the shops, and by firms on new equipment, i.e. investment. Conversely, a reduction in interest rates will tend to increase spending by consumers and firms."

"But sir, how does Reserve Bank use monetary policy to do that?" Prof Tom smiled and went on, "Monetary policy operates by influencing the price of money, i.e. the cost of borrowing, and the income from savings. The Reserve Bank of India sets the bank rate. This is an interest rate for the Reserve Bank's own market transactions with the financial institutions, the rate at which the Reserve Bank will make short term loans to banks and other financial institutions. This rate is known as the bank rate".

"And why is this bank rate so important?" quipped Raju, BLITR.

"This is because the changes in the bank rate affect the whole range of interest rates set by commercial banks, other financial institutions, etc. for their own customers. It will influence interest rates charged for overdrafts and mortgages, as well as for savings accounts. A change in the bank rate will also tend to affect the price of financial assets, such as bonds and shares," Prof Tom read the quizzical look on the face of the students. He went on, "These changes in financial markets affect consumer and business demand, and in turn, output. Changes in demand and output then, have an impact on the labour market, employment levels and wage costs, which in turn influence producer and consumer prices."

"You mean that there is a positive correlation between cut in bank rate and movement in interest rate?" asked Raju. "Precisely. Most banks make downward adjustment in their respective lending and deposit rates following slash in the bank rate."

Confucious could understand where the Prof was trying to lead them. He chipped in excitedly, "And while the cut in lending rate would bring down the interest income, it is only logical that most banks would try to compensate for the loss of income, by bringing down the interest outgo through adjustment in deposit rates, so as to neutralise the impact on their net interest income."

"Exactly. And to that extent, this would definitely reduce their cost of funds, and also bring down the interest income."

Miss Dreamy Eyes continued, "Sir, the article also mentioned something about the asset prices and exchange rates." Raju looked at her and explained further, "That's just like the substitution effect of the simple law of demand. Higher interest rates increase the return on savings in banks and PPF. This might encourage savers to invest less of their money in alternatives, such as property and company shares."

The Prof smiled at them and continued his point," Any fall in demand for these assets is likely to reduce their prices. This will reduce the wealth of individuals holding these assets, which, in turn, might influence their willingness to spend. Again, lower interest rates have the opposite effect; i.e. they tend to increase asset prices. Similarly, the significant fall in interest rates can be expected to reflect in higher stock prices."

Prof Tom decided it was time to wrap up the session, "Talking of global markets, can anyone explain the relation between interest rates and exchange rates?" The class looked towards Sanjay and he did not disappoint them. "A rise in interest rates, relative to those in other countries, will tend to result in an increase in the amount of funds flowing into India, as investors are attracted to the higher rates of interest. This will tend to result in an appreciation of the domestic currency against other currencies, in an open economy where there is Capital Account Convertibility."

"Very good. But in practice, the exchange rate is influenced, both by expectations about future interest rates, and by any unexpected changes in interest rates. That is because if investors expect interest rates to rise, they may increase the amount they invest in a currency, before interest rates actually rise."

Prof Tom looked at the clock in the classroom and declared that the time was over.

Chatper Summary

Monetary policy is one of the two principal means by which the government (through the central bank) regulates the level of aggregate output and money and also the general price level. The central bank has the choice to either fix a short-term interest rate on money or to fix a optimum (desired) reserve level as the operating target.

Central banks have been gradually getting increased autonomy and operational freedom with respect to the monetary policy decisions. The repo rate, CRR, open market operations—all have been used at different points of time. Today, we see a switch from outright open market operations to repo operations as the preferred tool. The commercial banks have also been provided with a greater degree of freedom and latitude to fix the interest rates.

Objective Type Questions

1. Government carry out monetary policy through
   (a) Commercial Banks (b) Co-operative Banks
   (c) Central Banks (d) None of the above

2. An expansionary open market operation creates ________ pressure on short term interest rates
   (a) Downward (b) Upward (c) Zero (d) None of these
3. Commercial Bank's credit creation capacity will ________, if central bank increases CRR
   (a) increase (b) come down (c) have no effect (d) None of these
4. Contracts for the sale and future repurchase of financial assets (most often Treasury Securities) is known as
   (a) Repos (b) OMOs (c) SLRs (d) MSS
5. Rate at which the commercial banks borrows from Reserve Bank of India is called as
   (a) Repo (b) PLR (c) Bank Rate (d) BPLR

Review Questions

1. What are the tools of monetary policy?
2. Analyse the objectives of monetary policy.
3. What is meant by 'reserve requirements' by banks?
4. Distinguish between Repo rate and Bank rate.
5. Do you think that central bank autonomy will help the countries in their economic activities? Validate your points.
6. What does 'Inflation targeting' mean?
7. Compare the monetary policy mechanism and tools in Canada, China and USA.
8. Is there any relationship between 'money supply' and inflation?
9. Discuss how monetary policy can be effectively formulated in India in the 21st century.

Class/Field Exercise

Japan has the lowest rate of interest among the developed countries. The Bank of Japan (Central Bank) followed Zero Interest Rate Policy for many years. Visit the website of Bank of Japan and analyses the data on interest rate in Japan. Compare this with the rate of interest in USA and India.

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Answers

Objective Type Questions

1. (c)	2. (a)	3. (b)	4. (a)	5. (c)

Annexure

Exhibit 11.1 (Data has been compiled from the publications of Federal Reserve Bank and Bank of England)

US Inflation rates

Year	Inflation Rate
1970	5.94
1971	4.31
1972	3.31
1973	6.2
1974	11.11
1975	8.98
1976	5.75
1977	6.62
1978	7.59
1979	11.28
1980	13.48
1981	10.36
1982	6.16
1983	3.21
1984	4.37
1985	3.54
1986	1.86
1987	3.66
1988	4.12
1989	4.81
1990	5.39
1991	4.22
1992	3.01
1993	2.98
1994	2.6
1995	2.76
1996	2.96
1997	2.35
1998	1.51
1999	2.21
2000	3.38
2001	2.86
2002	1.58

UK Inflation rates

Year	Inflation Rate
1970	6.34
1971	9.45
1972	7.16
1973	9.08
1974	16.05
1975	24.21
1976	16.58
1977	15.45
1978	8.65
1979	13.39
1980	17.97
1981	11.88
1982	8.61
1983	4.59
1984	4.98
1985	6.09
1986	3.4
1987	4.17
1988	4.91
1989	7.76
1990	9.46
1991	5.87
1992	3.73
1993	1.56
1994	2.48
1995	3.41
1996	2.48
1997	3.1
1998	3.42
1999	1.56
2000	2.95
2001	1.77
2002	1.68

Exchange rate US$/Pound)

Year	Rate
1970	$2.40
1971	$2.44
1972	$2.50
1973	$2.45
1974	$2.34
1975	$2.22
1976	$1.80
1977	$1.75
1978	$1.92
1979	$2.12
1980	$2.33
1981	$2.02
1982	$1.75
1983	$1.52
1984	$1.34
1985	$1.30
1986	$1.47
1987	$1.64
1988	$1.78
1989	$1.64
1990	$1.78
1991	$1.77
1992	$1.77
1993	$1.50
1994	$1.53
1995	$1.58
1996	$1.56
1997	$1.64
1998	$1.66
1999	$1.62
2000	$1.52

Source: www.federalreserve.gov

Exhibit 11.2

Year	UK Short-Term Interest Rate: Ordinary Funds, Contemporary Series (per cent per year)	US Short-Term Interest Rate: Ordinary Funds, Contemporary Series (per cent per year)
1960	4.89	2.87
1961	5.14	2.36
1962	4.17	2.77
1963	3.67	3.16
1964	4.59	3.54
1965	5.91	3.95
1966	6.12	4.86
1967	5.81	4.29
1968	7.03	5.34
1969	7.63	6.67
1970	7.02	6.39
1971	5.58	4.33
1972	5.52	4.07
1973	9.38	7.03
1974	11.38	7.83
1975	10.18	5.77
1976	11.15	4.97
1977	7.66	5.27
1978	8.51	7.19
1979	13	10.07
1980	15.12	11.39
1981	12.98	14.04
1982	11.38	10.6
1983	9.59	8.62
1984	9.3	9.54
1985	11.6	7.47
1986	10.34	5.97
1987	9.23	5.78
1988	9.8	6.67
1989	13.28	8.11
1990	14.09	7.5
1991	10.82	5.38
1992	8.94	3.43
1993	5.21	3
1994	5.15	4.25
1995	6.33	5.49

(Contd.)

(*Contd.*)

1996	5.78	5.01
1997	6.48	5.06
1998	6.82	4.78
1999	5.04	4.64
2000	5.8	5.82
2001	4.76	3.4

Source: www.federalreserve.gov

Exhibit 11.3 Inflation Rates Based on Price Index in India (1990–91 to 2002–03)

Year/Month	WPI
1994–95	12.58
1995–96	7.99
1996–97	4.63
1997–98	4.38
1998–99	5.94
1999–00	3.33
2000–01	7.13
2001–02	3.62
2002–03	2.90

Source: Economic Survey, Govt. of India 2004–05.

Exhibit 11.4 Summarised (annual) CRR figures (India)

Year	Maximum	Minimum
2000–01	8.5	8
2001–02	8	5.5
2002–03	5.5	4.75
2003–04	4.75	4.5
2004–05	5	4.5

Source: RBI Annual Reports, Various Issues.

Exhibit 11.5 Summarised (annual) Figures on Bank Rate (India)

Year	Maximum	Minimum
1996–97	12	12
1997–98	12	9
1998–99	10	8
1999–00	9	7
2000–01	8	7
2001–02	7	6.5
2002–03	6.5	6.25
2003–04	6.25	6
2004–05	6	6

Source: RBI Annual Reports, various issues.

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PART Five

Technology and Business Environment

Chapter 12: Technological Environment of Business

Chapter 12

Technological Environment of Business

Learning Objectives

- to understand the importance of technology
- role of IT in banking
- the process of evolution of high-tech banking
- study about the SWOT aspects of remote channels such as e-banking and ATMs

Chapter Structure

Technology can be defined as knowledge of methods to perform certain tasks efficiently and solve problems pertaining to products and services. Information technology has brought about revolutionary changes in the world and the business environment in most of the sectors have become technology-dependent. Since the banking sector has been subjected to tremendous changes because of the new technology, it is worth discussing the technological environment in the banking sector.

SECTION 1: ROLE OF INFORMATION TECHNOLOGY

The financial sector, comprising banks, stock exchanges and insurance organisations, have been the backbone of every country. They are the agents to implement and bring about economic reforms. Any change in this sector through technology would have a sweeping impact on any country. The developments in information collection, storage, processing, transmission technologies have influenced all aspects of the banking activity. The objectives of this chapter are to describe the extent to which these developments have taken place in the banking industry with special reference to India and analyse adaptations and risks related to technological progress as well as relevant issues.

Information technology (IT) developments affect banking in two ways.

1. First, they contribute in the reduction of costs associated with the management of information (collection, storage, processing and transmission) by replacing paper based and labour intensive methods with automated processes.
2. Secondly, they modify the ways in which customers have access to a bank's services and products, mainly through the use of automated processes such as remote banking. The phenomenon of remote banking is very recent.

Remote banking is currently offered by all the major banks in India. Most of the standard retail banking services are offered through the use of Automatic Teller Machines (ATMs), tele banking and online banking. Online banking is generally not widespread, yet all the major banks have their online banking portals. Internet banking is expected to have the highest growth potential incorporating increasingly sophisticated products. The use of electronic money is one such innovation. The main reasons for slow acceptance of internet banking are cost as well as security concerns, low reach of Internet and weak legal system.

SECTION 2: REMOTE BANKING*

Remote banking refers to the provision of extending banking services without face to face contact between the bank employees and its customers. The key feature is that the remote banking services represent complementary or even substitutes to the conventional services provided by the bank's branch offices. The following types of services fall within the range of remote banking defined above.

(i) Kiosk Banking (ATM Channel)

Here, the customer uses multipurpose ATMs installed by the bank which may also be used as an interactive link between the customer and the bank.

*Sections 2, 3 and 4 in this chapter were co-authored by Dr. Justin Paul with Amit K. Premchandani, Ankur Agarwal and Manish Bhagat, former participants of PG programme at IIM Indore.

(ii) Telephone Banking (Phone Channel) of Business

In this channel telephone is used as a message carrier to enable person to person or voice-activated automated communication between the bank and the customer.

(iii) Online Banking (Internet Channel)

In such cases, Internet is used as a message carrier where the customer uses a PC and a modem (or Local Area Network) to connect to the bank using its online website or a software provided by the bank.

Remote banking is offered by some major banks. Today, the upwardly mobile customer expects remote banking as a basic service to be provided by the bank. For example, these days a bank like Citi Bank conducts most of its retail banking transactions through remote channels. In an extreme case, a bank can exist as a virtual bank without even having many branch offices. A large branch network, which spans through the whole of rural and urban areas, is sometimes not a priority for some banks.

In principle, the banks can be categorised by their involvement in remote banking:

1. Banks that provide traditional services, but struggling with the new technology. For example, most of the public sector banks.
2. Old banking institutions that offer traditional banking services and are moving on to offer remote services in a big way. For example, SBI, which has started offering telephone banking, online banking and ATM facility on a very large scale.
3. New-age banks that operate with minimal number of physical branches and use remote banking for the bulk of their operations. E.g. ICICI, Kotak, HDFC which conduct a bulk of their operations through remote banking.

Penetration of Remote Banking Services and Channels

Most of the traditional banking services can be effectively implemented by banks using remote channels too. In many cases, the remote channels are better placed than the conventional ones to serve a customer. Until now, major emphasis has been given on ATM and telephone-based services by the banks that have used the remote banking channels but they have been slow to catch up with net-based banking. Moreover, the remote channels are still used to provide basic services while more sophisticated services are provided on a face to face basis or by direct contact through telephone.

Use of ATMs

Use of ATMs has seen an exponential growth in India. ICICI Bank is the most aggressive deployer of ATMs and has seen its base surge from 125 ATMs in January 2000 to more than 3000 ATMs today. Such has been the impact of ATMs that ICICI Bank's customer base has grown from two million to ten million. Banks are also developing new strategies to leverage their ATM outlets. For instance, rather than setting up a branch in every suburb, ICICI Bank has a ratio of 8 ATMs to one branch office, thus effectively reaching out to a large customer base at a substantially lower cost.

Online Banking

The total number of registered users for Internet banking in India is over five million. India has a little less than three million active Internet banking users. And though this is just 0.3 per cent of the total population, it represents a high per cent of the India's Internet user population, thus indicating that the concept of Internet banking is surely catching on.

Telephone Banking

Telephone banking is also catching up across the countries. Transactions, such as request for loan, credit cards and account balance enquiries, are increasingly being carried out through a phone or mobile.

Future Trends in Remote Banking

Banks are now increasingly adjusting their technology investments towards remote banking channels to account for the shift of customers towards the same. With ATM networks already in place in most of the urban areas, the drive is now focused towards the rural areas where the use of ATMs is still uncommon. The banks are also seeking IT solutions to ensure that transactions on the net are more secure and efficient. The spread of such e-banking is also subject to the socio-economic background of the clients but it is expected that in future, services offered through the net will be far more superior to those services offered through the conventional channels.

So, following are some of the future trends in the new-age banking channels:

- Spectacular growth in the use of online banking facilities to manage money rather than just for account reporting—in both retail and corporate sectors.
- New digital signatures legally binding in many countries leading to entirely new patterns of consumer activity.
- Huge growth in wireless banking and payment services using mobile phones.

One problem for the banks in this new age is the increased competition. On the internet, the competitors are just a mouse click away. So, it would be a challenge for the banks to differentiate their services from their competitors. The Internet and technology are expected to develop more quickly for such applications. Another challenge is to increase the use of PC and Internet which depends largely upon the cost to the customer, the telecom infrastructure and computer literacy among the population which is still low. Security problems, identification problems, increasing costs and legal frameworks also pose a challenge.

Increasing Use of Electronic Payment Channels

In conventional payment systems, the use of cash, cheques, and demand drafts is very common but with the emergence of remote banking, all this is set to change. New payments mechanisms designed to aid electronic commerce have started to become routine affair. Although there is an ongoing debate about the capabilities of the information and communication technology to bring forth important tools for conducting electronic commerce and payments, banks are in the midst of a wave of innovation and change.

Payment Systems—Current Status

There are diverse payment systems functioning in the banking sector, ranging from the paper based systems to the most sophisticated electronic fund transfer system which settle transactions on a gross, real time basis.

The *retail payment systems* comprise of both paper-based as well as electronic-based systems. These systems typically handle transactions, which are low in value, but very large in number, relating to individuals, and Corporates. These transactions relate mainly to settlement of obligations arising from purchase of goods and services. In India, there are about 1,050 cheque clearing houses. These houses clear and settle transactions relating to various types of paper-based instruments like cheques, drafts, payment orders and interest/dividend warrants. The clearing houses are voluntary bodies set up by the participating banks and post offices and they function in an autonomous manner.

There are various types of *electronic clearing systems* functioning in the retail payments area in the country. Electronic Clearing System (ECS), both for credit and debit operations, functions from 45 places (15 managed by Reserve Bank and the rest by the State Bank of India). The ECS is the Indian version of the Automated Clearing Houses (ACH) for catering to bulk payments. This is typically for individual/single payments and are governed by their own respective rules. A variant of the EFT, called the Special Electronic Funds Transfer (SEFT) System, is also operated by the Reserve Bank to provide nationwide coverage for EFT. All these electronic fund transfer systems settle on deferred net settlement basis. There are a few large value payment systems functioning in the country. They are the Inter-Bank Cheques Clearing Systems (the Inter-bank Clearing), the High Value Cheques Clearing System (the High Value Clearing), the Government Securities Clearing System (the G-Sec Clearing), the Foreign Exchange Clearing System (the Forex Clearing) and the Real Time Gross Settlement (RTGS) System. All these systems, except the High Value Clearings, are electronic-based and mostly relate to inter-bank/inter-financial institutional transactions. Only in the case of High Value Clearing, high-value customer cheques are cleared. The G-Sec Clearing and the Forex Clearing are managed by the Clearing Corporation of India Limited (CCIL). The RTGS system is operated by the Reserve Bank. All these are deemed to be Systemically Important Payment Systems (SIPS) and therefore, the Reserve Bank has, in line with the international trend, moved them (except the Inter-bank Clearings at other than Mumbai and the High Value Clearings) to either secure and guaranteed systems or the Real Time Gross Settlement System (RTGS).

Future of Payment Systems

The payment systems are envisaged to have the following four features, which relate to Safety, Security, Soundness and Efficiency.

- Safety addresses risk. Payment Systems, by their nature, are risk prone and so, the need for addressing these risks assumes significance. Sound designs, rules, and practices promote the safety of payments for users and their financial institutions.
- Security addresses the issues relating to confidence with specific reference to the users of these systems. Public confidence in the integrity of basic paper payment instruments was built up over a very long period of time. Prudent users will require strong evidence that these new systems will meet their needs in both normal and exceptional circumstances. The payment service providers realise that confidence is an asset to be guarded.
- Soundness aims at ensuring that the systems are built on strong edifices and that they perform over a long period of time. All the systems are envisaged to be on sound footing, with adequate legal backing, firm operational procedures, and transparency norms.
- Efficiency represents the measures aimed at efficiencies in terms of costs so as to provide optimal and cost effective solutions.

The financial institutions try to focus on the following major themes:

- A new organisational structure for retail payment systems
- Sound legal base
- Efficiency enhancements
- Rural Sector facilitation
- Customer facilitation and protection.

Diffusion of Electronic Money

Electronic money or e-money, as it is called, can be of two types:

- Card-based money
- Network-based money

Card based money refers to the e-money stored as value on small cards which can be used for transactions so that the customer doesn't have to carry cash in physical nature. This type of e-money provides the customer with a portable specialised magnetic tape which carries the information about the user and his/her bank details. Types of card based e-money include credit cards, debit cards and ATM cards. Sometimes, various types of card based e-money are integrated into a single card.

Network based e-money refers to the e-money transactions conducted via telecommunication networks, primarily the Internet. Network based e-money can be used to conduct online transactions, online share trading, online bill payment and cash transfer to other countries (very important in the case of India since a lot of NRIs transfer money to India). Inter-country money transfer is, in fact, a very major portion of the total e-transactions taking place in India among others.

Customers seem to be adopting the e-money slowly because of following few reasons:

- Reluctance of merchants to accept the cards as the mode of payment
- Cost considerations of the merchant. i.e., the installation and transaction costs
- Cost considerations of the customer.
- Insufficient customer information.

Despite the impediments mentioned above, the card based e-money could play a major role in future in making payments for almost everything from parking fees to one's child's education to the purchase of car.

The network based e-money such as Electronic clearing systems and Electronic fund transfer are also common these days.

The emergence of e-money, along with Internet banking and e-commerce, is a perfect example of a case where one technological innovation reinforces another.

SECTION 3: TECHNOLOGY IMPLEMENTATION FOR CARD BASED BUSINESS: CASE OF DEUTSCHE BANK, ITALY

As a leading financial services organisation, Deutsche Bank, credit card market leader in Italy as an issuer and acquirer of VISA and MasterCard brands, wanted to take advantage of the growth opportunities in that business. However, it needed a new card processing system that was able to meet the complex demands of the market.

The bank examined a number of solutions before deciding on CSC's Card and Merchant System (CAMS II) software as the basis for its card processing needs. As the first customer to implement CAMS II, Deutsche Bank's Competence Centre for Cards could offer processing services not only within the Deutsche Bank group but also to other card issuers. The time to market for new card-based offerings has been reduced and it is positioned to react quickly to the growing needs and opportunities within the card market.

Increasing Market Demands

With total assets of over $950 billion and more than 84,500 employees, Deutsche Bank serves some 12 million customers in 75 countries worldwide. It is ranked among the leaders in asset management, capital markets, corporate finance, custody, cash management and private banking. It is also the biggest bank in the euro zone, with 1,500 branches in Germany and extensive branch networks in Italy, Spain and Belgium.

The Deutsche Bank credit card division is a service provider for more than 400 partner banks, providing assistance and expertise in both the issuing and acquiring processes of VISA and Mastercard brands. With more than three million issued cards and over 300,000 associated merchants—the main goal of the centre (credit card division) is to distinguish itself as a first class service provider.

By the mid 1990s, Deutsche Bank, with the BankAmericard brand, had started processing card payments for third-party card issuers. In addition, opportunities in the Italian card market were growing as credit card usage was increasing. With the business demands of the card market becoming more complex, and existing systems increasingly becoming unable to handle the requirements effectively, Deutsche Bank decided to look for a viable solution for its card processing.

Deutsche Bank Italy, because of its experience of this market, was charged with creating a European Centre of Competence for Cards. The company started looking for a new platform based on advanced technology that could meet current market demands and expand to meet Deutsche Bank's future goals.

CASM II–Solution and Implementation

After carrying out extensive research on a number of solutions, the bank finally chose CAMS II software as the basis for its card processing needs. CAMS II enables card issuers to manage a wide range of credit and debit card products. It processes all operations for the entire card business, including automated security and authorisation functions that help banks manage risk more cost effectively. The system authorises new applicants, creates and dispatches PIN numbers and cards, and handles complete transactions every time a card is used—including automatically deducting fees payable and crediting retailers with the remainder due. CAMS II can handle 100 million accounts and high volumes of card transactions—processing more than 200 authorisations per second and over 17 million transactions per day.

In early 1998, the first release of CAMS II was announced. More than 150 man-years of development effort had re-engineered the previous version of CAMS to include the functionality required to meet the needs of the evolving card business.

The bank went live late in 1998, with a pilot that included about 20,000 cards. In June 2000, the first American Express card in Italy was launched and made available through all 260 Deutsche

Bank branches in Italy. More than 4.5 million credit cards are now processed and CAMS II is now used at all Deutsche Bank branches in Italy and Germany.

Meeting Future Opportunities

The new platform enables Deutsche Bank to manage a wide range of card products while providing a base for developing new or enhanced products to attract and retain customers. The bank is now able to issue card products and start new businesses that were not originally foreseen by the bank. Since the introduction of CAMS II, the bank has become full processors for other card issuers, and has issued American Express cards on its own licence. Deutsche Bank is able to meet market demands very quickly as the introduction of new products or changes to existing products are easy due to the parameterized nature of CAMS II.

CAMS II—At a Glance

CAMS II supports virtually every form of card and electronic transaction requirement for issuing banks, merchant acquirers and third-party processors. It provides the functional and technical foundation necessary to help support the future of global payments.

Questions

1. Why did Deutsche Bank choose CAMS II software?
2. How did Deutsche Bank emerge as market leader in credit card segment in Italy?

SECTION 4: TECHNOLOGY AND BANKS' STRATEGIES

As an all-encompassing development, new technology has important implications for all aspects of strategy and offers major opportunities through investment in the following areas:

- Application of IT into banks' internal operations, products and distribution methods in order to gain competitive advantages and increase the market share as well as to improve efficiency and risk management.
- The formation of alliances with technology partners, telecommunication providers and IT vendors in order to create common platforms which allow further developments in the effective application of the most up-to-date IT and to optimise R&D implementation costs; and
- Diversification into other businesses such as electronic commerce and non-financial services.

Technology is an important strategic tool for banks to safeguard long-term competitiveness, cost efficiency and profitability. Technology enables banks to obtain additional marketing instruments and a better knowledge of the needs and habits of their customers and possibly to achieve significant cost reductions. In any case, banks also need to evaluate the risks involved in adopting any technology.

Cost Aspects

The most important driver of quick adoption of technology in any sector is the possibility of achieving significant cost reductions in the long term. Banking sector is no different. The use of technology in banking sector might reduce the per transaction cost and hence the overall operating expenses in the long run. The cost reduction may be attributed to the following factors:

- The reduced cost of automated processes as compared to labour-intensive ways to process the various bank transactions. This is a long term phenomenon.
- The lower Turn Around Time (TAT) and the response time for the transactions.
- Existence of greater economies of scale in the case of automated processes as compared to manual processes.
- Centralisation of information and processing functions lead to reduction in costs in the long run.

Typically, it might cost a bank close to Rs 50 per transaction if conducted in a branch. The same, if done through an ATM, costs about Rs 15. A look at the volume of ATM transactions conducted reflects the level of success of this delivery channel. The other important delivery channel, from a bank's perspective is Internet banking. The adoption of Internet banking by the bank's customers is important since the costs per transaction in this case are even lower than those of an ATM. A net-based transaction costs the bank only about Rs 4.

There might be certain catches while implementing technology in banking. These are:

- A relatively large number of transactions might have to be built up before economies of scale are achieved.
- Some redundancies might build up. For example, a remote banking channel and conventional channel catering to the same segment of customers will involve redundancy since multiple channels are present for the same use.
- Higher use of technology requires highly trained manpower. This involves significant training costs for the existing employees and a general rise in salaries.
- The technology keeps changing very rapidly and hence, banks must keep pace with the latest IT tool, which will further push up the cost.

In the banks, significant cost advantages will accrue only in long term, however, these reductions might not be dramatic. The variable costs will decrease while the fixed costs might increase. At present, it is difficult to assess how much cost advantage has been achieved by banks, however, the labour costs have seen a decline with the gradual implementation of technology.

Revenue Aspects

The investments in IT are not just on the basis of cost considerations but also with a view to attract more customers and thereby to increase the revenues. This is done by offering new services using technology and attracting more number of tech-savvy customers. Many banks have seen a surge in customer base and revenues since the time they implemented technology.

Technology has a major impact on a bank's relationship with its customer since the implementation of CRM (customer relationship management) tools in banking. Personal information and banking behaviour of each customer is retracked and stored which helps in coming up with customised solutions for the person. This improves the customer loyalty and also helps in targeted marketing for the bank.

Another aspect is the emergence of competition with the websites of banks just a mouse click away. This helps the customer look out for the best deal in the market. The market has today seen that many customers deal with multiple banks trying to locate the best player for their specific needs. One might have an account in ICICI but avail of a loan from SBI and carry a Citibank credit card. Increased competition might create a pressure to change the system to cost-based pricing. The new entrants, which avoid the costs related to a branch network, will have a certain cost advantage compared to established banks. Customers demand the best services and the implementation of technology can help retain the customers in the long run.

Impact on the Banking Sector

The technology resources are used in a number of ways by the banks. Certain effects on banking structure are visible in the form of:

Number of Customers

The branch networks are witnessing an impact as a result of technology. This is being done by deciding the number of customers to be serviced through both remote banking and conventional banking.

Bank Branches

In the short term, the branch network will remain as it is, since the physical presence is still considered necessary because the remote channels would not become complete substitutes.

Bank Personnel

The redundancy among bank employees will rise due to the automation of previously manual functions. The technical competency among the employees will rise and bulk of employee work will shift to marketing, telephone operations and maintenance of the systems. Thus, the employee strength might not exactly change.

Outsourcing

Banks outsource activities, such as IT support, printing, security, transportation and document processing. Outsourcing is slated to increase drastically in future as organisations identify their correct position in the value chain. Outsourcing is being considered due to various reasons which include absence of in-house competence, improvement in efficiency and economies of scale or flexibility.

Mergers and Strategic Alliances

Increased cost of technology might force the banks to merge to leverage upon complementary competencies. Cost efficiency can be achieved by the use of more efficient technologies in merged banks. Strategic alliances have been forged between various banks to increase cooperation and know-how and share IT costs, reap economies of scale and provide systems such as common use of ATMs. Thus synergies of two or more banks can lead to increased profitability for all.

SECTION 5: EFFECT OF TECHNOLOGY ON RISKS IN BANKING

The technological innovations and subsequent adaptation of technology by the banks have an impact on the overall risk profile of banks. Possible effects of IT on various types of risks for banks are classified below.

Strategic Risks

The strategic risks include:

- Increased competition
- Excessive investments in technology
- Long time lag for break even

Legal Risks

The legal risks are attributable to the laws and regulations in the wake of the ever changing technology. These laws relate to validity and proof of electronic signatures, customers' privacy, technical failure responsibilities and data protection. The legal disputes may arise due to disputed cash withdrawals, sharing responsibility between banks vulnerability of transactions on internet, hacking and breakdown of computers.

Operational Risks

For banks, there is always an operational risk of technological failures. Open Internet architecture poses a risk of external intrusion while employees pose a risk of data leakage. Some operational risks are the mishandling of IT products, inadequate safety of IT infrastructure, leakage of passwords, dependence on third parties, obsolescence of technology or ill designed IT package.

Operational risks also pose a major reputation risk which can lead to loss of customers.

Credit Risks

An increased use of technology leads to easing of mechanisms to disburse loans. The use of IT has enabled better quantification and management of credit risks.

SECTION 6: DELIVERY CHANNELS AND CHANNEL MIGRATION*

The evolution of high-tech banking can be divided into three stages:

Business Complexity

Past	Present	Future
• Simple products • Low volumes • Focus on high value corporate business	• Retail push • Complex products • Multiple channels • Challenge of increasing volumes	• Continued retail focus • Transaction intensive—High volume corporate business • Need to push down per transaction costs

Changing business needs paved the way for new technology and channel migration. The key areas of application of technology can be classified into two as mentioned as follows:

*Author Dr. Justin Paul acknowledge the help received from S. S. Sandhu, ICICI Bank for writing this section.

(i) Transaction processing
- Makes the routine but necessary work
  - Easier
  - Faster
  - Accurate
  - Cheaper
- Focused factory concept for processes like account opening and cheque clearing
- Economies of scale
- Control and consistency in processes
- Reduced load on branches
- Improved turnaround times
- Automated check processing

(ii) Cost cutting
- Normal transaction re-routing
- Automating integral administrative tasks
- Rapid increase in customer base led to proportionate growth in number of transactions, creating a need to use technology to improve productivity and efficiency of the processes
- Centralised operations

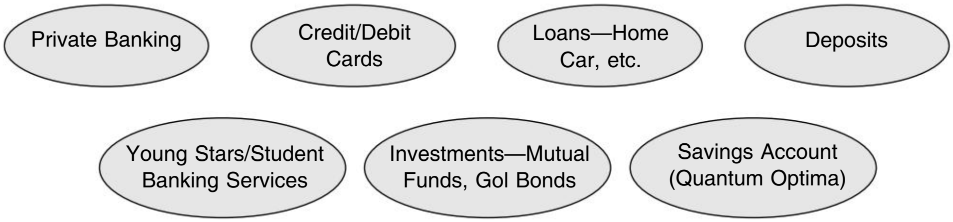

Fig. 12.1 Technology-led Delivery of Products

Migrating the customers to alternate channels improves the quality and lowers the cost of service delivery. The banks are getting consumers to use the right channels for the right transactions and interactions. The alternate delivery channels are the biggest growth drivers for the banks.

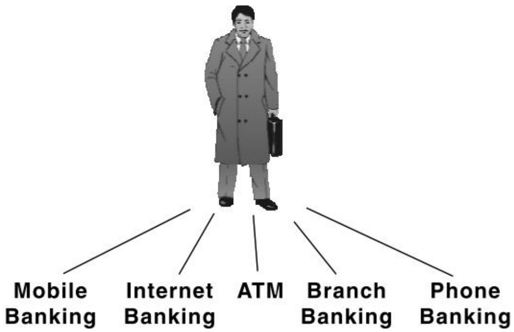

Fig. 12.2 Extended Reach by Multi-channel Offerings

Table 12.1 Channels

Internet Banking Services	• Electronic bill presentment and payment • Online bill payment for shopping, travel etc. transactions • Funds transfers 24X7 facility • Money to India for NRI customers • All routine transactions regarding banking, cards, loans and investment services
Automatic Teller Machine	• Routine Banking transactions like balance enquiry, cash withdrawal, funds transfer and cheque book requests • Features like airtime recharge for pre-paid mobile phones, donations to temples/trusts • ATMs for visually challenged customers
Mobile Banking	• SMS alerts for salary credit, account getting credited/debited, cheque bounce • SMS alerts for credit card due date reminders, approaching credit limit reminders
Call Center	• Customer contact through voice, IVR, e-mail, correspondence, video conferencing • Wide range of solution offerings to customer right from balance enquiry to execution of banking transactions like funds transfer, bill payment over phone

Table 12.2 Channel Migration—Data on use of Channels by Customers (Approximate Figures)

2000				2004			
ATM	Call Centre	Internet	Branch	ATM	Call Centre	Internet	Branch
15%	5%	2%	78%	46%	12%	12%	30%

Functions of Channels

Functions that channels must perform can be classified as:

(i) Sales
(ii) Transaction

What are the various activities under sales and transactions?

Activities Under Sales are:

(i) Pre sale
- Account opening

(ii) Post sale
- Cross sell
- Relationship deepening

Activities Under Transactions:

- Cash payment/withdrawal

- Request for Demand Draft/Pay Order
- Account opening/closure/transfer
- Investment Consultancy
- Balance Enquiry/last few transactions
- Statement of Account
- Cheque Book Request
- Cheque Status Enquiry
- Demat Queries
- Standing Instructions
- Fixed deposit renewal/closure/opening
- Address Change
- Stop Payment
- Cheque Deposit
- Funds Transfer
- Balance/Interest Certificates
- Others

Types of Channels

Predominantly Human
(Branch channel)

Predominantly Technology
(ATM channel, Internet channel, Phone channel)

Fig. 12.3

Let us do a SWOT of each channel to understand the above mentioned points clearly.

Branch Channel

Strengths	Weaknesses
Personal touch	Requires high manpower
Personalised information	High infrastructure cost
Facilitates complex banking activities	Restricted timings
Customer retention	Limited accessibility
Deepens relationships	Time consuming
Brand visibility	
Inculcates customer loyalty	
Perceived as a trusted advisor	
Opportunities	Threats
Financial advisor	Increasing cost of transactions in the branch
Facilitates channel migration	High footfall vis-à-vis employee ratio
Effective cross selling	

ATM Channel

Strengths	Weaknesses
Cost effective Better reach Brand visibility Round-the-clock availability Quicker transactions Networked to centralised database enabling Online updating Adds a fillip to bank's customer base	Cost of set-up Limited cash dispensing ability Lack of human interface Waiting time is not eliminated completely
Opportunities	**Threats**
Platform for cross selling Value-added services like donations and mobile phone prepaid recharging Shared ATMs to reduce cost and maximise reach Mobile ATMs to reach remotely located customers	Security concerns Lower brand loyalty Communication gap

Internet Channel

Strengths	Weaknesses
Lowest cost per transaction Reach Minimum physical infrastructure Round-the-clock availability Convenience banking Account integration for single relationship View Waiting time eliminated Information gateway	All transactions not possible Slow adopters of Internet banking Lack of human interface Poor penetration of Internet in India
Opportunities	**Threats**
Platform for cross selling Value-added services like ticket reservations Virtual banking	Security concerns Lack of strong trust environment Perceived notion that internet is not a safe place to conduct financial transactions Not accessible to masses

Phone Channel

Strengths	Weaknesses
Cost effective and accessible Most of the banks offer 24 × 7 × 365 days service Convenience banking Economies of scale Single point of contact for multiple products Supports complaint resolution	Cost of set up Limited transactions Communication barrier High AHT (Actual Handling Time)

(Contd.)

(Contd.)

Opportunities	Threats
Campaign & cross selling opportunities Accessibility across locations Deepening of relationships Acquisition of new customers	Customer perception of incurring cost while transacting

Case

Technological Environment—Case of Malaysia and Multimedia Development Corporation

Dr. Arif Nun, COO with the Multimedia Development Corp. (MDC), was reviewing the proposals of some 30 multimedia companies which wished to assist in refining the Multimedia Super Corridor (MSC) concept, setting priorities for development and establishing standards. Although the project had been stuck for almost 2 years, the MDC initiatives had contributed significantly to development of technology in Malaysia.

An Overview of Malaysia: Political, Social and Economic Environment

Geographic Location

Malaysia, around 330,000 square kilometres in size, is located in South East Asia. It consists of two geographical regions, separated by the South China Sea. Peninsula Malaysia is located between Thailand in north and Singapore in south.

National Income and Quality of Life

Malaysia is classified as an upper middle income country by the World Bank, with GDP of US$ 90 billion. According to the United Nations Development Programme (UNDP), Malaysia ranks 56th out of 162 countries in the Human Development Index (HDI), this places the country within the top quarter of the medium human development group.

Population Demographics

Malaysia carried out its fourth post-independence census in July, 2000 when the country's population was estimated at 23.3 million, with an annual growth rate of 2.6 per cent (between 1991–2000), and a population density of about 70 inhabitants per square kilometre. One third of Malaysians are under the age of 15, while just four per cent are over 65; the median age is 24 years.

Political Conditions

After the Federation of Malaya (today's Peninsula Malaysia) gained independence from the United Kingdom on 31st August, 1957, it united with Sarawak, Sabah and Singapore to become Malaysia in 1963. Singapore left the union two years later. The multi-ethnic country has generally enjoyed a politically stable environment. When ethnic tensions developed at the end of the 1960s, the government introduced the New Economic Policy, a measure that increased economic growth and reduced disparities, and helped to lessen social divergences.

Malaysia is a parliamentary democracy. A constitutional Monarch, picked by rotation every five years from amongst the sultans of nine Peninsula Malaysia states, heads the nation.

Malaysian Labour Markets

The population growth declined to 2.2% in 1990s, from 2.8% in 1980s. Hence, Malaysian government has launched incentive programs to encourage births. The seventh five year Economic plan introduced in May 1996, placed emphasis on attracting capital intensive technology industries and automation to reduce labour demands. Malaysia also has strict labour laws, which coupled with tight labour market, forced wages to increase faster than productivity.

Infrastructure

Malaysia's persistent drive to develop and upgrade its infrastructure has resulted in its being one of the better developed infrastructures among the newly industrialising countries of Asia.

The greatest advantage to manufacturers in Malaysia has been the nation's persistent drive to develop and upgrade its infrastructure. Over the years, these investments have paid off, and serious bottlenecks have been avoided. Today, Malaysia can boast of being the leader among the newly industrialising countries as regards its well developed infrastructure.

A landmark event was the completion of Malaysia's newest and biggest airport, the Kuala Lumpur International Airport (KLIA), which opened for business in 1998. The following year, Cyberjaya, Malaysia's first intelligent city, and the nucleus of the country's Multimedia Super Corridor (MSC), became a reality, complete with a multimedia university to provide a pool of knowledge workers for industries.

Recently launched is Kuala Lumpur Central, a transportation hub integrating all major rail transport networks, including the Express Rail Link to the KLIA and Putrajaya, the government's new administrative centre.

Multimedia Super Corridor and Multimedia Development Corporation

The Multimedia Super Corridor (MSC), managed by the Multimedia Development Corporation, is a major project initiated by the Malaysian Government, with the goal for turning Malaysia into the Asian hub for Information Technology. This project has been undertaken with a larger goal to shift the economy from labour based to service based economy. Public efforts in support of the MSC include fiscal incentives for setting up ICT companies, building the infrastructure and developing the intelligent cities of Putrajaya and Cyberjaya. Companies can apply for MSC status if they are heavy users or providers of multimedia products, employ a substantial number of knowledge workers, and are able to transfer technology to Malaysia. The companies were also classified into "web-shapers" and "web adopters", and 'web-shapers' were given preference. Companies with MSC status receive additional privileges and taxation relief. By the end of 31st December, 2001, there were 631 approved MSC companies and 50 world-class companies. The number of world-class companies was reached one year ahead of schedule, which prompted an upward revision of targets.

To speed up the project's development, the following flagship applications have been included in the priority list—Electronic government, National multipurpose card, Smart schools, Telemedicine, R&D clusters, borderless marketing centers and worldwide manufacturing hubs.

Intellectual Property Rights

- Computer software piracy is a major concern, with the proportion of illegal software in 1995 being 77%
- Five new cyberlaws introduced :
  - Digital signature cyberlaw
  - Multimedia intellectual property cyberlaw
  - Computer crime cyberlaw
  - Telemedicine development cyber law
  - Electronic Government cyberlaw
- Multimedia Convergence Act established.

The Road Ahead

Malaysia has reached an enviable level of ICT development, considering its per capita income. At the end of 2000, Malaysia ranked 30th in the world in internet penetration, above several more developed nations. The Malaysian government has created a number of institutions and programs to accelerate ICT use within the country. In many ways, Malaysia's proactive approach to ICT is unique, and provides an interesting example for the rest of the world. This includes the creation of the Multimedia Super Corridor (MSC), the establishment of a technologically neutral and converged industry regulator, trend setting research in ICT access, and equity and the application of ICT to evolve into a knowledge-based society. The government's strong ICT thrust and novel approach are to be applauded and encouraged.

With the government so involved in encouraging ICT, the nature of the recommendations for enhancing ICT development is different from other countries. Perhaps, it would have more to do with allowing a grass root, bottom up approach to development, in conjunction with the obvious top down one. As the framework analysis above illustrates, Malaysia is strong in the pervasiveness, geographical dispersion and organisational setting for ICT. Its weaknesses are in the absorption, connectivity, infrastructure and sophistication of use. Thus, recommendations mainly address these areas.

The country also faces three dilemas at present. One is the trade-off between devoting resources to the MSC at the expense of ICT development in the rest of the country. The second is reconciling inexpensive, and allegedly below cost, dial-up Internet access with a need to rebalance rates. The third is a low level of broadband access.

Questions

1. Discuss the Technological advancements in Malaysia?
2. Do you think that Malaysia is going to emerge as a developed country, based on the information given in this case? You may also collect information from other sources.

Chapter Summary

All the technological initiatives taken by banks are part of their channel diversification strategy. Though there is certainly a high level of importance attached to technology, it is at present not necessarily a priority for all banks. As far as banks are concerned, migrating customers to any self-directed channel is the main goal. However, the future of banking will be one in which customers can address most of their needs through self-directed means and the key differentiator will be how effective a bank is in getting its customers use technology and derives measurable value.

Objective Type Questions

1. Centralised operations for transaction processing does not result in
   (a) Reduced load on branches
   (b) Increase in transaction cost
   (c) Improved turn around times
   (d) Controls and consisting in processes
   (e) (c) and (d)
2. One of the following is not the feature of Branch Channel
   (a) Personal touch for customers
   (b) Low cost channel
   (c) Brand visibility
   (d) Opportunity to effectively cross sell
   (e) All of these
3. Application of technology to banking can help in
   (a) Transaction processing
   (b) Cost cutting through automating internal administrative tasks
   (c) Creation of new products
   (d) (a) and (b) above
   (e) All of the above
4. PIN (ATM) is
   (a) Personal Identification Number
   (b) Postal Index Number
   (c) Stored in magnetic strip of the card
   (d) (a) and (c)
   (e) None of these
5. Debit Card offers
   (a) Revolving credit
   (b) Pay off the entire amount after 2 days
   (c) Online debit of amount of card usage with commission
   (d) All of above
   (e) (b) and (c)
   (f) None of these

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Answers

Objective Type Questions

1. (b) 2. (b) 3. (e) 4. (d) 5. (f)

PART Six

Investment Environment, Opportunities and Indicators: Legal and Regulatory Systems

Chapter 13

Capital Market, Stock Exchanges, and Present Scenario

Learning Objectives

- to understand the structure of Indian capital market and capital markets institutions like Bombay Stock Exchange, the Securities and Exchange Board of India, the National Stock Exchange, NSDL and foreign institutional investors
- to learn the importance, need and role of derivatives market
- to carry out international comparisons of NASDAQ, New York stock exchange, Dow Jones, S&P 500, KOSPI, Nikkei

Chapter Structure

Section 1: **Capital Market**

Section 2: **Capital Market Institutions**

Section 3: **Stock Indices**

Section 4: **Derivatives Market**

Section 5: **Global and Indian Scenario**

Section 6: **Major Stock Exchanges in the World**

SECTION 1: CAPITAL MARKET

Financial Markets and Government Policies

By 1990s, the term "globalisation" had become a catch-phrase to describe the phenomenon of an increasingly integrated and interdependent world economy that exhibited free flow of goods, services and capital.

After more than four decades of heavy regulation and low rate of economic growth, Indian government opened the economy in 1991 to market forces and promoted modernisation of financial institutions. For four decades after Independence, India had followed a development strategy based on extensive government direction. This included broad public ownership of commercial enterprises, government approval for new investment by large private companies, substantial protection against imports, strict limitations on foreign investment and a government policy framework that posed obstacles to the development of capital markets. Most finance for investment projects was sourced through banks, which were heavily administered by the government.

Financial markets were constrained by five particular government policies:

- The government controlled almost all of the banking system.
- The insurance and pension fund industry was government-owned.
- Nearly all interest rates were set by the government.
- Banks had to meet high reserve requirements.
- Listing by private firms in the capital markets needed government approval (including government determination of terms) on new capital issues.

Role of Capital Market in Economic Development

Increased efficiency in the financial sector is expected to direct financial resources into the sectors where the productivity is the maximum. This, in turn, is expected to increase the rate of economic growth. Faster economic growth is then expected to reduce poverty.

The government policies have moved a substantial distance over the past few years towards free markets for goods and finance. Countries with better policies have significantly faster rates of economic growth. Improvements in capital markets would provide impetus to growth.

The role of capital markets in India's development can be understood in the following way:

> To achieve faster economic growth, the capital market can channelise the source of finance in the primary segment (new issues). Capital market makes two important contributions to growth. Firstly, it signals to other providers of capital (such as banks) the prospects, and therefore, the risk of lending to companies. Secondly, it provides opportunities for investors to seek out and invest in companies of the future.
>
> A country like India needs to grow at 8 or 9 per cent a year in order to eliminate pervasive poverty. It is difficult for the country to achieve this without better capital markets. Improving capital markets would have two important effects. Firstly, it would increase the quality and quantity of investment in the economy. Better capital markets are particularly important to mobilise savings into more efficient investments. Secondly, efficient and transparent capital markets can attract increased foreign savings to India (billions of dollars a year) to finance additional investment.

SECTION 2: CAPITAL MARKET INSTITUTIONS

(i) The Securities and Exchange Board of India (SEBI)

Established in 1992 under an Act of Parliament (Act 15 of 1992), SEBI has a dual mandate of regulating capital markets and promoting their development.[1] Since its creation, SEBI has sought to improve the structure and functioning of stock exchanges and ensure disclosure and investor protection.The functions entrusted to the Board under the Act include protection of the interest of investors and regulating the business in stock exchanges and other securities markets, regulating the working of stock brokers and intermediaries associated with the securities markets, registering and regulating the Foreign Institutional Investors, venture capital funds, mutual funds as well as keeping a check on fraudulent and unfair trade practices and insider trading in securities.

(ii) Bombay Stock Exchange (BSE) and Regional Stock Exchanges

The Bombay Stock Exchange, the oldest stock exchange in India, was founded in 1875. Twenty-two other stock exchanges also operates in India. There are some 7,000 listed stocks, 7,000 brokers who are members of the 23 exchanges, along with an estimated 100,000 sub brokers who interface with investors, a million active traders, and perhaps 20 million citizens who hold equities in some form, usually a mutual fund.[2] Despite its long history and large number of listed stocks, the equity market has had major problems, such as lack of disclosure of actual transaction prices, unreliable clearing and settlement.

(iii) The National Stock Exchange (NSE)

The NSE was established in 1994 as a competitor to the Bombay Stock Exchange (BSE). NSE was backed by major financial institutions, led by the Industrial Development Bank of India. The exchange introduced nationwide screen-based trading with a dish-to-satellite data transmission system that provides instant trading access to brokers anywhere in India. It spent more than $100 million in developing its system, which now has instantaneous access through more than 1,500 locations throughout the country. NSE inspired BSE and other exchanges to adapt computerised systems and reform trading rules and procedures. BSE shifted from an “open outcry” trading system to a screen-based system, making major investments in equipment, and revised its own procedures to provide transparency for investors.

The chart below gives a comparative movement of BSE and NSE over the past 10 years[3]. Both BSE and NSE have been moving in tandem if we look at the yearly closing figures for the two indices.

(iv) National Securities Depository Limited (NSDL)

In mid-1996, NSE began guaranteeing execution of trades through a new clearing corporation. This removed a major risk that had always been in the past and forced BSE to respond with improved

1. www.sebi.gov.in
2. *Source:* BSE Annual Report 2005–06.
3. Graph drawn based on data collected from the BSE & NSE websites.

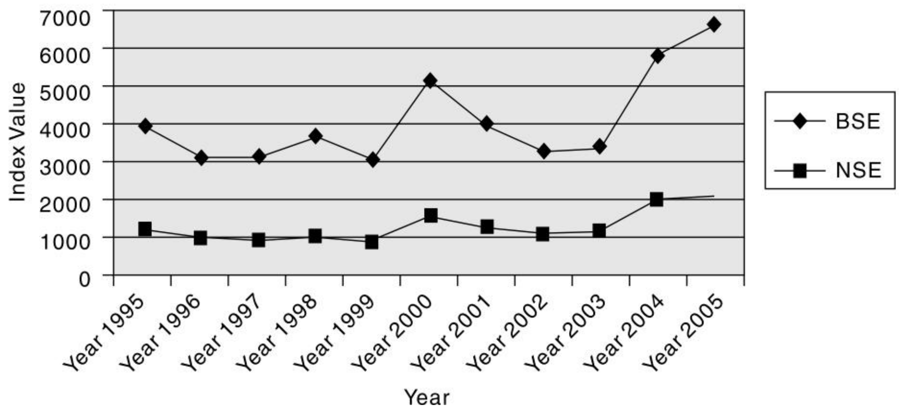

Fig. 13.1 BSE, NSE in 1995–2004

clearance procedures. In late 1996, the National Securities Depository Limited (NSDL) was inaugurated. NSDL provides a means by which securities trading takes place using electronic channels. An earlier proposal for a depository that would hold physical shares was under consideration for several years, but the Indian securities industry decided to forgo the costs of storing physical shares and created a depository for "dematerialised" shares. Trading takes place in both physical and dematerialised shares, but SEBI now requires institutions to trade only in the latter form.

(v) Foreign Institutional Investors (FIIs)

Since 1993, foreign institutional investors have begun to take an active interest in the Indian capital market. There are a total of over 500 registered foreign institutional investors, though most of them are small. About 20 large foreign investors are present in the market today, including firms such as Merrill Lynch, Jardine Fleming, Pioneer, CS First Boston, the Alliance Group, Lehman Brothers and Hong Kong Shanghai Bank. The number has grown gradually as the experience of the pioneers convinced others that the Indian market did provide an opportunity for placing capital with prospects of profitable investment.

SECTION 3: STOCK INDICES

An index is a number that represents the changes in a set of values between a base time period and another time period. Similarly, a stock index represents change in the value of a set of stocks, which constitute the index, over a base year. Sensex and Nifty are the two major stock indices of India, representing Bombay Stock Exchange and National Stock Exchange respectively. Just as the thermometer measures temperature of a person, a stock index determines whether the market is cold or feverish. This enables the investors to know the market trend and the direction in which it is moving. Two main objectives of stock indices are:

1. To reflect market direction
2. To indicate day to day fluctuations in the prices of scrips

The utility of a stock market index lies in a positive relationship with returns to different securities. The BSE-Sensex consists of 30 selected stocks and the Nifty consists of 50 selected stocks. Most of these companies are blue chip companies having a very good track record. As they are actively traded, the index shares have a very high liquidity.

A stock market index is created by selecting a group of stocks that represent the whole market or a specified sector or segment of the market. An index is calculated with reference to a base period and a base index value.

Stock market indices are useful for a variety of reasons. Some of them are:

- They provide a historical comparison of returns on money invested in the stock market against other forms of investments such as gold or debt.
- They can be used as a standard against which to compare the performance of an equity fund.
- It is the lead indicator of the performance of the overall economy or a sector of the economy.
- Stock indices reflect highly up-to-date information.
- Modern financial applications, such as Index Funds, Index Futures and Index Options, play an important role in financial investments and risk management.

BSE Sensex and Other Index Numbers

The BSE–Sensitive Index is a "Market Capitalisation-Weighted" index of 30 stocks representing a sample of large, well-established and financially sound companies. The BSE-SENSEX is the benchmark index of the Indian capital markets with wide acceptance among individual investors, institutional investors, foreign investors and fund managers.

The objectives of the index are:

1. To measure Market Movements

Given its long history and wide acceptance, no other index matches the BSE-SENSEX in reflecting market movements and sentiments. SENSEX is widely used to describe the mood in the Indian Stock markets.

2. Benchmark for Funds Performance

The inclusion of blue chip companies and balanced industry representation in the SENSEX makes it the ideal benchmark for fund managers to compare the performance of their funds.

3. For Index-based Derivative Products

Institutional investors, money managers and small investors all refer to the BSE-SENSEX for their specific purposes. The BSE-SENSEX is in effect proxy for the Indian stock markets. The country's first derivative product i.e., Index-Futures was launched on BSE-SENSEX.

Criteria for Selection of Scrips in Sensex

The eligibility criteria to be included in the SENSEX can be specified as follows.

(a) Market Capitalisation

The scrip should figure in the top 100 companies listed by market capitalisation. Also market capitalisation of each scrip should be more than 0.5% of the total market capitalisation of the Index i.e., the minimum weight should be 0.5%.

(b) Liquidity and Trading Frequency

The scrip should have been traded on each and every trading day for the last one year. Exceptions can be made for extreme reasons like scrip suspension and so on.

(c) Number of Trades

The scrip should be among the top 150 companies listed by average number of trades per day for the last one year.

(d) Value of Shares Traded

The scrip should be among the top 150 companies listed by average value of shares traded per day for the last one year.

(e) Trading Activity

The average number of shares traded per day as a percentage of the total number of outstanding shares of the company should be greater than 0.05% for the last one year.

Whenever the composition of the index is changed, the continuity of historical series of index values is re-established by correlating the value of the revised index to the old index (index before revision). The back calculation over the last one-year period is carried out and correlation of the revised index to the old index should not be less than 0.98. This ensures that the historical continuity of the index is maintained.

Scrip selection would take into account a balanced representation of the listed companies in the BSE. The index companies should be leaders in their industry group.

Sensex Movement

SENSEX had crossed 12000 mark in March-April 2006, which was then considered to be the peak point. SENSEX is being taken as a signal of performance of the corporate sector in the country. The daily SENSEX value is available in the market and it fluctuates depending upon the demand and supply factors. If SENSEX is in the range of 16000-20000, then it is generally considered as positive sign in the stock market. SENSEX point below 16000 indicates recessionary trend in the market. BSE SENSEX had witnessed more than 100% return during 2004–2007, over a period of 3 years. SENSEX crossed 20000 mark in 2007.

Calculation of SENSEX

SENSEX is calculated using a "Market Capitalisation-weighted" methodology. As per this methodology, the level of index at any point of time reflects the total market value of 30 component stocks relative to a base period. (The market capitalisation of a company is determined by multiplying the price of its stock by the number of shares issued by the company).

The base period of SENSEX is 1978–79. The actual total market value of the stocks in the index during the base period has been set equal to an indexed value of 100. This is often indicated by the notation 1978–79 = 100. The closing SENSEX is computed taking the weighted average of all the trades on SENSEX constituents in the last 15 minutes of the trading session. If a SENSEX constituent has not traded in the last 15 minutes, the last traded price is taken for computation of the index closure. The use of Index Closure Algorithm prevents any intentional manipulation of the closing index value.

Other Indices of BSE

The BSE pioneered the concept of stock market indices in the country by launching "SENSEX" in 1986. In order to fulfil the need of the market participants for broader, segment-specific and sector-specific indices, the Exchange has continuously been adding to its family of indices, which presently consist of the following indices, besides SENSEX.[4]

Sensex, BSE-100, BSE-200, BSE-500, Dollex BSE-100, BSE-200 and BSE-500 are index numbers with 100, 200 and 500 major scrips from different sectors. DOLLEX is the US$ version of the BSE-200 Index. The US$ linked index was launched to facilitate investment evaluation in US$ terms for foreign investors. The base year of DOLLEX is the fiscal year of 1989–90. The BSE has introduced a broad based index consisting of 500 scrips w.e.f. 16 August, 1999 to represent all segments of listed stocks. The base date and base value of BSE-500 is Ist February, 1999 and 1000 points respectively. It represents all 23 major industries and 102 sub-sectors of the Indian economy covering more than 80% of the total market capitalisation.

Nifty and NSE Index Numbers Major Indices of NSE are S&P CNX Nifty, CNX Nifty Junior, S&P CNX 500, CNXMidcap 200. The CNX indices are computed using market capitalisation weighted method, wherein the level of the index reflects the total market value of all stocks in the index relative to a particular base period. The method also takes into account constitutent changes in the index and important corporate actions, such as stock splits and rights, without affecting the index value. Among these indices, S&P Nifty is considered as a benchmark index of NSE. NIFTY is being considered as an indicator of stock price movements, like SENSEX in India. NIFTY, of which the base value was 1000 in the year 1995, was in the range of 2000–2500 in the year 2004–05, (NIFTY's value was in the range of 1300–2000 during 2000–04). It has witnessed bullish trend in value and crossed the 4500 mark in 2007. The average return from NIFTY (increase in value) has been approximately 80–100% during 2004–07.

Salient Features of Nifty S&P CNX Nifty, known as Nifty, is a well diversified 50 stock index comprising the largest companies in India. Nifty covers nearly 25 sectors of the economy and a market capitalisation of almost 49% of the total market capitalisation of the Indian Stock Market. The ownership and management rights of this index rests with India Index Services & Products Ltd (IISL), a corporate body jointly promoted by NSE and the Credit Rating and Information Services of India Ltd. (CRISIL), a leading rating agency in India. Nifty is a scientifically developed market capitalisation weighted index. Nifty was developed keeping in mind that an index, besides being a true reflection of

4. www.bseindia.com. Author Justin Paul prepared this. Write-up based on raw information from the website.

the stock market, should also be used for modern applications such as benchmarking fund portfolios, index-based derivatives and index funds.

The salient features of Nifty are:

(a) The total traded value of all Nifty stocks is approximately 62% of the traded value of all the stocks on the NSE.
(b) Nifty represents about 45% of the total market capitalisation.
(c) Ideal for derivatives trading.

People analyse the NIFTY fluctuations and consider it as a barometer of the corporate sector's performance. Whenever the demand for the stocks of major organisations listed at NSE increases, the NIFTY value also increases proportionately. It could be due to demand by investors in India or foreign institutional investors. It is generally believed that the share market become bullish and the economy is said to be in good mood if NIFTY crosses 4000. NIFTY value, which is less than 3000, indicates bearish trend in stock market and recession in the economy.

Criteria for Selection of Companies Included in Nifty The constituents and the criteria for the selection judge the effectiveness of the index. S&P CNX Nifty is unique in this respect. Selection of the index set is based on two criteria:

Market Capitalisation All companies to be included in the index should have a market capitalisation of Rs 5 billion or more. All selected securities bear a weight in the index in proportion of their market capitalisation.

Liquidity (Impact Cost) For inclusion in the index, the security should have traded for 85% of the trading days at an impact cost of less than 1.5%.

Impact cost can be defined as the cost of executing a transaction in a security in proportion to the weightage of its market capitalisation as against the index market capitalisation at any point of time.

Base Date and Value The base period selected for S&P CNX Nifty index is the close of prices on November 3, 1995, which marks the completion of one year of operations of NSE's Capital Market Segment. The base value of the index was set at 1000 and a base capital of Rs 2.06 trillion.

Other NSE Indices **(i) CNX Nifty Junior** It was introduced on January 1, 1997, with base date and base value being November 03, 1996 and 1000 respectively and represents about 7% of the total market capitalisation.

The selection of the CNX Nifty junior index set is based on the following criteria:

Market Capitalisation All companies to be included in the index will have a market capitalisation of Rs 2 billion or more. All the selected securities will bear a weight in the index in proportion to their market capitalisation.

Liquidity (Impact Cost) For inclusion in index, the security should have traded for 85% of the trading days at an impact cost of less than 2.5%.

(ii) S&P CNX 500 The calender year 1994 has been the base year for this index due to its proximity to the current economic environment, with a base value 1000. Selection of the index set is based on the market capitalisation, industry representation, trading interest and financial performance. The influence of each company on the index is directly proportional to its market value. Therefore, a company's rank on market capitalisation is an important consideration for its inclusion in the index. The index includes most companies, which are leaders in or representative of their industries, and reflect the market as closely as possible. Industry weightages in the index dynamically reflect the mood of the market and the index is disaggregated into 79 industries.

(iii) CNX Midcap 200 The base period is calendar year 1994, indexed to a value of 1000.

Selection of the index set is based on the following criteria.

Market Capitalisation The average annual market capitalisation of a company, for inclusion in the index must range between Rs 1.5 billion and Rs 15 billion.

Industry Representation The distribution of industries in the CNX Midcap 200 Index represents the industry distribution in the midcap segment of the market.

(iv) S&P CNX Defty Almost every institutional investor and offshore fund enterprise with an equity exposure in India would like to have an instrument for measuring returns on their equity investment in dollar terms. To facilitate this, a new index called S&P CNX Defty Dollar Denominated S&P CNX Nifty has been developed. Computations are done using Nifty index with online exchange rate (US $ - INR) disseminated by Knight-Ridder information vending system. Defty is an indicator to foreign institutional investors, off shore funds and so on.

SECTION 4: DERIVATIVES MARKET

A derivative security can be defined as a security whose value depends on the values of other underlying variables. "Derivative" means Forward, Future or Option contract of pre-determined fixed duration, linked for the purpose of contract fulfilment to the value of specified real or financial asset or to index of securities.

Derivatives are meant essentially to facilitate temporarily hedging of price risk of inventory holding or a financial/commercial transaction over a certain period. The use of forward/futures contracts as hedging techniques is a well-established practice in commercial and industrial operations. Derivatives are very important financial instruments for risk management as they allow risks to be separated and traded and act as a form of insurance. Risks in trading derivatives may change depending on what happens to the underlying asset.

Derivative securities are available on stocks, stock indices, bullion, index, currency, bonds, interest rates, commodities in the world. The financial derivatives can be broadly classified into (i) futures, (ii) options. Both futures and options on stock indices and individual stocks are traded through stock exchanges in many countries.

The derivative products like futures and options have been introduced in capital markets in India. The derivatives market performs a number of economic functions:

- Helps in managing risks.
- Helps in the discovery of future prices.
- Increases the volume traded in markets because of participation of risk averse people in greater numbers.
- Increases savings and investment in the long run.

Components of a Derivatives Exchange

A derivatives exchange is made up of four components: product, trading mechanism, clearing facility, and settlement procedures.

Product

Derivatives exchange trade products like futures and options. An example of such a product could be a stock futures contract on an index, or options on a security or options on a commodity. All aspects of the traded contract would need to be specified, including the expiration date, date of making delivery and the quantity of the goods which will be delivered.

Trading

A derivatives exchange needs a trading system. The trading takes place in anonymity, where individuals all across the country have equal access to the trading floor. Therefore, prices are transparent.

Clearing

Trading on a derivatives exchange takes place anonymously which means that the buyer does not know the identity of the seller, and vice versa. This would only be feasible if credit risks were eliminated. This is done through innovation at the clearing corporation.

Settlement

Derivatives can involve the exchange of funds (financial derivatives) and goods (commodity derivatives). For example, the holder of an option to buy coffee might choose to exercise the option, delivering funds and taking delivery of coffee. The derivatives exchange has established smooth procedures for settlement.

Relationship Between the Cash (Shares) and the Derivatives Market

The crucial difference between shares and derivatives is that while shares are financial assets, derivatives are usually contracts (the major exception to this are warrants and convertible bonds).

Arbitrage transactions between the futures market and the cash market for equities is likely to have a beneficial effect on the functioning of the cash market in terms of price discovery, broadening of liquidity and the overall efficiency.

- A significant indicator of the effect of derivatives on the underlying market is volatility in the spot market. Their sound development is closely inter-related. Hence, it is necessary to make both derivatives market and cash market fair, efficient and transparent. This objective can best be achieved by separating cash market and futures market and thereby regulating them effectively.
- An efficient cash market is required for an efficient futures market. It is, therefore, necessary to recognise the danger that if the cash market behavior is erratic or does not reflect fundamentals, a futures market, based on such a cash market, will fail to give a correct indication of future spot prices and its usefulness for price discovery will be reduced.

The participants in a derivatives market are of three types.

(i) Hedgers
(ii) Speculators
(iii) Arbitrageurs

- Hedgers use futures or options markets to reduce or eliminate the risk associated with the price of an asset.

- Speculators use futures and options contracts to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and potential losses by usage of derivatives in a speculative venture.
- Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Advantages of Derivatives Over Equity Trading

The financial derivative instruments futures and options have the following advantages.

- Derivatives can be used as a convenient substitute for other investments, leaving risks and rewards unchanged.
- Derivatives can be used to hedge the risk and can help manage the risks inherent in a business.
- Derivatives can be used speculatively to increase risk and reward through leverage.
- Derivatives are also the basis for modern financial engineering.

Stock Index Futures

Although futures on stock index futures and individual stocks can be traded as derivative instruments, the former is more popular. Hence, we discuss the features of index futures in detail.

The contract specifications of BSE and NSE Index Futures contracts are as follows:

Features	BSE Index Futures Contracts	NSE Index Futures Contracts
Underlying Index	Sensex	S&P CNX Nifty
Contract Multiplier	50	200
Last trading day/ Expiration day	Last Thursday of the month. If it happens to be a holiday, the contract will expire on the previous business day	Last Thursday of the month. If it happens to be a holiday, the contract will expire on the previous business day

Where

Contract Multiplier is standard for an Index Futures Contract and is defined by the exchanges in the contract specification before the introduction of the contract's trading. Different Indices may have different Contract Multipliers or the same index may trade with different Multipliers.

Settlement of Index Futures

Index based derivatives worldwide are cash settled i.e., settlement of these trades takes place only through the settlement of the difference in the buy/sell price and final settlement price of the contract. They are designated as Cash-Settled Derivatives Contract.

There are many reasons for the wide international acceptance of stock index futures as well as for the strong preference for this instrument in India too compared to other forms of equity derivatives.

This is because of the following advantages of stock index futures:

- Institutional and other large equity holders need portfolio hedging facility. Hence, index-based derivatives are more suited to them and more cost-effective than derivatives based on indi-

vidual stocks. Even pension funds in USA are known to use stock index futures for risk hedging purposes.
- Stock index is difficult to manipulate as compared to individual stock prices.
- Stock index, being an average, is less volatile than individual stock prices. This implies lower margin requirements in the case of index futures than in the case of derivatives on individual stocks. The lower margins will induce more players to join the market.

Options

When a investor hedges his position with the help of a futures/forward contract, he basically locks himself at a price with no room of taking the advantage of the favorable price movement of the asset in the cash market as, both, the buyers and the sellers have the obligation to honor the contract.

Options address this issue of advantage to the hedger in case of favorable price movement in the price of the underlying, by offering the right to buy or sell the underlying. Therefore, the essential difference between Futures and Options Contracts is that in Futures Contract, both the parties have obligation to perform the contract, while in case of Options, only the seller has the obligation, while the buyer has the right without the obligation to exercise the contract.

In other words, options are contracts giving the holder the right (but not the obligation) to buy or sell securities at a pre-determined price (known as "strike price" or "exercise price"), within or at the end of a specified period. In order to acquire the right of option, the option buyer pays to the option seller (option writer) an Option Premium, which is the price paid for the right.

Future	Right with obligation to exercise the contract
Option	Right without obligation to exercise the contract

Styles of Options

European Style The European Style options can be exercised only on the specified date, which is generally the expiration date. Index options are European in style.

American Style The American Style options can be exercised at any time on or before its expiration date. Stock options are American in style.

Types of Options

Call Option The option which gives the buyer a right to buy the underlying asset is called a Call Option.

Put Option The option which gives the buyer a right to sell the underlying asset is called a Put Option.

Risk and Return Profile of Option Contracts

Option Buyer Limited Risk (the maximum loss is the premium paid to the Option Writer) and Unlimited return potential.

Option Writer Unlimited Risk and Limited return potential (the maximum gain is the premium received from the Option Buyer).

The following table summarises the relationship between an Option's Strike Price and the Market Price of the underlying asset.

Market Scenario	Call Option	Put Option
Market Price > Strike Price	In-The-Money(ITM)	Out-of-The-Money (OTM)
Market Price < Strike Price	Out-of-The-Money(OTM)	In-The-Money (ITM)
Market Price = Strike Price	At-The-Money(ATM)	At-The-Money (ATM)
Market Price ~ Strike price	Near-The-Money(NTM)	Near-The-Money (NTM)

SECTION 5: GLOBAL AND INDIAN SCENARIO*

By far, the most significant event in financial markets during the past decade has been the development and expansion of derivatives. The Global Derivatives Market is comparatively very well developed with high depth and liquidity. The portfolio managers are increasingly investing in derivatives and making them integral parts of their management strategies. The utility of derivatives is more pronounced in the international arena as they allow international managers to take position on an entire market at a fraction of the cost.

The rise of electronic trading has heightened competition between markets and brought about a wave of alliances between futures exchanges. Today, electronic trading accounts for almost half of all the trade on Liffe (London International Financial Futures and Options Exchange). Technology has heightened competition elsewhere too. Even established electronic markets like US-based Nasdaq have to ensure that their market mechanisms are as efficient as the latest technology will allow.

The profitability of derivative products has been a major factor in the dramatic rise in large banks' non-interest earnings in the American corporate sector during the past decade. Bearing witness to this is the rise of Electronic Communication Networks (ECNs) in the US, which have developed as a remedy to market inefficiencies. ECNs allow investors to identify and access pools of liquidity in any stock at any time. But these barriers are coming down. Alliances between exchanges are forming in a big way. In Switzerland (1993), Germany (1994), the Netherlands, Finland, France and Austria (1997), and Sweden (1998), stock and derivatives exchanges have merged. Links between derivatives exchanges have also been formed, between Sweden's OM and its London branch, OMLX, and the Oslo Exchange (1997), to create Eurex (1998). Similarly, the Chicago Mercantile Exchange, Paris Bourse and Singapore International Monetary Exchange have created Globex. The Euro-Globex alliance also links the Paris Bourse with Spain's Meff Renta Fija exchange.

Equity Cash and Derivatives Markets in India

Till 1994, equity trading in India was dominated by floor-trading on the Bombay Stock Exchange (BSE). In 1994, a consortium of government-owned financial institutions started the National Stock Exchange (NSE). The NSE built a state-of-the-art electronic order-matching system that was fully

*This section was co-authored by Dr. Justin Paul, Gagan Suryavanshi, Saumitra Bajpai and Vikas Ramrakhiani.

automatic. NSE formed itself as a limited liability corporation that franchised out to brokerage firms. The NSE also admitted corporate entities and foreign brokerage firms. This competition between the BSE and NSE is now in the similar lines of the competition between the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation Systems (NASDAQ) where companies vie not only for listings, but also for order flow.

A number of other policy and institutional changes have led the creation of a fairly efficient and robust equity capital market in India. Some of these key developments in the recent past have been:

- The launch of equity index futures trading in 2000
- The launch of equity index options trading in 2001
- The launch of the stock options market in 2001

Debt Markets in India

Debt markets in India have suffered from chronic neglect on the part of policy makers, despite the fact that there is clear evidence of fairly strong debt preference among households for their financial investment portfolio. Very little has been done to create the infrastructure required for an efficient and developed debt capital market. In fact, the debt markets in India are currently at a similar stage of their evolution as the equity markets were prior the reform process in the early 1990s.

The early 1990s saw the following major reforms take place:

- "Delivery versus payment" system was implemented.
- The RBI successfully set up a regulatory system for trading in government securities bonds.
- The Wholesale Debt Market (WDM) was established on the NSE. All trades were reported to the WDM and conducted through it. The WDM does not possess liquidity, but reveals useful data about prices and trading volumes.

The debt market is really limited to a few brokers and institutional investors with inadequate provisions for active participation by the small investors. Even less progress has been made in creating the infrastructure and implementing the policy regime that is needed to facilitate the evolution of the Indian debt capital market into a global participant.

The requirement of investment funds for productive investment in capital markets can be divided into three broad categories—equity, long-term debt, and medium to short-term debt. The proportion in which different forms of funds are required depends on the nature of the activity, the sector in which the investment is proposed to be made, and on the perceptions regarding the future developments in the financial sector.

Looking at the successes in the case of the equity markets, the need of the hour is thrust by policy makers towards creating a well developed market. The institutionalisation of the key ingredients is the first critical step in this process. Concrete steps needs to be taken for improving market micro-structure to bring in best practices from international markets.

Market Surveillance and Risk Containment

Market Surveillance plays a key role in ensuring safety and integrity of the markets. Market Surveillance Division was set up in SEBI in 1995. Some of the surveillance systems and risk containment measures that have been put in place are briefly given below: [SEBI Annual Report 1995–96]

- Risk containment measures in the form of elaborate margining system and linking of intra-day trading limits and exposure limits to capital adequacy of the brokers;
- Daily price bands to curb abnormal price behavior and volatility;
- Reporting by stock exchanges through periodic and event-driven reports;
- Establishment of independent surveillance cells in stock exchanges;
- Inspection of intermediaries;
- Suspension of trading in scripts to prevent market manipulation;
- Formation of Inter Exchange Market Surveillance Group for prompt, interactive and effective decision making on surveillance issues and co-ordination between stock exchanges.
- Implementation of Online automated surveillance system at stock exchanges.

SECTION 6: MAJOR STOCK EXCHANGES IN THE WORLD

(i) NASDAQ in the US

NASDAQ, originally an acronym for National Association of Securities Dealers Automated Quotations, is a stock exchange run by the National Association of Securities Dealers. When it began trading on February 8, 1971, it was the world's first electronic stock market. Since 1999, it has been the largest American stock exchange with over half the companies traded in the United States listed. NASDAQ is made up of the NASDAQ National Market and the NASDAQ SmallCap Market. The main exchange is located in the United States of America, with branch exchanges in Canada and Japan. They also have associations with exchanges in Hong Kong and Europe.

NASDAQ allows multiple market participants to trade through its Electronic Communications Networks (ECNs) structure. The Small Order Execution System (SOES) is another NASDAQ feature, introduced in 1984, to ensure that in 'turbulent' market conditions small market orders are automatically processed. On July 17, 1995, the NASDAQ stock index closed above the 1,000 mark for the first time. The index peaked at 5048.62 on March 10, 2000, which signaled the beginning of the end of the dot-com boom. In 2002, NASDAQ adopted SuperMontage or SUMO, which allows market makers show up to 5 levels of their prices. Eventually, SOES was replaced by SUMO. NASDAQ was closed from September 11 to 14, 2001 as a result of the September 11, 2001 terrorist attack.The index value fell down drastically as an outcome of the attack on the World Trade Centre (see Figure 13.2)

The Fig. 13.2 here shows the movement of NASDAQ index for the past 10 years. During the second half of 2000, NASDAQ had witnessed a sharp decline due to the infamous scandals viz. Worldcom, Enron and Anderson.

(ii) New York Stock Exchange (NYSE)

New York Stock Exchnage (NYSE) is one of the largest stock exchanges in the world. The NYSE is operated by the not-for-profit corporation New York Stock Exchange Inc, with its main building located at 18 Broad Street, at the corner of Wall Street in New York City, U.S.A. NYSE is home to some 2,800 companies valued at nearly $15 trillion in global market capitalisation. As of December 2004, 28 out of the thirty companies in the Dow Jones Industrial Average were listed on the NYSE, the exceptions being Intel and Microsoft. NYSE trades, unlike those on some other more "virtual" exchanges (e.g., NASDAQ), always involve face-to-face communication in a particular physical location. There is one

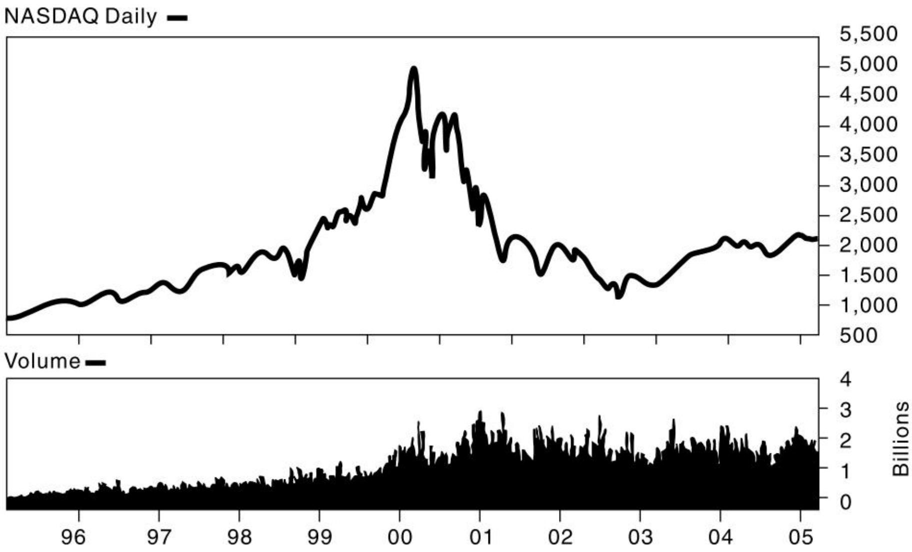

Fig. 13.2 NASDAQ Index Movement 1996–2005

station at each post on the trading floor for each of the exchange's stocks. Exchange members interested in buying and selling a particular stock on behalf of investors gather around the appropriate post where a specialist broker, who is employed by an NYSE member firm (that is, he/she is not an employee of the New York Stock Exchange), acts as an auctioneer in an open outcry auction market environment to bring buyers and sellers together. They do, on occasion, facilitate the trades by committing their own capital and as a matter of course, disseminate information to the crowd. Most of the time, natural buyer and seller meet in a market that provides price discovery in an auction environment that produces the fairest price for both parties. The current structure of electronic and human order execution is constantly being improved to offer customers the greatest possible choice in order execution.

(iii) Dow Jones

The Dow Jones Industrial Average (DJIA) is one of the several stock market indices created by Wall Street Journal editor and Dow Jones & Company founder Charles Dow. Dow compiled the index as a way to gauge the performance of the industrial component of America's stock markets. It is the oldest continuing U.S. market index, and today it consists of 30 of the largest and most widely-held public companies in the United States. To compensate for the effects of stock splits and other adjustments, it is currently a weighted average, not the actual average of the prices of its component stocks.

First published on May 26, 1896, the DJIA represented the average of twelve stocks from various important American industries. Of those original twelve, only General Electric remains. Some people criticize the DJIA because it is a price-weighted average, which gives relatively higher-priced stocks more influence over the average than their lower-priced counterparts. This can produce misleading results, as a $1 increase in a lower-priced stock can be negated by a $1 decrease in a much higher-priced stock, even though the first stock experienced a larger percentage change. Additionally, the inclusion of only 30 stocks in the average has brought on additional criticism of the average, as the DJIA is widely used as an indicator of the overall market performance. Because of these issues, the S&P 500 is becoming more widely quoted and used as a more realistic broad market performance indicator.

(iv) S&P 500

The S&P 500 is a list of 500 US companies, ordered by market capitalisation. The list is owned and maintained by Standard & Poor's Corporation. All of the companies in the list are large publicly-held companies which trade on major US stock exchanges such as the New York Stock Exchange and Nasdaq. The market-value weighted performance of the stocks of these companies is known as the S&P 500 index. After the Dow Jones Industrial Average, the S&P 500 is the most widely-watched index of large-cap US stocks and is considered to be a barometer for the US economy.

Many index funds and exchange traded funds track the performance of the S&P 500 by holding the same stocks as the S&P 500 index, attempting to match its performance. In stock and mutual fund performance charts, the S&P 500 index is often used as a baseline for comparison. Although the 500 companies in the list are among the largest in the US, it is not simply a list of the 500 biggest companies. The companies are carefully selected to ensure that they are representatives of various industries in the US economy. In addition, companies, which are privately held and stocks which do not have sufficient liquidity, are not in the index. By contrast, the Fortune 500 attempts to list the 500 largest companies in the United States, regardless of whether they are publicly or privately held and without adjustment for industry representation.

(v) KOSPI

The Korea Composite Stock Price Index (KOSPI) is an index of all the companies traded on the Korea Stock Exchange. The index is a market capitalisation based index introduced in 1983. The base value of 100 was set to January 4, 1980.

(vi) Nikkei

Nikkei 225 is a stock market index for the Tokyo Stock Exchange. The Nikkei average is the most watched index of Asian stocks. It has been calculated daily by the Nihon Keizai Shimbun newspaper since 1971. It is a price-weighted average (the unit is Yen), and the components are reviewed once a year.

Chapter Summary

During 2001 and 2002, major changes were made in the trading system with a ban on age-old Badla system, introduction of rolling settlements and addition of three more derivatives products—index options, stock options and stock futures. In the derivatives segment, interest in instruments started increasing in 2001 but their usefulness was essentially realized after September 11 when players with hedged positions could mitigate their losses compared to those caught unaware by volatile moves after the WTC attacks. Their popularity increased further after introduction of stock futures with average volumes in the segment increasing by many folds.

The entry of exchange-traded funds (ETFs) is expected to add more to this transition as they can be used as hedging and arbitrage instruments. The product is popular in international markets, like in the US where 60 per cent of trading volume on the American Stock Exchange (AMEX) is captured by ETFs.

It would be difficult to forecast the combined effect of all these on the share prices, but look at the way the capital market has grown in the past few years and with an increased awareness. There may be problems initially but ultimately the popularity of the products or systems will be determined by what the market wants.

The market is witnessing the fluctuation these days at unprecedented levels.

Review Questions

1. Discuss the role of capital market institutions and stock exchanges.
2. How does a derivative segment help the investors and companies?
3. Compare the mechanism of international exchanges NASDAQ, Dow Jones, KOSPI and Nikkei.
4. Distinguish between NIFTY and SENSEX.
5. How do you understand the business cycle of corporate sector based on stock indices?
6. Distinguish between Future and Options.
7. Distinguish between:
   (a) Call options and Put options
   (b) In-the money, At-the money and Out of the money
   (c) European style and American style options

Objective Type Questions

1. Name the regulatory authority of capital market in India.
2. How many companies' stocks are included in the construction of BSE SENSEX.
3. How many companies' stocks are included in NIFTY?
4. Name the US$ version of BSE-200 Index.
5. Name the derivative contract that has right without obligation to exercise the contract.

True or False

1. Index based options are European in style i.e., they can be exercised on the specified date.
2. 'Buy' option is known as call option.
3. Index futures, index options and stock options have been launched in India.
4. NASDAQ was established as the world's first electronic stock market.
5. Nikkei is a stock market index of Korea Stock Exchange.

Class/Field Exercises

Collect data on the following topics and analyse the Business Environment in the respective sector with reference to the information given below.

1. Stock/Commodity Exchanges and Market in India—Growth, types of commodities, trading mechanism, price determination, investment points and implication on society.
   Ref: BSE, NSE, MCX and NCDX websites and publications
2. Mutual Funds in India and world–industry analysis, competitive strategies, product segmentation and differentiation, new products.
3. Study of NAV movement of leading mutual funds considering it as a investment alternative based on the developments like SENSEX movements (Correlation between NAV and SENSEX).

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Answers

Objective Type Questions

1. SEBI 2. 30 3. 50 4. DOLLEX 5. Option

True or False

1. True 2. True 3. True 4. True 5. False

Case

Investment Return from Indian Stock Market—Bombay Stock Exchange (BSE) SENSEX

It is important for all investors who invest or tend to invest in equities to take a historic trip, particularly during times when the investor feels tired and let down by the market. We need to be aware that bearish/bullish time is not new in the market but public memory being short, one tends to forget the days of despair.

The following table depicts the peaks and bottoms of BSE Sensex in the recent past. Only the recent past is given here because it is relatively easier to connect to it.

SENSEX High	Date	SENSEX Low	Date
4546	02.04.1992	1980	27.04.1993
4643	12.09.1994	2713	04.12.1996
6150	14.02.2000	2156	03.10.2001
6249	09.01.2004	4227	17.05.2004
12671	11.05.2006	8799	14.06.2006
14723	09.02.2007	12316	16.03.2007
21206	10.01.2008	8701	24.10.2008

Source: Bombay Stock Exchange.

It is worth noting that the most interesting development of the period early 1990s was the amazing growth of investor population in the stock market and stock investing becoming fashionable for the first time, with new Stock Exchanges mushrooming in every nook and corner of the country. This was a time when market regulations were weak and SEBI had no effective punitive power.

Now look at the table again. In a matter of seventeen months the very same market bounced back to touch 4643 points on 12th September 1994 from 1980 on 27th April 1993. The market went up by more than 100 percent in 17 months! Just have a look at the market peaks alone. The next peak was at 6150 (in 3 years 2 months), the next at 6249 (in 2 years 3 months), then at 12671 (in 2 years), then at 14723 (in 8 months) and then at 21206 points (in 10 months). Here, the intention is not to predict when and to where the Sensex will bounce back in the days to come, but to point out that all those who courageously got into the market in each of the troughs and waited patiently got incredible return as the market often peaked above the previous peak.

Now what happened to those who invested during the peak time in each of the market peaks—many new investors tend to start investing at the peak—they saw their wealth going down by 50 to 70 percent!

Compare this to the wealth of all those who got into the market when the market touched bottom every time! The lesson to be learnt is—it requires courage to invest when every other investor leaves the market, not *vice versa*.

In this backdrop we must also analyse what happened in the market that pulled the Sensex down to 8700 points in late 2008. Many foreign institutions and hedge funds have become bankrupt in their home countries forcing them to sell Indian assets at throwaway prices pulling the market down. One serious difference is that this time we had a global magnitude to this crash in relation to liquidity.

Question

Compute the percentage return (profit or loss) an investor got as per the following schedule:

Date of Investment	Date of Sale
03.10.2001	09.01.2004
17.05.2004	11.05.2006
11.05.2006	14.06.2006
14.06.2006	10.01.2008
16.03.2007	10.01.2008
09.02.2007	24.10.2008
17.05.2004	10.01.2008

The McGraw-Hill Companies

Chapter 14

Legal Environment of Business, Mergers and Acquisitions

Learning Objectives

- to understand the legal environment of business that drives the companies to acquire or merge with others
- to learn the difference between merger, acquisition, joint venture and strategic alliance
- to elucidate different types of mergers
- to study the scenario of M&As
- to discuss the strategies and synergies of M&As

Chapter Structure

The factors driving mergers and acquisitions include globalisation, technology, deregulation, favorable economic and financial conditions, and changes in the business laws. The structural adjustment programme and the new industrial policy adopted by the government of India have allowed business firms to undertake any programme of expansion either by entering into a new market or through expansion in an existing market. In that context, many organisations are increasingly resorting to mergers and acquisitions as a means of growth. The first part of the chapter deals with the theory and strategic aspects of mergers and acquisitions, and the second part is devoted to discuss the legal environment of business with reference to the business laws such as MPTP, competition and Companies Acts. Case study of Bank of Madura merger with ICICI Bank has been discussed in Section 3.

SECTION 1: MERGERS AND ACQUISITIONS

Business combinations, which may take forms of mergers, amalgamation and takeovers, are important features of corporate restructuring and governance. They have played an important role in the growth of a number of leading companies in the world over. Subsequent to the structural adjustment programmes in the Indian economy, restructuring of companies in the form of collaborations, mergers and acquisitions have taken place in most of the industries including Banking, Information Technology, Fast Moving Consumer Goods and Pharmaceuticals.

The principal factors behind the corporate restructuring activity in India have been the policy changes that were announced in the form of economic reforms. These include removal of restrictions on corporate investments and growth contained in the Monopolies and Restrictive Trade Practices Act (MRTP Act), extensive trade reforms involving lowering of tariff and physical barriers on imports, financial sector reforms permitting public sector banks and financial institutions to tap capital markets, a policy to encourage the inward flow of foreign direct investment and foreign portfolio investment.[1]

There are some factors that motivate the executives to think about a merger or an acquisition. Most executives think it's good to be big in a globalising economy. Companies seem to be combining at a rate almost unprecedented in history on a global scale.[2] In the automobile industry, Daimler-Benz and Chrysler have joined hands, Ford has taken over the automobile operations of Volvo and so on. In the banking industry, Grindlays merged with Standard Chartered Bank. Similar merger examples can be seen in industries as diverse as entertainment, telecommunication and even in the oil sector. In India, the merger of Times Bank with HDFC Bank and that of Bank of Madura with ICICI Bank, are examples of mergers in the banking sector.

Definitions

- **Mergers** result in the combination of two or more companies into one wherein the merging entities lose their identities. Normally, an exchange of shares takes place between the entities involved in such a process. The company that survives is the buyer which retains its identity.
- A **merger** can be defined as an amalgamation if all assets and liabilities of one company are transferred to the transferee company in consideration of payment in the form of equity shares of the transferee company or debentures or cash or a mix of the above modes of payment.

1. Basant, Rakesh (2000), Corporate Response to Economic Reforms, Eco and Political Weekly March 4.
2. Ghemawat, Pankaj and Ghadar, F (2000), Dubious Logic of Global Megamergers, Harward Business Review, July–August, pp 65–72.

- **An acquisition** is aimed at gaining a controlling interest in the share capital of the acquired company. It can be enforced through an agreement with the persons holding a majority interest in the company's management or through purchasing shares in the open market or purchasing new shares by private treaty or by making a takeover offer to the shareholders.
- A **joint venture** refers to the process of firms joining together (normally, two) under a contractual agreement to run a specific business enterprise with both parties sharing profits and losses. The venture is a new legal entity in which both firms will take equity stake.
- **Strategic Alliance** is a partnership between two business firms in which both combine efforts involving anything from getting a better price for goods, seeking business together and so on. The idea behind alliances is to maximise the leverage. Partners do not form a new legal entity. It is an arrangement without equity stake.

i.e., Joint Venture = Strategic Alliance + Equity Stake + New Legal Entity

Distinction between Mergers and Acquisitions

When a company takes over another one and clearly becomes the new owner, the purchase is called an acquisition. From a legal point of view, the target company would cease to exist and stock of the buyer would continue to be traded. In pure sense of the term, a merger happens when two firms, agree to go forward as a new single company rather than remain separately owned and operated. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don't happen very often. Often, one company would buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger, even if it's technically an acquisition. Acquisition often carries negative connotations. By using the term "merger," top managers try to make the takeover more acceptable.

A purchase deal will also be called a merger when both firms agree that joining together in business is in the best interests of both. But when the target company does not want to be purchased—it is regarded as an acquisition. So, whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors and shareholders.

Strategy of M&A

With the process of 'globalisation and liberalisation' gathering momentum, mergers continue to grow at an ever increasing pace. The United States Federal Trade Commission reports that the number of mergers in 2004 was almost three times that of 1998. This same trend is being experienced worldwide.

The key strategy behind buying a company is to create shareholder value. Two companies together are more valuable than two separate companies—at least, that's the rationale behind M&A. Strong companies buy other companies to create more competitive, cost-efficient structure. The companies come together hoping to gain a greater market share and because of potential benefits, target companies often agree to be purchased when they know they cannot survive alone.

Acquisitions have now surpassed Initial Public Offers (IPOs) not only in value, but in number completed. For many companies, the nature of the IPO market is far too risky. With the market changing so rapidly, organic growth through expansion has become difficult and is not always a viable option.

M&A has essentially become an efficient means to enter a new market. Buyers, at times, are more than willing to pay premium prices to gain market entry. Acquisitions can also expand customer base, providing a more solid business base.

Mergers are not without their downsides. They can consume a lot of time, money, legal and tax complications, and problems with mixing corporate cultures. It has been estimated that some companies never achieve the initial goals projected after the merger.

Synergies of Mergers

Synergy is the force that enhances efficiencies of the business after the merger. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

(i) Staff Reductions Reduction in the number of staff members (downsizing) might be a part of any merger.

(ii) Economies of Scale Mergers translate into improved purchasing power for the companies. When placing larger orders, companies would get greater ability to negotiate price with their suppliers. There ought to be economies of scale when two firms are combined.

(iii) Acquiring New Technology as a Means to Competitiveness To stay competitive, companies need to stay on top of technological applications. By buying a smaller company with unique technologies, a large company can achieve competitive edge.[3]

(iv) Market Reach and Industry Visibility Companies buy other firms to enter into new markets and increase revenues. A merger might help to expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community.

Types of Mergers[4]

Different types of mergers or tender offers can be grouped on the basis of the stage of economic activity and the degree of relatedness of the firms.

Horizontal Merger

It is a merger between two companies that are in direct competition in the same product lines and markets.

Vertical Merger

It is a merger between a distributor and producer or a supplier and a company. Example, merger of a cone supplier with an ice cream maker.

3. Pawaskar, Vardhana (2001): Effect of Mergers on Corporate Performance in India, Vikalpa, Vol 26, No.1, pp 19–31.
4. Baker & McKenzie Guide to Mergers and Acquisitions 2004–05.

Market-extension Merger

It is a merger between two companies that sell the same products in different markets.

Product-extension Merger

It is a merger between two companies selling different but related products in the same market.

Conglomeration

It is a merger between two companies that have no common business areas.

Purchase and Consolidation Mergers

From the perspective of how the merge is financed, there are two types of mergers:
- purchase mergers
- consolidation mergers

Purchase Mergers

As the name suggests, this kind of merger occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt instrument.

Consolidation Mergers

With this merger, a brand new company is formed and both companies are bought and combined under the new entity.

Types of Acquisitions

Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike mergers, all acquisitions involve one firm purchasing another—there is no exchanging of stock. Acquisitions are often congenial, with both the parties feeling satisfied with the deal. Otherwise, acquisitions could be hostile.

In an acquisition, as in some of the merger deals as discussed above, a company can buy another company with cash, stock, or a combination of the two. Another possibility, which is common in smaller deals, is that one company acquires all the assets of the another one. Company A buys all of Company B's assets for cash, which means that Company B will only have cash. In the process, Company B becomes merely a shell and will eventually liquidate.

Another type of acquisition is a reverse merger. A reverse merger occurs when a private company that has strong prospects and is eager to raise finance, buys a publicly-listed company. Together, they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on how well this synergy is achieved.

The Merger Process

Acquiring Point of View

What typically happens if a company wants to go in for an acquisition or merger is that the top management of the company and financial advisors put their heads together to form a positioning strategy. The strategy might involve carefully acquiring shares in the target firm by discreetly building up a position. Jointly with the investment bankers, the acquiring company will arrive at an overall price that it is willing to pay for its target in cash, shares, or both. The tender offer would be given, stating the offer price and the deadline by which the shareholders in the target company must accept (or reject) it.

Target Company's Point of View

There are two ways the process of merger can be explained from the point of view of the target company.

(a) If the target firm's top managers and shareholders are happy with the terms of the transaction, they will go ahead with the deal.

(b) In a merger, there may be much at stake for the management of the target—their jobs, in particular. Hence, if they're not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms that let them keep their jobs or send them off with a nice, big compensation package.

Merger Settlement—Payment Mechanism

In a merger in which one company buys another, the acquirer pays for the target company's shares with cash, stock, or both.

A cash-for-stock transaction is fairly straightforward: target-company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company.[5]

If the transaction is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates at the pre-determined swap ratio. So many M&A deals are carried out based on the swap ratio. [The case of Bank of Madura merger with ICICI Bank, discussed in this chapter, is a classic example.]

When a company is purchased with stock, new shares from the acquirer's stock are issued to the target company's shareholders. When the deal is closed, investors usually receive the acquiring company's stock. Sometimes, investors get new stock of the new corporate entity that is created by the M&A deal.

Surge in Mergers and Acquisitions

Mergers and Acquisitions between business firms have been taken place right through the post-Independence period in India. However, recently there has been a surge in the mergers and acquisitions taking place, especially after 1991 because a number of significant changes in government policies became operative. These changes were heralded through the abolition of Monopolies and Restrictive Trade Practices Act 1969 (MRTP Act).

Companies had used mergers and take-overs as an important means of growth since the 1970s. However, the pace was slow but there have been signs of acceleration in the merger movement in the liberalisation years of the 1990s. The total number of mergers during the period 1975–76 to 1979–80

5. Pandey, Ajay (2001): Takeover, Announcements, Open Offers, and Shareholders, Vikalpa Vol 6, No. 3, pp 19–26, IIM Ahmedabad.

was 156. That figure remained same during 1980–81 to 1984–85, and then fell to 113 during the period 1985–86 to 1989–90. However, facilitated by changes in the policy environment, the number of mergers rose sharply to 236 during the period 1990–91 to 1994–95 and hundreds of M&A deals have taken place during 2000–05.

SECTION 2: LEGAL ENVIRONMENT OF BUSINESS

MRTP Act, 1969 and Competition Act, 2002

Anti-trust and competition issues in India were governed by the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act). The MRTP Act got replaced by the Competition Act, 2002 (Competition Act). The provisions relating to the Competition Commission have been brought into force.[6]

A "monopolistic trade practice" was defined under the MRTP Act as "unreasonably preventing or lessening competition in the production, supply or distribution of any goods or in the supply of any services" and "maintaining the prices of goods or charges for the services at an unreasonable level by limiting, reducing or otherwise controlling the production, supply or distribution of goods or the supply of any services or in any other manner." Under the Competition Act, the Competition Commission can conduct an inquiry into any monopolistic or restrictive trade practice, if required.

The Companies Act regulates:

- Certain acquisitions of shares by dominant undertakings
- Acquisitions which would result in the creation of dominant undertakings

These provisions are not applicable to Government-owned companies, corporations established under any Central legislation and the financial institutions. The term dominant undertaking refers to an undertaking which (on its own or as a group) produces, supplies, distributes or otherwise controls not less than one-fourth of the goods produced, supplied or distributed or controls not less than one-fourth of any services rendered in India or any substantial part thereof.

Under the MRTP Act, the Central government had the power to direct severance of inter-connection between certain undertakings if such practices were detrimental to the concerned industry or to public interest. The Competition Act, although stands for encouraging competition, regulates all anti-competitive agreements, or combinations—including mergers, amalgamations and acquisitions that may give rise to anti-trust issues. The Competition Act seeks to regulate the abuse of dominance and not the mere existence of a dominant position by any company. It does enumerate the instances of abuse of dominant position. For example, if an enterprise, directly or indirectly, imposes unfair or discriminatory conditions or prices, or restricts the production of goods or services or indulges in practices for denial of market access or uses its dominant position in one relevant market to enter into or protect another relevant market.

Further, the Competition Act seeks to regulate certain mergers and acquisitions where any of the parties to the transaction, or the acquirer already has control over another company which is engaged in a similar or identical business, and the company being acquired and the company controlled by the acquirer jointly has:

- In India, the assets of the value of more than approximately USD 200 million or a turnover of more than approximately USD 600 million; or

6. Venkiteswaran N (1997), "Effect of Mergers on Corporate Performance, Vikalpa, Vol 22, No. 3, July–Dec, pp 3–13.

- In India or outside India, in aggregate, the assets of the value of more than USD 500 million or a turnover of more than USD 1500 million.

The Competition Act also regulate mergers and acquisitions by groups by laying down certain thresholds for the total value of the assets of a group. Further, any acquisition where a group to which the enterprise being acquired (including a scenario where the entity to be acquired is engaged in the production of similar or substitutable goods) would belong after the acquisition, has a certain value of its assets outside India, then such an acquisition should be a combination for the purposes of the Competition Act.

Importantly, under the Competition Act, any person or enterprise which proposes to enter into a combination can approach the Commission for approval of the combination within a period of seven days after the approval of the board of directors of the concerned enterprises for the combination. If the Commission is of the opinion that the combination has or is likely to have an adverse effect on competition then under the Competition Act, it could direct that such combination shall not take effect.

Securities Law

Securities transactions in mergers and acquisitions are primarily regulated by the Securities and Exchange Board of India (SEBI) and the Stock Exchanges, pursuant to the Securities and Exchange Board of India Act, 1992 (SEBI Act) and the Securities Contracts Regulation Act, 1956 (SCRA).

The SEBI Act, under which the SEBI was constituted, is a legislation to protect the interests of investors in securities and promote the development of, and regulate, the securities market. The SEBI Act also provides for registration of investment advisers, stock brokers, banker to an issue and so on, under the provisions of regulations framed for mergers and acquisitions.

Normally, the shares of a listed company have to be in dematerialised form. The Depositories Act, 1996 regulates and facilitates the establishment of depositories and the holding of shares by them. Under the SCRA, contracts for the sale and purchase of securities in mergers and acquisitions, are ordinarily allowed only on a spot delivery basis.

Scenario: Post 1991

The government introduced liberalisation with the announcement of the New Industrial Policy Statement on July 24, 1991 which included norms authorising Foreign Direct Investment (FDI) and technology collaborations in specific sectors, subject to certain limitations. Initially, FDI was permitted up to 51% in certain high priority industries, requiring large investments and advanced technology. However, these limits have been gradually relaxed over the past two decades. The liberalised economic policies have exposed Indian industry to several challenges. In response to this, the Indian economy has witnessed a sharp increase in mergers and acquisitions. Some of the notable mergers in the recent past have been listed below:

- Dabur acquired Balsara Group of Companies in 2005
- Reliance Industries merged with Reliance Petroleum in March 2002
- Merger of ICICI Limited, ICICI Capital Sercvices Ltd and ICICI Personal Financial Services Limited with ICICI Bank in 2002
- ICICI Bank acquired Madura Bank in 2000
- IDBI & IDBI Bank in 2004
- Recent acquisition of Kochi Refinery by BPCL
- Punjab National Bank acquired Kerala-based Nedungadi Bank
- HCL Tech merged with HCL Enterprise systems

- L&T Cement Division acquired Grasim
- Arena Multimedia and Aptech Training
- Global Trust Bank amalgamated with Oriental Bank of Commerce
- Daksh acquired by IBM
- Wipro acquired Spectramind
- The Tata Oil Mills Company Ltd merged with HLL in April 1993
- Ponds India Ltd merged with HLL in January 1998
- Lipton India Ltd merged with Brooke Bond India Ltd and name changed to Brooke Bond Lipton India Ltd. in July 1993
- Kissan Products Ltd merged with Brooke Bond India Ltd in April 1993
- Brooke Bond Lipton India Ltd merged with HLL in January 1996
- Polaris merged with Orbitech

SECTION 3: BANK OF MADURA MERGER WITH ICICI BANK

Case: Bank of Madura's Merger with ICICI Bank*

On Friday December 8, 2000, Bank of Madura and ICICI Bank decided to work out a merger of former with the latter. The news was published on the daily newspapers on 9th December and the merger decision with swap ratio was officially announced on 11th December 2000. The shareholders approved the decision on January 19, 2001 and the banks got legal approval from the Reserve Bank of India on March 1, 2001.

In this case, analysis pertains to the synergies of the merger of Bank of Madura with ICICI Bank in the Indian banking industry and the strategic factors considered while taking merger or acquisition decision. To understand the rationale for the merger and its impact, we look at the valuation of swap ratio (Ratio at which shareholders of the old company is receiving shares of the new company in exchange for shares in old company), the announcement of the swap ratio, share price fluctuations of the banks before the merger decision announcement and the impact of the merger decision on the share prices. An attempt has also been made to look at the suitability of Bank of Madura to merge with ICICI Bank.

Profiles of the Banks (Before the Merger)

Profile of Bank of Madura (BoM)

- A South India-based well established bank with a track record of 57 years with strong brand equity, established in the year 1943
- Asset Base – Over Rs 4,400 crore with a Capital Adequacy Ratio of 14.25%
- Distribution Reach (Financial year 2000) and Automation—263 banking branches, but 182 branches in Tamil Nadu with 1.2 million customer accounts, 132 branches computerised that account for 90% of business, 47 branches networked through VSATs
- Employees—Total strength of 2,577 of which 2000 employees computer literate

*Data reported in this case are based on the information pertaining to ICICI Bank and Bank of Madura during the year 2000. ICICI Bank's business, asset base, employee strength, branch network etc. have grown many times during 2001–08.

Profile of ICICI Bank

- 1st Indian Bank to list on New York Stock Exchange with US GAAP accounting. It was established in the year 1994 by Industrial Credit and Investment Corporation of India (ICICI) as a new generation private sector bank.
- Asset Base – It is one of the largest private sector banks based in India with an asset base of over Rs 12,000 crores with Strong Capital Adequacy ratio of 19.6%
- Distribution Reach and Automation-Technology-driven business growth with 104 branches, 366 ATMs (on 7th December, 2000), the largest ATM network in India. (Total No. of ATMs have been increased to more than 1000 by ICICI Bank in the year 2001), ten call centers, all branches computerised, Internet banking facility to the customers.
- Employees—Total strength of around 1500 and all computer literate.

A comparison of balance sheets of ICICI Bank and Bank of Madura (Financial year 2000) shows that the ICICI Bank has more assets (both fixed and other) than Bank of Madura (See Table 14.1). They had given more advances (Rupees 36,573 million) than Bank of Madura (Rupees 16,655 million), and have mobilised more amount of deposit (Rupees 98,660 million) than Bank of Madura (Rs 36,310 million).

Table 14.1 Comparison of Balance Sheets

Balance Sheets (FY 2000) Rs million	ICICI Bank	Bank of Madura
Liabilities	120,726	44,437
Equity Capital	1,968	118
Reserves & Surplus	9,527	2,361
Deposits	98,660	36,310
Borrowings	4,915	1,836
Other liabilities & provisions	5,656	3,812
Assets	120,726	44,437
Cash and balances with RBI	7,219	4,561
Balances with banks and call	26,933	3,072
Investments	44,167	17,128
Advances	36,573	16,655
Fixed assets	2,221	1,788
Other assets	3,613	1,233

Source: Annual Report of the ICICI Bank 2000–01 & www.icicibank.com

The income statements of ICICI Bank and Bank of Madura for the financial year 2000 are given in Table 14.2. ICICI Bank interest income was Rs 8,528 million whereas Bank of Madura's interest income is much lower at Rs 3,702 million. Total income of ICICI Bank (Rs 10,470 million) is more than twice of Bank of Madura's total income (Rs 4,689 million). Profit after Tax of ICICI Bank is also more than twice of Bank of Madura's Profit after Tax.

Table 14.2 Comparing Income Statements of ICICI Bank and Bank of Madura (Financial Year 2000) (in Million Rupees)

	ICICI Bank	Bank of Madura
Interest Income	8,528	3,702
Other Income	1942	987
Total Income	10,470	4,689
Interest expense	6,670	2,661
Operating Expense	1,534	1074
Provisions and Taxes	1,214	498
Total Expenses	9,417	4,233
Profit After Tax	1,053	456

Source: www.icicibank.com on 11/12/2000.

Swap Ratio and Stock Price Fluctuations

The competition for more business volume and the motivation to increase the shareholder value and the desire to become a big player have motivated the banking executives in India to think about mergers and consolidations. Though the Indian banking industry witnessed the emergence of new private banks like Times Bank, IndusInd Bank, ICICI Bank, HDFC Bank, UTI Bank, Global Trust Bank in the early 1990s, many executives felt the need for consolidation of operations in the late 1990s in order to compete with other strong players. There were talks between banks (even with the old private sector banks) to arrive at an acceptable swap ratio for a possible merger.

On December 8, 2000, ICICI Bank and Bank of Madura came together to work out a merger of Bank of Madura with the former. Swap ratio announcement was postponed to 11th December, Monday by the board of directors of the banks. However, on hearing the news (before it appeared in newspapers on 9th December, 2001 Saturday) about the merger decision between these banks, ICICI bank's stock shot up 12 per cent to Rs 170 and Bank of Madura by 8 per cent to Rs 131.6 on 8th December at Bombay Stock Exchange (Saturday & Sunday are holidays in the stock market). The expectation that the acquiring bank would become a strong player motivated the people abroad too, and on the same day, shares of ICICI Bank at New York Exchange were purchased in bulk and the price of American Depository Share (ADS) of ICICI bank shot up by 17 per cent on the same day from the previous day's closing value of $8.12.

It is interesting to look at the factors influencing swap ratio in a merger deal. The swap ratio announced in the case of Bank of Madura (BoM)–ICICI Bank merger was 1:2. i.e., the shareholders of Bank of Madura get two shares of ICICI Bank for each BoM share. The market price of ICICI Bank share on December 7, 2000 was Rs 152.95 and Bank of Madura's price was Rs 122.45 (National Stock Exchange closing price. See Appendix). They could have derived a swap ratio in favour of ICICI Bank on the basis of the market price of the shares of both the banks, had they not considered other factors (both financial and strategic). It could have been 10 shares of ICICI Bank for 13 shares of Bank of Madura, if the valuation was done on the basis of balance sheets of both the banks. Again, the swap ratio could have been in favour of ICICI Bank, if they had done valuation on the basis of Non-Performing Assets (NPA) of both the banks. The net NPA to net advances is 1.3 per cent for ICICI Bank, while it was 4 per cent in the case of Bank of Madura. To quote from The Economic Times (as published on

9th December 2000), 'Swap ratio could be 10 shares of ICICI Bank for 13 shares of Bank of Madura. The ratio could be influenced by NPA level of the two banks." The swap ratio was derived on the basis of strategic and financial ratios. Financial ratios such as Book Value of the share of both the banks as on September 30, 2000, Earning Per Share (Net profit/shares outstanding), Last Dividend paid by both of them, and the per cent of Non-Performing Assets were taken into consideration for deriving swap ratio.

Table 14.3 Swap Ratio Announced (No. of Shares)

Bank of Madura	ICICI Bank
1	2

Table 14.4 Important Dates

Rapid Round of Negotiations	Nov 24-Dec 8, 2000
Newspaper Reports on merger decision and swap ratio	Dec 9, Saturday, 2000
Trading after swap ratio announcement in both the scrips	Dec 11, Monday, 2000
Shareholders' Approval	Jan 19, 2001
Reserve Bank of India Approval	March 1, 2001
US GAAP Recasting	March 31, 2001

Source: Compiled from The Economic Times 7 Dec to 15 Dec 2000 and ICICI Bank Annual Report 2000–01.

Bank of Madura had an edge while analysing the Earning per share, Book Value and per centage of last dividend paid (See Table 14.5) whereas ICICI Bank had more assets earned, higher market price of share (pre-merger announcement phase), low Non-Performing Assets (NPA) and high-tech image. The swap ratio for BoM:ICICI Bank merger could have been in the range of 1:1 to 1:1.5 as most of the advantages of the Bank of Madura gets neutralised by the disadvantages (high NPA level, low market price etc.). In this case, swap ratio was announced in favour of Bank of Madura mainly because of the desire of ICICI Bank to acquire a good bank from South India where they did not have strong presense and geographical advantage.

Table 14.5 Important Financial Ratios to be analysed for Swap Ratio Derivation

	Bank of Madura	ICICI Bank
NPA	4%	1.3%
Last Dividend Paid	55%	15%
Earning Per Share	Rs 44/-	Rs 7/-
Book Value (as on Sep 30, 2000)	Rs 206/-	Rs 62/-
Market Price of Share before the merger (7th Dec at NSE closing price)	Rs 122.45	Rs 152.95
Profit After Tax (Financial year 2000)	Rs 456 million	Rs 1,053 million

Source: The Hindu Business Line 10th, 11th & 12th December 2000.

The ICICI Bank could have got a better Swap ratio, if the valuation was done only on the basis of market price of the shares of both the banks and with the Ceteris Paribus (Other things being same) assumption. ICICI Bank should have got the Swap Ratio 1: 1.35 i.e, 1 share ICICI Bank equal to 1.35 share of Bank of Madura on the basis of market price of the shares traded at NSE (Rs165: Rs 122) on December 7, 2000. But this is not the way the Swap ratio to be calculated in any merger decision. The companies need to analyse other factors like Book Value, Earning Per Share, Dividend Paid, Profit After Tax, financial ratios as well as the need for merger and the motivation for acquisition. The range of possible swap ratios (theoretical and practical) based on various parameters have been given in Table 14.6.

Table 14.6 Range of Possible Swap Ratios that could have been Possible

Bank of Madura	ICICI Bank	Basis Parameters
1.35	1	Market Price of the Shares on 7th Dec, 2000
1.8	1	Market price of the shares on 15th Nov, 2000
1.3	1	Economic Times prediction (as published on 9th Dec, 2000)
1	3 to 3.5	EPS, Book Value and Last Divident paid
1	1.5	NPA, Profit After Tax, EPS, Book Value, Last Divident Paid, Market Price of the shares
1 (Announced)	2 (Announced)	All factors mentioned above and strategic factors like motivation for acquisition

There was speculation in the stock market that Bank of Madura would get a favourable swap ratio for about two weeks, when the discussions were going on between the banks. Bank of Madura had gained sharply by around 70 per cent in the past fortnight (last week of November and first week of December 2000), expecting better swap ratio and merger. The swap ratio for Bank of Madura/ICICI Bank merger was announced as 1:2 (1 share of Bank of Madura = 2 shares of ICICI Bank) on 11th December, Monday. This proved that the higher swap ratio is the only way an acquisition can be done in Indian banking sector. Bank of Madura shareholders got a better deal as they could exchange 1 share worth approximately Rs 120/- and get approximately Rs 304/- (Average of ICICI Bank share price during 4–8 Dec 2000 = Rs 152 multiplied by two).

The impact of announcement of swap ratio on share prices of acquiring bank (ICICI Bank) and acquired bank (Bank of Madura) shows that the investors in stock market reacted immediately (on hearing the news of swap ratio, before it was appeared in next day's newspaper). The share price of Bank of Madura at Bombay Stock Exchange and National Stock Exchange shot up on 11th December, 2000 on the same day suddenly after the announcement of swap ratio and the ICICI Bank's share price slipped down (See Tables 14.7 and 14.8). An extract from Economic Times dated 12th December, 2000: "The Bombay Stock Exchange share price of ICICI Bank fell into Rs 165.30 on 11th December Monday, against the Friday's close of Rs 169.85, however, closed at Rs 165.30 (down Rs 4.55 from Friday's close). Bank of Madura scrip, on the other hand, gained from Rs 131.6 (8th Dec, 2000 Friday's close) to touch at Rs 142.1 (11th December Monday's close)". The same trend is seen at the National Stock Exchange too.

Table 14.7 Closing Share Price of Bank of Madura (Before & After the Announcement of Swap Ratio)

Date	Bombay Stock Exchange (BSE)	National Stock Exchange (NSE)
8/12/2000	131.6	132.25
11/12/2000	142.1	142.85

Source: Compiled from the websites of BSE and NSE on 10th and 12th, December 2000 (www.bseindia.com and www.nseindia.com)

Table 14.8 Closing Share Price of ICICI Bank (Before & After the Announcement of Swap Ratio)

Date	Bombay Stock Exchange	National Stock Exchange
8/12/2000	169.85	168.95
11/12/2000	165.30	164.50

Source: Compiled from the websites www.bseindia.com and www.nseindia.com

Table 14.9 Crucial Parameters as on the Date of Announcement of Merger and Swap Ratio

Name of the Bank	Book Value of Bank on the day of merger announcement	Market price on the day of announcement (Opening Price at National Stock Exchange)
Bank of Madura	183.0	142.85
ICICI Bank	58.0	176.00

Source: The Hindu Business Line, December 10, 2000 and nseindia.com

The share price and volume-data for Bank of Madura and ICICI Bank traded at National Stock Exchange of India (NSE) from 15th November, 2000 to 29th December 2000 are given as appendix. The data shows that Bank of Madura scrip was traded at 79.20 on 15th November, 2000 and increased sharply over the period from 15th November, 2000. The closing value of Bank of Madura scrip on 30th November, 2000 was Rs 90.50 (up from 79.20) and touched Rs 122.45 on 7th December, 2000 (around 70 per cent increase over a period of fortnight). This could be linked to the rounds of negotiations held between Bank of Madura and ICICI Bank during this period for a possible merger. (ICICI Bank had held negotiations with other banks too for a possible acquisition) The closing price of ICICI Bank scrip at National Stock Exchange on 15th November was Rs 142.30 and increased to Rs 142.95 (closing price of 30th November 2000) and Rs 168.95 on 8th December 2000 before the announcement of the merger. This shows that the share price of both the banks increased in the pre-merger announcement period, but the percentage price increase of Bank of Madura scrip was much more than the increase in the ICICI bank share price. A quotation from The Hindu Business Line (Stock Focus Column, December 10, 2000, One day before the announcement of Swap Ratio) is reproduced here to substantiate the point mentioned above. "It is quite likely that the Swap Ratio may be fixed in a manner that holds out a good deal for shareholders of Bank of Madura. The scrip has gained sharply by around 70% in the past fortnight, expecting a favourable swap ratio and merger".

Though the merger swap ratio was announced on 11th December, 2000 by the board of Directors of the banks, the scrips were available for trading till the date the decision was approved by the shareholders of both the banks. Hence, it is important to look at the impact of swap ratio announcement on the share prices of both the banks. The National Stock Exchange data given in the appendix shows that the Bank of Madura scrip shot up from Rs 132.25 (closing price on 8th December, 2000) to Rs 142.85 and Rs 154.30, Rs 166.65, Rs 180, Rs 194.40, Rs 209.95, Rs 226.75 and Rs 244.90 on 11th, 12th, 13th, 14th, 15th, 18th, 19th and 20th December respectively. On the other hand, ICICI Bank scrip fell down from Rs 168.95 (closing price on 8th December, 2000) to Rs 165.30, Rs 160.05, Rs 159.10, Rs 157.60, Rs 157.20 and Rs 157.05 on 11th, 12th, 13th,14th, 15th and 18th December respectively. Though the ICICI Bank share price increased to Rs 158.00 on 19th December, it slipped down further to Rs 143.35 and Rs 141.10 on 26th and 27th December 2000. The increased demand for Bank of Madura scrip resulted into the increase in the price of Bank of Madura scrip, because of the expectation of the investors to make money by exchanging the share in future against the ICICI bank share at 1:2 swap ratio, after the shareholders and Reserve Bank of India approve the merger decision. (The shareholders can swap the scrip only if the decision of boards get approval in the meeting of the shareholders and from the Central bank of the country, if it is a bank). The stock price fluctuations have been shown in the graph in Diagram 1 (before the announcement of merger and swap ratio from 15th November 2000 to 11th December 2000) and Diagram 2 (After the announ-cement of merger decision and swap ratio- from 12th December to 29th December 2000) using Daily data on share price of BoM and ICICI Bank scrip traded at National Stock Exchange. [See the data given as Appendix.]

Strategic factors like immediate strength of customer base, geographical base and enhancement of future shareholder value were also taken into account for derivation of swap ratio. To quote P. H. Ravikumar, the then Senior Vice President, ICICI Bank (as appeared in the Economic Times dated 12/12/2000), "Three issues were considered for the merger. Customer base, Geographical Base and enhancing shareholder value. We had been looking for such an activity. South is high economic activity area where Bank of Madura had strong presence". In fact, ICICI Bank had negotiated with other South India-based banks, including Karnataka based Vysya Bank, Kerala based Federal Bank and South India Bank, for a possible merger with the intention of expanding its operations to South India. But the negotiations were not successful. The statement of Mr. Sinor, the then Managing Director of ICICI Bank is as follows: "Bank was looking at a branch network of 350–400, which would have taken at least 5 years to achieve. Moreover, to get an additional 1.2 million customers (Bank of Madura's client base) would have required a minimum 2 years. On the other hand, Mr. K.M.Thiagarajan, the then Chairman and Managing Director of Bank of Madura released a statement which is reproduced here. "The financial consolidation was becoming necessary for the growth of the bank . Shareholder value is important than anything else. The decision is based on value creation".

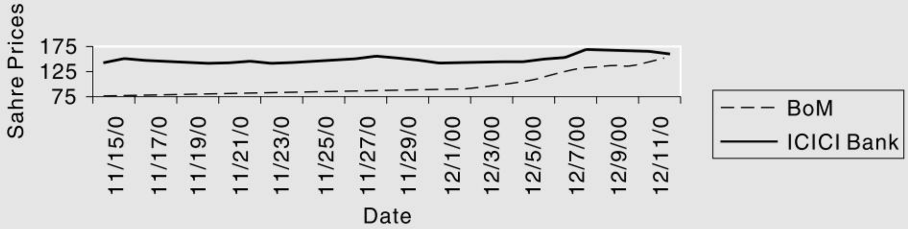

Fig. 14.1 Share Price Fluctuations of ICICI Bank and BoM (Pre-Swap Ratio Announcement)

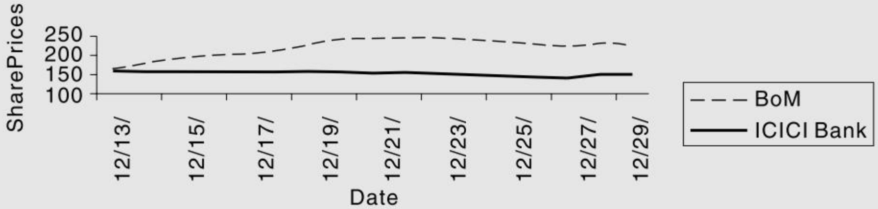

Fig. 14.2 Share Price Fluctuations of BoM and ICICI Bank (Post-Swap Ratio Announcement)

Suitability Analysis

The suitability analysis is undertaken to ascertain the suitability of Bank of Madura merger with ICICI Bank. Bank of Madura represents the culture of a 57-year-old organisation whereas ICICI Bank represents a six-year-old 'new age' organisation. Hence, an attempt has been made to position both the banks in the context of the new trends in the industrial sector. The emerging trends in banking sector is summarised in the form of What's IN and What's OUT format and given in the Table 14.10. Being an old private sector bank, Bank of Madura had thrust for a long period of time on the parameters listed under the title What's OUT in the banking sector. They had, traditionally, focused on Mass banking strategies based on the social objectives, whereas ICICI Bank has been emphasising on parameters like profitability in the interests of shareholders. Being a new born private bank, ICICI bank has a Credit Recovery Management cell, whereas Bank of Madura had a cell working like a Credit Monitoring Department.

Table 14.10 New Strategies (IN) and Old Priorities (OUT) in Banking Sector

	What's In	What's Out
Objective	Profitability	Developmental & social
Interests of	Shareholders	Priority sector
Strategies	Pro-active	Passive
Segment	Target banking	Mass banking
Business	Fee based	Fund based
NPA Mgt.	Recovery mgt. cell	Credit monitoring cell
Concentration	Investments	Advances
HR policy	Hire & fire	Job Security

ICICI Bank is a leading private player emphasising more on 'What's In' rather than 'What's Out' in the banking sector. Thus this merger is beneficial for the parties concerned since the Bank of Madura has also been trying to focus on new strategies (See Table 14.10: What's In) in the banking sector, after the implementation of banking sector reforms in India. It was not a mammoth task for them to position themselves with the functional style of ICICI Bank. However, integrating the human resources of Bank of Madura with ICICI Bank's employees would be a difficult process for the ICICI Bank.

Synergies of Merger

The synergies of the merger of Bank of Madura with ICICI Bank can be summarised as follows:

(a) Network of over 360 branches
(b) Reduced time for setting up new branches
(c) Combined customer base of 2.7 mn
(d) Combined asset base of Rs. 16,000 crores, which makes the ICICI Bank amongst the largest in private sector banks in India.

In detail, the synergies can be discussed on the basis of the following parameters.

1. Financial Capability The merger has enabled them to have a stronger financial and operational structure, which is supposed to be capable of greater resource/deposit mobilization. And ICICI will emerge as one of the largest private sector banks in the country.

2. Branch Network The ICICI Bank's branch network not only increased by 264, but also increased the geographic coverage as well as convenience to its customers.

3. Customer Base The largest customer base (combined) enabled the ICICI Bank to offer banking and financial services and products and also facilitate cross-selling of products and services of the ICICI group.

4. Tech Edge The merger will enable ICICI bank to provide ATMs, Phone and the Internet banking and financial services and products to a large customer base, with expected savings in costs and operating expenses.

5. Priority Sector Advances The commercial banks are required to lend money to the people in the priority sector which include the farmers, people in rural areas and small scale industry. ICICI Bank did not have many branches in rural areas whereas Bank of Madura had lot of branches in rural and semi-urban areas. The enhanced branch network enabled the ICICI Bank to lend for micro-finance activities through self-help groups, and for the agricultural sector in its priority sector initiatives through its acquired 87 rural and 88 semi-urban branches.

6. Equity Capital and EPS The swap ratio approved was ratio of 1:2 – two shares of ICICI Bank for every one share of BoM. And the merger was expected to bring 20 per cent gains in the EPS of ICICI Bank. And also the bank's comfortable Capital Adequacy Ratio (CAR) of 19.64 per cent got declined to 17.6 per cent, because of the merger.

Table 14.11 Financial Standings of ICICI Bank and Bank of Madura (Rs Crore)

Parameters	ICICI Bank		Bank of Madura	
	1999-2000	1998-99	1999-2000	1998-99
Net worth	1129.90	308.33	247.83	211.32
Total Deposits	9866.02	6072.94	3631.00	3013.00
Advances	5030.96	3377.60	1665.42	1393.92
Net profit	105.43	63.75	45.58	30.13
Share capital	196.81	165.07	11.08	11.08
Capital Adequacy Ratio	19.64%	11.06%	14.25%	15.83%
Gross NPAs/ Gross Advances	2.54%	4.72%	11.09%	8.13%
Net NPAs /Net Advances	1.53%	2.88%	6.23%	4.66%

Source: Compiled from Annual reports (1999–2000) of ICICI Bank and BoM.

7. Managing Human Resources One of the greatest challenges before ICICI Bank was managing human resources. When the head count of ICICI Bank was taken, it was less than 1500 employees; On the other hand, BoM had over 2500. The merged entity has about 4000 employees which made it the largest private sector bank. The staff of ICICI Bank were drawn from various banks and business schools, mostly young qualified professionals with computer background and who prefer to work in metros or big cities with good remuneration packages. Whereas under the influence of trade unions, most of the BoM employees had low career aspirations. Many of them had already availed Voluntary Retirement Scheme and gone. Meanwhile, pay of most of the BoM employees was revised upwards. It was a Herculean task to integrate the two work cultures.

8. Managing Client Base The client base of ICICI Bank, after merger, was as big as 2.7 million from its past 0.5 million, an accumulation of 2.2 million from BoM. The nature and quality of clients was not of uniform quality. The BoM had built up its client base for a long time in a hard way on the basis of personalised services. In order to deal with the BoM's client base, the ICICI Bank needs to redefine its strategies to suit to the new culture. If the sentiments or a relationship of small and medium borrowers is hurt, it may be difficult for them to reestablish the relationship, which could also hamper the image of the bank.

9. Managing Rural Branches ICICI's major branches were in metros and major cities, whereas BoM spread its wings mostly in semi urban and rural segments of south India. It was a difficult task for ICICI bank to increase dramatically the business mix of rural branches of BOM. On the other hand, due to geographic location of its branches and level of competition, ICICI Bank had a tough time to cope with the different scenario. For example, an account holder needs to maintain minimum Rs 5000/- in Savings bank account with ICICI Bank, whereas Bank of Madura's requirement to open a Savings bank account was just Rs 500/-. The branches in the rural area have a number of customers from low and middle income groups who do not maintain Rs 5000/- in their savings bank account. Also, most of the Bank of Madura employees, who were working in the rural branches, are likely to be retired soon, as the average age of Bank of Madura employees is almost twice of ICICI Bank. The ICICI Bank employees, mostly youngsters, would not prefer to get transferred to the rural branches because of the preferences for city life and culture.

Conclusion

In the era of globalisation, the organisations will have to be competitive in order to face the challenges. 'Survival of the fittest' has become reality in most of the sectors including banking, with the entry of foreign players. On the other hand, mergers can be considered as barriers to perfect competition. But the inclination to create monopoly, desire to become 'champion' in the respective industrial sector and so on, motivate the 'big' players to take over the 'small' ones. 'Small' companies tend to look at the short term (immediate) gain through merger and let the 'big' wigs acquire them. Lack of resources, both capital and labour that is required to compete with the big players, sometimes, force the 'small' to merge with the 'big'. In the case of Bank of Madura-ICICI Bank merger, Bank of Madura got a better deal in the form of higher swap ratio. Therefore, one finds that Bank of Madura has not compromised in the negotiation with the ICICI Bank. At the same time, the desire of ICICI Bank to achieve more strength within a less span of time and their urge for relentless expansion have led them to agree upon a higher swap ratio to the Bank of Madura shareholders. In totality, Bank of Madura shareholders benefited from the merger in the short run and the ICICI Bank could increase the number of customers, branches and business which would be helpful to them in the long run to raise new challenges to other competitors in the Indian banking industry.

After viewing the merger syndrome, there could be a possibility that permutations and combinations of mergers in Indian banking industry may take place in the future. The Public sector banks, which will shortly be losing their public sector nature (as the Government of India is planning to reduce its stake from 100 per cent to 33 per cent) are strong contenders to take over old generation private sector banks. Foreign banks will not stay behind in the takeover bids.

Questions

1. Do you think that the changes in the legal environment (move from MRTP Act to Competition Act) facilitate business expansions and acquisitions?
2. Why did Bank of Madura agree for the merger?
3. Bank of Madura would not have got 1:2 Swap Ratio – Do you agree with this statement? Validate your arguments.
4. Did ICICI Bank consider this as a strategic decision? Had you been the CEO of ICICI Bank, what decision you would have been taken? Do you think that the 'Business Strategy' of ICICI Bank played an important role than the financial ratios, while deciding the SWAP ratio?
5. What are the synergies of BoM merger with ICICI Bank?
6. Discuss the impact of 'Swap ratio' on share prices during post announcement days. Discuss the lessons for investors on such occasions based on the data given in the appendix.

Review Questions

1. Distinguish between mergers and acquisitions.
2. Why should a company merge with or acquire another company?
3. Discuss the types of mergers and acquisitions.
4. Write a note on the recent M&A deals that have taken place in India.
5. What are the developments and changes occurred in Indian business environment in the recent past that created new scenario for M&A deals?
6. Compare and contrast the salient features of Competition Act, with that of MRTP Act.

Objective Type Questions

True or False

1. MRTP Act has been abolished in India.
2. The key strategy behind acquiring a company is to create shareholder value.
3. A merger between two companies that are in direct competition in the same product line can be called as horizontal merger.
4. MRTP Act got replaced by the Competition Act, 2002 in India.
5. Conglomeration is a merger between two companies that have no common business areas.

Class/Field Exercise

1. Survey the literature on Foreign Acquisitions in the company in your home country during last 3 years i.e. Acquisition in Tata Telecom by Japanese firm NTT, Acquisition of Ranbaxy by Dai-Ichi Sankyo of Japan etc. Discuss the legal environment pertaining to foreign acquisition in Your country.
2. Indian Govt. has announced decision to offer Visa on Arrival facility to the citizens of 5 countries from January 2010. See the newspaper weblink. The five countries are Japan, Singapore, Finland, New Zealand and Luxemburg. This is first time that India offers such a facility to foreigners. Collect more information regarding this and examine the implications. Also, check the countries where Indian passport holder is eligible for Visa on Arrival and analyse the implication on Business (See the weblink http://economictimes.indiatimes.com/news/new-by-industry/services/travel/visa-power/India-introduces-tourist-visa-on-arrival-for-five-countries/articleshow/5403684.cms.)

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Answers

Objective Type Questions

1. True 2. True 3. True 4. True 5. True

Appendix

Share Price Volume Data (National Stock Exchange)
Data for BANK of MADURA—from 15-11-2000 to 12-12-2000

Date	Prev. Close	Open	High	Low	Close	Traded Qty	Turnover (Rs lakhs)
15-Nov-2000	78.85	83.00	83.00	79.20	79.20	2200	1.78
16-Nov-2000	79.20	79.75	81.40	79.00	79.60	3150	2.52
17-Nov-2000	79.60	80.95	81.40	79.20	79.20	2450	1.96
20-Nov-2000	79.20	78.85	83.00	78.85	82.35	4400	3.61
21-Nov-2000	82.35	81.50	83.65	81.00	83.15	3150	2.60
22-Nov-2000	83.15	82.45	83.00	82.25	82.95	1700	1.41
23-Nov-2000	82.95	80.00	83.75	80.00	83.45	3650	3.00
24-Nov-2000	83.45	83.05	84.35	83.05	84.25	1500	1.26
27-Nov-2000	84.25	83.50	85.00	83.50	84.25	6100	5.15
28-Nov-2000	84.25	85.00	88.50	85.00	87.20	5200	4.52
29-Nov-2000	87.20	85.15	92.50	85.10	87.85	7550	6.79
30-Nov-2000	87.85	87.00	90.50	87.00	90.50	5250	4.69
01-Dec-2000	90.50	90.40	95.00	88.50	89.95	13700	12.51
04-Dec-2000	89.95	90.00	97.15	90.00	97.15	23100	21.79
05-Dec-2000	97.15	104.95	104.95	104.95	104.95	2650	2.78
06-Dec-2000	104.95	113.35	113.35	113.35	113.35	18000	20.40
07-Dec-2000	113.35	122.45	122.45	122.45	122.45	14850	18.18
08-Dec-2000	122.45	132.25	132.25	126.35	132.25	89400	117.75
11-Dec-2000	132.25	142.85	142.85	142.85	142.85	3450	4.93
12-Dec-2000	142.85	154.30	154.30	154.30	154.30	2200	3.39

Share Price—Volume Data
Data for BANK of MADURA—from 13-12-2000 to 30-12-2000

Date	Prev. Close	Open	High	Low	Close	Traded Qty	Turnover (Rs. lakhs)
13-Dec-2000	154.30	166.65	166.65	166.65	166.65	150	0.25
14-Dec-2000	166.65	180.00	180.00	180.00	180.00	200	0.36
15-Dec-2000	180.00	194.40	194.40	194.40	194.40	1350	2.62
18-Dec-2000	194.40	209.95	209.95	209.95	209.95	3000	6.30
19-Dec-2000	209.95	226.75	226.75	226.75	226.75	7900	17.91
20-Dec-2000	226.75	244.90	244.90	240.10	244.90	434600	1062.42
21-Dec-2000	244.90	249.90	259.90	240.50	242.35	345350	854.02
22-Dec-2000	242.35	245.70	258.00	238.10	250.00	265850	661.52
26-Dec-2000	250.00	250.00	251.00	230.00	230.15	120200	283.50
27-Dec-2000	230.15	220.00	225.00	213.00	220.45	67100	146.30
28-Dec-2000	220.45	216.00	237.90	206.50	231.00	125350	285.02
29-Dec-2000	231.00	232.95	235.00	225.05	231.00	51650	118.82

Share Price—Volume Data

Data for ICICI BANK—from 15-11-2000 to 12-12-2000

Date	Prev. Close	Open	High	Low	Close	Traded Qty	Turnover (Rs. lakhs)
15-Nov-2000	122.65	124.75	142.30	124.75	142.30	295465	404.25
16-Nov-2000	142.30	143.00	162.00	143.00	151.15	494907	758.46
17-Nov-2000	151.15	151.90	151.90	140.15	147.20	303746	441.25
20-Nov-2000	147.20	149.50	149.50	139.55	141.25	161529	230.31
21-Nov-2000	141.25	143.00	152.00	138.25	142.35	193952	277.77
22-Nov-2000	142.35	147.00	153.00	145.00	145.65	143503	211.11
23-Nov-2000	145.65	143.10	143.10	139.15	141.65	71117	100.52
24-Nov-2000	141.65	142.00	144.50	142.00	143.15	53625	76.72
27-Nov-2000	143.15	146.00	152.00	144.15	150.35	204631	304.89
28-Nov-2000	150.35	149.80	157.90	145.00	156.10	278024	431.28
29-Nov-2000	156.10	153.00	155.95	151.00	152.15	54639	83.46
30-Nov-2000	152.15	152.05	154.00	147.20	147.95	50807	76.00
01-Dec-2000	147.95	145.00	147.95	140.15	142.00	117359	168.23
04-Dec-2000	142.00	141.40	146.30	141.40	144.75	78897	114.65
05-Dec-2000	144.75	144.40	146.50	144.05	144.45	68577	99.73
06-Dec-2000	144.45	147.60	156.00	147.60	150.10	208424	314.08
07-Dec-2000	150.10	151.55	156.25	148.50	152.95	203511	309.51
08-Dec-2000	152.95	153.85	171.90	152.50	168.95	490187	796.51
11-Dec-2000	168.95	176.00	182.00	158.60	165.30	846339	1430.87
12-Dec-2000	165.30	163.15	163.15	152.10	160.05	739518	1162.20

Data for ICICI BANK—from 13-12-2000 to 31-12-2000

Date	Prev. Close	Open	High	Low	Close	Traded Qty	Turnover (Rs. lakhs)
13-Dec-2000	160.05	161.00	161.00	151.05	159.10	275203	433.87
14-Dec-2000	159.10	159.00	160.00	156.50	157.60	194739	307.42
15-Dec-2000	157.60	156.55	158.70	153.05	157.20	351909	548.59
18-Dec-2000	157.20	157.00	158.50	153.25	157.05	149768	234.84
19-Dec-2000	157.05	156.55	159.50	156.15	158.00	182074	286.61
20-Dec-2000	158.00	157.00	157.95	152.00	157.05	228654	354.12
21-Dec-2000	157.05	155.00	156.00	152.10	153.75	316820	488.52
22-Dec-2000	153.75	153.20	157.00	153.20	155.25	189770	294.14
26-Dec-2000	155.25	154.30	155.70	139.00	143.35	244325	357.55
27-Dec-2000	143.35	140.50	145.00	132.10	141.10	143202	198.35
28-Dec-2000	141.10	138.10	154.00	138.00	150.30	234139	346.80
29-Dec-2000	150.30	152.00	154.50	147.05	150.50	190248	286.22

Source: http://nseindia.com

Annexure Case

Hewlett-Packard—Compaq: The Merger Decision[1]

Amidst great drama, HP and Compaq merged on March 19, 2002. The decision had to face several hiccups and the final decision in favour of the merger was passed on a slender majority. The merger witnessed a direct confrontation between Carly Fiorina, the CEO of HP, and HP's heirs Walter Hewlett and Woodley Packard. The $24 billion deal marked the largest merger in the history of computer industry.

In 2001, faced with myriad challenges, Fiorina hired McKinsey & Co. to help evaluate strategic options for future growth of the company. Also in early 2001, Compaq CEO Capellas contacted Fiorina and raised the idea of possible business combination.

Thereafter both companies evaluated the possible merger option with the help of consultants and investment bankers and finalised to merge Compaq with HP citing following reasons:

(a) Improved Economics and Innovation-Personal systems
(b) Complementary leadership in key markets
(c) IT services: strengthened business provides critical mass in key growth market
(d) Financial benefits

But the merger idea was widely opposed by analysts, other investment bankers and consultants and market experts. The son of HP cofounder, Walter Hewlett with 5.9% shareholding, widely criticised and opposed the merger decision and voiced concerns that the merger would destroy the shareholder value. Ignoring all these concerns and oppositions, board of both the companies decided to go ahead with merger decision and got approval from 51.4% shareholders of HP.

The intention behind the merger was to create a global technology powerhouse that could provide end-to-end products and services increasingly demanded by lucrative enterprise (large-scale business) customers. The merger would position the combined company to challenge the industry leader IBM.

IT Industry–Mile Stones of Major Players

Mile stones and competitive path of major players in the Information Technology Industry are given in this sector.

IBM (International Business Machine)

IBM introduced first computer in 1952. Throughout 1960s and 1970s, IBM combined strength in R&D and marketing and earned market share of 80%. In 1981, PC based on Microsoft's Windows OS and Intel's computer chips was introduced. New CEO Louis Gerstner was appointed in 1993. He set a new course for IBM by offering customers integrated solutions—comprehensive, end-to-end solutions consisting of hardware, software and services. IBM also shifted its hardware focus away from low-margin PCs toward profitable servers and storage.

In 1995, IBM formed IBM global services (IGS) a single, global team that delivered seamless, integrated solutions to customers worldwide. IBM also merged its consulting practices to IGS. Between 1995 and 2001, IGS revenue and employee count increased at a compound annual rate of 9.5%. Much of this growth was achieved as a result of powerful effect of Internet on business. By 2001, IGS became world's largest consultancy, system integrator and surpassed IBM's hardware revenue. IBM's

1. Author prepared this case for class discussion. This case is not intended to show effective or ineffective handling of decision or business processes.

integrated solution strategy offered customers the benefits of a one-stop shopping experience with packaged solutions offered at a predictable price.

Dell Computer

Dell computer was founded in 1984 by M. Dell on a simple concept: by selling computer system directly to customers. Business model consisted of buying component parts wholesale, manufacturing computer and selling them by mail order to customers. Due to very low inventory piling, Dell was able to introduce the latest technology more quickly. Within 8 years of its start, in 1992, Dell was included in Fortune 5oo list of world's largest companies and also joined ranks as one of the five top computer system makers worldwide.

Dell launched its website in 1994 to quickly encash the benefits of Internet. In 1996 Dell began selling PCs through website (e-commerce) and added online technical support in 1999. By 2001, nearly half of the company's 32 billion in revenue came from Internet based sales. Dell's success stemmed from its ability to offer significant price discounts and then maintaining close relationship with its major customers.

In 2001, Dell was ranked first in Global PC market share. It was ranked number one in service and customer satisfaction in nearly every industry survey. Dell was also extraordinarily profitable during the fiscal years 2000 and 2001.

Compaq Computer

Compaq was founded in 1982 in the United States to manufacture and sell potable IBM-compatible computers. Within a year of its operation, Compaq recorded $111 million sales-greatest first year sales record in American business history. Compaq's early success was attributed to its emphasis on leading-edge technology. In 1987, it was first company to surpass $1 billion in sales in first five year of operations. Compaq leveraged the dealer and suppliers network built around the IBM PC to sell its products.

Even though Compaq was strong enough, the rapid growth in dealer network also added an extra layer of expenses and put Compaq at a cost disadvantage to Dell.

In 1997, to combat diminishing margins, Compaq responded with two-pronged strategy, emulate Dell by introducing a direct sale channel and emulate IBM by transforming itself into a full-line provider. Compaq's direct channel dramatically reduced its own inventory but due to fear of loss of market share, it continued to fill orders through dealers and ship its products through retail channels. Due to dealer interface, Compaq was unable to develop closer customer relationship, as fostered by Dell. To emulate IBM's strategy and implement it, Compaq acquired Tandem Computers in 1997 and Digital Equipment Corporation in 1998 to offer high-end, mission-critical business computing. Despite those acquisitions, Compaq continued to perform below expectations 1998 & 1999 and triggered a 22% decline in share price.

In July 1999, Michael Capellas took over as the Chief Executive Officer. In the very next year, Capellas made the internet as Compaq's primary focus and sales increased by 10% that year with slight improvement in gross margins. But the collapse of Dotcom sector in 2001 and a dramatic slowdown took a heavy toll on IT industry. Compaq's revenue fell by 21%, mainly due to price competition.

Hewlett-Packard

HP was founded in 1939 in a garage by William Hewlett and Davis Packard. Since then, HP has grown to $45 billion company by 2002 with 87,000 employees.

As per company's annual report, HP sought to be category leader in which it competed. As on October 2001, HP's three major business segments included Imaging and Printing Systems, Computing Systems and Information Technology Services.

HP's imaging and printing division ranked number one while ranked fourth, both in PC market and server market. HP's services division marketed design and installation services, hardware related support and maintenance services, and increasingly consulting and outsourcing services.

Despite the new launches and product innovation, HP's sales growth declined to a 15-year low in 1998. Even cost reduction initiatives did not yield much. In 1998 HP began to take the initiatives for offering the PCs online but sales decline continued in 1999. The CEO Platt announced retirement in 1999 after 33 years of service and board appointed a new outside president and CEO, Carly Fiorina with mandate for radical change. Fiorina identified 6 strategic priorities for reposition of HP's sustainable growth which included accelerating growth in existing business, implementing customer experience approach, use of cash reserves for funding new growth initiatives, leveraging HP's market position to drive adoption of the next-generation appliances, and e-services. Fiorina also scrapped HP's profit sharing plan in favour of double barreled pay-for-performance incentive programme.

Amid these changes, HP posted 4 quarters of improving top line in 2000 but able to post only 6% growth in net earnings and share price declined to 31% for the year.

In 2001, HP had to contend with slowdown in business and they laid off 8000 workers for cost saving.

Worldwide IT Industry: 1984–2001

Post 1984, IBM witnessed losses at each subsequent year till 1993. IBM had a change of guard in 1993. Louis Gerstner, the new CEO of IBM, marketed the philosophy of providing "integrated solutions" to its customers. IBM shifted its focus from hardware towards more profitable servers and storage business. Gerstner realised that the next generation of IT belongs to the internet, value-added services and consulting. IBM was quick to offer services in these areas and got the first mover advantage. IBM's initiative to work closely with its customers, understanding and providing solutions to every aspect of its clients business, transformed its journey. By 2001, IBM had become the industry leader in the software and IT consultancy segment.

DELL computers focused its strategy to low-margin segments of the industry, personal computers and servers. Its customer centric business model led to high level of customer satisfaction and repeat purchases. Dell focused on the "sell direct" model to lock-in customers. The abundant cash generated by Dell helped it to diversify its business to new lines of networks, servers and storage. Dell's profitability was its competitor's envy.

Compaq was another big firm in the personal computer business. Rather the "sell direct" model, Compaq leveraged on its large and aggressive sales force and gave exclusive rights to its dealers. By 1994, Compaq overtook IBM as the world's leader in PC sales. However, in 1997 Compaq began to face heat from Dell. Its margin started diminishing. Its acquisition of Tandem Computers and Digital Equipment Corporation couldn't reverse its falling fortunes and the balance sheet of the company started bleeding by 1999. By 2001, Compaq was facing financial crisis. Its revenue had dropped drastically, stock prices had hit bottom low and company faced strategic and financial challenges.

Hewlett-Packard (HP) was a diversified company in the IT sector, having its presence in personal computers, image and printing and IT services. For decades, HP was a collection of independent businesses, each selling a particular kind of product. Carly Fiorina was hired to execute an "e-services" strategy that would meld these pieces into one powerful, profitable whole. HP could sell everything from handheld gizmos to back-office servers, with the high-margin software and consulting to make it all work.

HP was the leader in Imaging and Printing sector, ranked fourth in both the PC and server, and growing strongly in the services sector. Despite Fiorina's organisation restructuring and application of cost controlling strategies, HP could not take over Dell and IBM in PC and services business.

Rationale and Synergies of the Merger

The dotcom burst followed by the terrorist attacks triggered a US recession in the year 2001-02. Consumer and corporate spending declined and the IT sector started running for cover. In such a scenario, Fiorina started looking for possible targets for acquisition to fuel HP's growth.

HP hired McKinsey to evaluate the options for future growth of the company. Fiorina approached Compaq to figure out if the synergies between the two companies can bail both of them out. The initial rounds of talks, threw open the idea of merger between the two companies.

Management's reasons for merger:

1. Providing a one-stop shopping destination to the clients of HP and Compaq. The two companies had complementary product offerings resulting in the broader portfolio of products and services.
2. Using the economies of HP's and Compaq's PC business. The plan estimated a $2.5 billion in annual cost savings by mid-2004.
3. Beat competition from Dell and IBM.

But the families of both Hewlett and Packard opposed the merger. Their argument was that such huge mergers have never succeeded in the corporate history and would be a burden on HP's financials. According to them the deal was highly overvalued and Compaq's future earnings were not looking very promising. They instead felt that HP should concentrate on its profitable businesses and shed away all non-core businesses.

So the final decision boiled down to shareholders vote. The 51.4% shareholder approval margin reflected the high level of uncertainty concerning the merits of merger.

Some of the pros and cons of HP-Compaq merger were:

The Positives:

- Cost saving, resulting from the economies of strategy
- Financial bulk, the combined asset of both the companies was sizable
- Cross-selling and technology
- Increase in buying power

The Negatives:

- Execution challenges: The corporate cultures of both companies were contrasting
- PCs business overlap
- Competitive positioning against each other
- Employee Morale: Around 15,000 job cuts were suggested post merger.

Merger Challenges and Opportunities

HP and Compaq had to integrate the product lines which required them to discontinue some products in order to rationalise the product line (and probably to meet federal requirements for approval).

The companies had to undergo a massive re-organisation, integration and cultural change. This has NEVER been done successfully in the computer industry for a deal of this size. The HP's culture of engineering, consensus building, and entitlement is ill suited to meld with the hard-charging sales culture of Compaq.

The opportunities can be specified as given below.

- HP Compaq (HPC) has become a big company and that's what HP was looking for.
- HPC will have a significant services business, albeit a much smaller one than IBM, and that's a key goal.

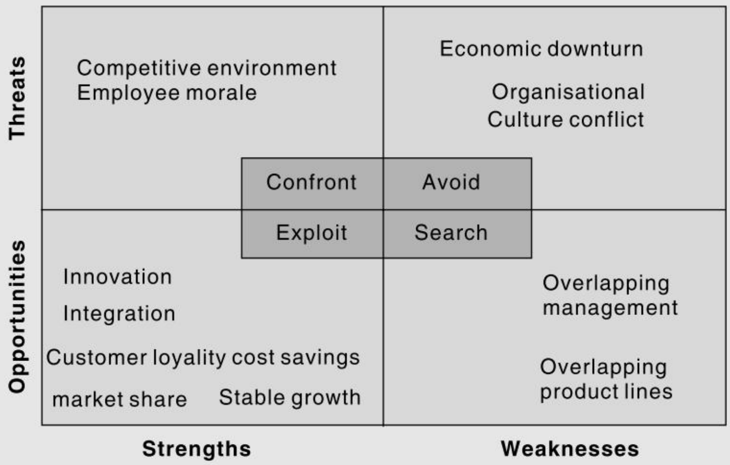
- The organisation has become a favoured vendor in a lot of highly desirable customers' IT departments

Questions

1. Discuss the current scenario in the worldwide IT Industry.
2. Do you think that the HP–Compaq merger is successful as expected?
3. After merger, the top-level management thought that they could become market leaders in higher segment (high-end server market) as well as lower segment (PCs, Printer) by pushing down IBM, Sun Microsystems and Dell from their positions. Find out from the market what happened after three or four years? Which company has become the market leader?
4. What was the fate of their strategic plan? Did they lose revenues in many part of their business units or made abnormal profit?
5. How did the share price of the company move after the merger?

Exhibit

Post Merger- SWOT Analysis



PART Seven

International Economic and Business Environment

Chapter 15

Global Recession and New Business Environment*

Learning Objectives

- to learn about the causes of global recession and financial crisis 2008–09
- to understand the nature and implications of global recession on the new business environment
- to learn more about the impact of global recession on the developed countries as well as emerging countries

Chapter Structure

Section 1: **Introduction**

Section 2: **Review of Global Economy**

Section 3: **Business Environment in Developed Countries**

Section 4: **Business Environment in Emerging Countries**

*Professor Justin Paul co-authored some paragraphs in this chapter with Ryoko Ichinoise, Nagoya University of Commerce and Business, an AACSB accredited business school in Japan.

SECTION 1: INTRODUCTION

The financial crisis that began in the United States in the year 2007 became a full-scale crisis in the year 2008 and 2009 affecting each and every economy in some way or the other including the ones which were not directly related to the crisis. There has been considerable slowdown in most developed countries. Investment banks have collapsed, rescue packages were drawn up involving more than a trillion US dollars, and interest rates have been cut around the world in what looks like a coordinated response. Leading indicators of global economic activity, such as shipping rates, were declining at alarming rates.

Global economy had declined substantially after the collapse of Lehman Brothers on September 15, 2008, which is called "Lehman Shock".

Lehman Brothers was a global financial-services firm that did business in investment banking, equity and fixed-income sales, research and trading, investment management, private equity and private banking. The firm's worldwide headquarters was in New York City, with regional headquarters in London and Tokyo, as well as offices located throughout the world.

On September 15, 2008, Lehman brothers filed for Chapter 11 bankruptcy protection; the filing marked the largest bankruptcy in the US history. The following day, Barclays PLC announced its agreement to purchase Lehman's North American investment-banking and trading divisions along with its New York headquarters building. Lehman Shock had moved quite a lot of investors away from positive purchase of stocks everywhere for sometime.

On September 22, 2008, Nomura Holdings, Inc. (a Japanese company) announced that it had agreed to acquire Lehman Brothers' business in the Asia Pacific region, including Japan and Australia. The following day, Nomura announced its intention to acquire Lehman Brothers' investment banking and equities businesses in Europe and the Middle East also. The deal became effective on Monday, October 13, 2008.

SECTION 2: REVIEW OF GLOBAL ECONOMY

The year 2008–09 is now known as the extreme recession time in the history of global economy, primarily caused by sub-prime mortgage crisis, i.e., financial crisis triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States, with major adverse consequences for banks and financial markets around the world.

Many US mortgages issued in recent years were made to sub-prime borrowers, (those with lesser ability to repay the loan) when USA house prices in the US began to decline in 2006–07, mortgage delinquencies soared, and securities backed with sub-prime mortgages, widely held by financial firms, lost most of their value. The result has been a large decline in the capital of many banks and tightening credit around the world.

The first instance become of which people realised about the worsening of the economy was the collapse of Bear Stearns which was one of the largest global investment banks and securities trading; however, beginning in 2007, the company was badly damaged by the sub-prime mortgage crisis. Although the Federal Reserve Bank provided an emergency loan to the company in March 2008, the company could not be saved and was sold to JP Morgan Chase.

Moreover, the collapse of Lehman Brothers made global market fall into great disorders. As a result of that, investors withdrew their money from the capital market all of a sudden. In response to this critical situation, the US Government enacted the Emergency Economic Stabilization Act of 2008 authorising the United States Secretary of the Treasury to spend up to US$700 billion to purchase distressed assets, especially mortgage-backed securities, and make capital injections into banks.

Needless to say, this financial crisis spread and became extremely critical in Europe, Japan and emerging countries as well. Euro area was also hit by this financial crisis seriously. The problems were brought into public attention when Sachsen Landesbank in Germany which invested large sum of money in securitised instruments related to sub-prime loan went to slump in business in January 2008, and government provided an emergency loan to this bank. In February 2008, the Northern Rock bank in Britain was nationalised by the British Government, due to financial problems caused by the sub-prime mortgage crisis.

From the end of September to the first half of October 2008, several incidents happened, and many financial institutions were nationalised. Fortis was nationalised by Benelux countries (Belgium, Netherland and Luxembourg), Bradford & Bingley was nationalised by British government, and three largest commercial banks of Iceland, Glitnir, Landsbanki and Kaupthing were also nationalised by Icelandic government.

Also, the Irish government issued a sweeping guarantee to insure deposits and bank borrowings against a potential collapse. As a result of this, huge amount of money moved to Ireland, and then, this created confusion in European countries.

Japan, which too had been dependent on business from the US, is also a victim of great depression 2008–09. One of the main industries in Japan is manufacturing industry, especially automobile industry, which is now struggling due to great depression because of the over-dependence on foreign markets for sales (exports). In 2007, international sale of automobiles had exceeded domestic sales and its revenue had been increasing for a few years. However, in the year 2008–09, manufacturing companies suddenly terminated contract workers with reasons like “some financial problems”. Companies did not allow them to stay even for a while.

The nutshell countries like Japan and Korea, which were not even related to the causes of crisis itself but depend heavily on international business, had got adversely affected due to the global economic crisis.

According to IMF report regarding GDP growth rate in the world, it had been growing around 5% since 2004; however, in the end of 2008, GDP growth was 3.1%, which was the lowest growth rate in the period 2003–08. IMF also released 1.5% GDP growth rate in the year 2009. In 1991, GDP growth rate was at the same low level; however, the impact of global financial crisis 2008–09 is obviously different from the past recessions. One of the reasons of this is that World economy and financial markets have been globalised rapidly and the evils of crisis were spread widely among emerging countries. Another notable point is minus GDP growth rate of advanced countries such as US, Germany, Italy and Japan in the year 2008 (Crisis Time), the first ever since 1980s (See Table 15.1 given on next page).

SECTION 3: BUSINESS ENVIRONMENT IN DEVELOPED COUNTRIES

The United States of America

Sub-prime mortgage has involved financial institutions providing credit to borrowers who do not meet prime underwriting guidelines. Sub-prime borrowers have a heightened perceived risk of default, such

Table 15.1 Economic Growth Rates in the World

Growth Rates in the World	Pre Crisis Time (2007)	Crisis Time (2008)
World output	5.1	3.1
Advanced economies	2.7	0.8
United States	2	1.1
Euro area	2.7	0.8
Germany	2.5	1.3
France	2.3	0.3
Italy	1.6	–1
Spain	3.7	1.2
Japan	2.3	–0.7
United Kingdom	2.6	0.7
Canada	2.5	0.4
Other advanced economies	4.7	1.6
Economies	5.7	1.5
Emerging and developing economies	8.3	6
Africa	6.2	5.2
States	8.6	5.5
Russia	8.1	5.6
Excluding Russia	9.8	5.4
China	13	9
India	9.4	7.3
Brazil	5.7	5.1
Mexico	3.3	1.3
ASEAN-5	6.3	4.8
Middle East	6.3	5.2

Source: World Economic Outlook update, July 8, 2009 (IMF), http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/index.aspx

as those who have a history of loan delinquency or default, those with a recorded bankruptcy, or those with limited debt experience. However, sub-prime mortgages were not created for low income borrowers who had little or no money to put down, as commonly believed. Sub-prime mortgages were actually intended to be temporary loans to borrowers who expected to sell the property early or increase their income soon after purchase. Many property investors, or flippers, also used sub-prime loans to finance their investment homes.

Their expectations that the property prices would increase remained as dream when home bubble burst. Most of the borrowers who could not manage their obligation decided to default and securitised instruments from US depreciated gradually.

It is worth noting, in this context, that Japan economic bubble burst and economy was in recession in 1990s after the book time of 1980s and it took more than 10 years to recover the situation. Japanese stagnant economy after bubble burst was caused by domestic home price; however, it did not influenced foreign countries seriously because other countries were not relying on income from Japan. This is the remarkable difference between bubble burst in Japan and the US.

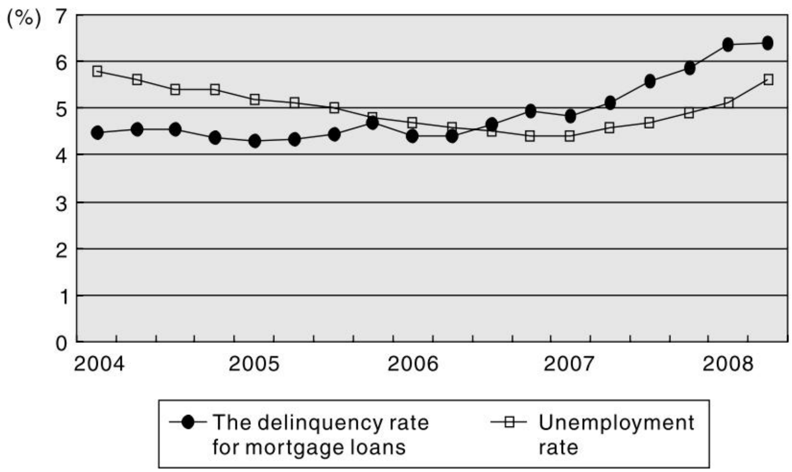


Fig. 15.1 The delinquency rate for mortgage loans and unemployment rate

Source: Mortgage Bankers Association Department of Labor

What is worse, the Federal Reserve Bank already provided huge amount of emergency loans and subsidies and the fact of deficit financing of the US was exposed in public. It was expected to pull down home prices, and therefore, stock market slump and dollar depreciation. US economy and stock market have started to recover slowly and gradually.

European Countries

In European Countries, just same as United States, financial crisis caused by subprime mortgage crisis was seriously discussed. The first action of the European Central Bank against this crisis with lower the rate of interest was taken in autumn in 2008. It would take a few more years to go back to the same index level before financial crisis, in most of the countries in Europe.

Japan

It is said that Japan was not involved in sub-prime mortgage crisis itself; however, Japanese economy has been heavily depending on external demand which in turn had a deep negative effect. This fact hit Japanese economy substantially.

The export industry which is the breadwinner of Japanese economy was damaged hard. Because foreign countries demand declined and investors took deleverage actions, as a result of this, yen appreciation against foreign currencies and stock price slide occurred.

Look at the graph titled "Actual Exports from Japan". It is obvious that exports to the US declined dramatically since 2007, so as the Japanese exports to EU countries since the middle of 2008.

Besides this, yen appreciation and lower stock price hit Japanese economy from September 2008, because of the aftereffects of the collapse of Lehman Brothers on September 15, 2008. Comparing average of July 2008 and the end of February, 2009, Nikkei index shrunk approximately 45% and Yen appreciated around 15% against US dollar.

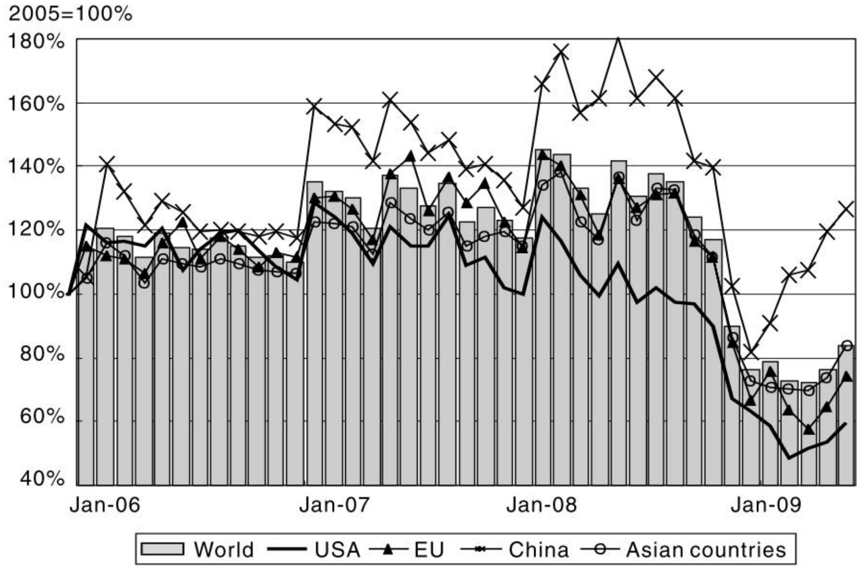


Fig. 15.2 Actual Export from Japan

Source: Ministry of Finance.

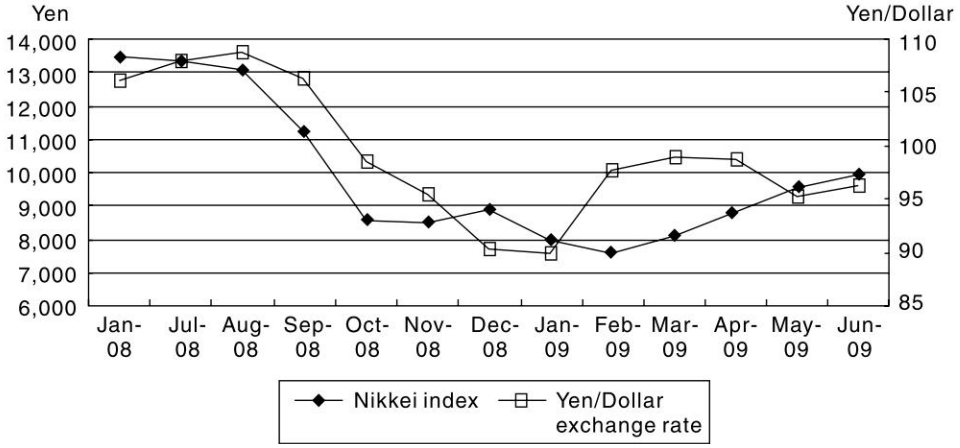


Fig. 15.3 Nikkei Index and Foreign Exchange Rate

Source: Infoseek.

On the other hand, steep rise in oil and food prices in early 2008 made import conditions worsen prominently, however, in contrast, recent low resource price would give Japanese economy some relief.

SECTION 4: BUSINESS ENVIRONMENT IN EMERGING COUNTRIES—BRIC (BRAZIL, RUSSIA, INDIA AND CHINA)

Most of all advanced countries have undergone through the great economic depression 2008–09; at the same time, emerging countries which had been growing rapidly year by year could not avoid the evils of worldwide recession. A lot of US investors withdrew huge amount of money from BRIC stock markets, which made the shrinkage of stock market index in each of BRIC country. What is particularly obvious is Russia and Brazil. Those factors would give Russia and Brazil suffering.

However, BRIC is now facing the different stage. The economy of each country is close to reach the mature mode, people in the upper income brackets are increasing recently and their domestic demand is going to broaden.

India's top think tank—Prime Minister's Economic Advisory council (PMEAC) said that the nation can achieve a 7 to 8% growth rate in the forthcoming years despite a global financial meltdown impact. It was announced that Indian economy is now controlled more by domestic factors than international factors. Stock Indices in India have already bounced back to the pre-crisis period peak (BSE SENSEX crossed 18,000 in 2009 November as against 8000 in Oct. 2008 in India).

In addition, China announced on November 9, 2008, to take measures to counter depression. Those measures taken action, by Chinese government would help to facilitate trade and regain confidence in China.

In November 2008, the Group of 20 (includes the Group of Eight richest countries—United States, Germany, Japan, France, Italy, Britain and Canada and Russia—in addition to the European Union, Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea and Turkey) had convened a conference to discuss about the global economic crisis. The Group of 20 countries account for 90% of the world economy and about two-thirds of its population.

The five key objectives the leaders agreed upon were:

1. reached a common understanding of the root causes of the global crisis;
2. reviewed actions countries had taken and would take in the future to address the immediate crisis and strengthen growth;
3. agreed on common principles for reforming their financial markets;
4. launched an action plan to implement those principles and asked ministers to develop further specific recommendations that would be reviewed by leaders at a subsequent summit;
5. reaffirmed their commitment to free market principles.

However, any of specific and concrete guidelines like financial market regulations were not discussed yet.

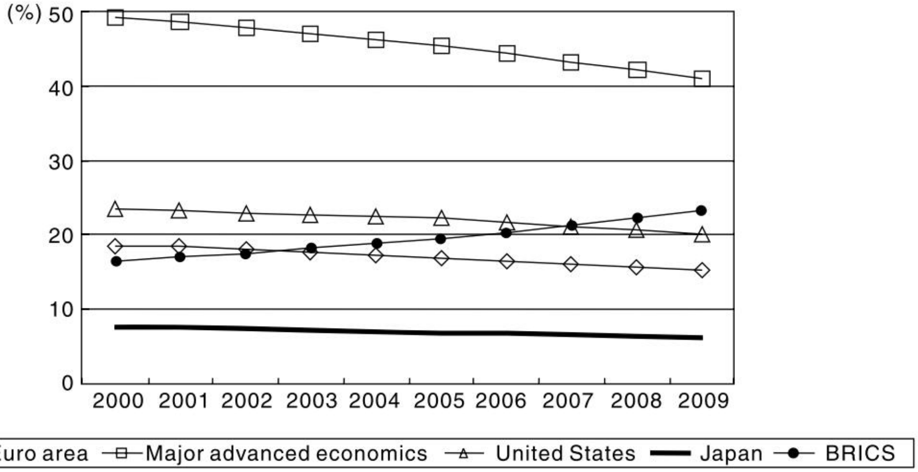


Fig. 15.4 GDP based on purchasing power parity share of world total

Source: IMF world economic outlook.

Looking up GDP based on purchasing power parity (PPP) share of world total, on the one hand, emerging market and developing counties is on the rise remarkably, on the other hand, the US GDP based on PPP share of world total shrunk slowly after the year 2000. Moreover, BRICs total GDP based on PPP share of world total exceeded that of US in 2007.

Table 15.2 Projected Relative Size of Economies in 2007 and 2050 (US=100)

Country (Indices with US = 100)	GDP at market exchange rates in US $ terms		GDP in the PPP terms	
	2007	2050	2007	2050
US	100	100	100	100
Japan	32	19	28	19
China	23	129	51	129
Germany	22	14	20	14
UK	18	14	15	14
France	17	14	15	14
Italy	14	10	13	10
Canada	10	9	10	9
Spain	9	9	10	9
Brazil	8	26	15	26
Russia	8	17	17	17
India	7	88	22	88
Korea	7	8	9	8
Mexico	7	17	10	17
Australia	6	6	5	6
Turkey	3	10	5	10
Indonesia	3	17	7	17

Source: PricewaterhouseCoopers estimates (using UN population projections).

According to projected relative size of economies in 2007 and 2050 by PricewaterhouseCoopers, China is expected to overtake the US as the largest economy by 2050 and India has potential nearly to catch up with the US by 2050.

The US would keep its position as "No. 1 economy" and the world economy was under the leadership of advanced economy. However, the circumstances of the world economy and stock market would be now on the turning point.

Needless to say, the future of stock market is unpredictable. Each analyst has different perspective; however, it is important to analyse and discuss what is happening in the world economy. However, the future of stock market might be led by BRICs or current emerging countries, not advanced economies.

Chapter Summary

Considering the circumstances mentioned above, it would be tough for many firms to do the business in foreign countries and expand globally because of shrinkage of advanced economies for a few years. It is said that this situation is caused by globalisation which strengthened the ties among each country with economic and financial sides. During the expansion of world economy, it gave huge benefits; however, it started to move to wrong directions, and we are facing negative aspects of globalisation. Exports, which was primal pulling force of the economy, slowed down in advanced economies which had created huge demand in the world. Also, the global financial trade has caused disrupt exchange rate and drop in asset price. The firms which formulate their business strategy taking into account all these changes and diversify their destination might emerge as winners in the post-crisis era of globalisation.

Class/Field Exercise

1. Visit the website http://stat.whoorg/ analyse the data on International Trade and report whether global recession has adverse impact on international trade based on data from the year 2007 (take 2007–2010 as recession period and 2004–07 as pre-recession period).
2. Visit the website www.forecasts.org and examine the forecasted economic indicators for the US, China, Japan and India.

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Chapter 16

WTO: Agreements and Current Issues

Learning Objectives

- to learn the essence of WTO agreements
- to analyse the phases of implementation of WTO agreements
- to study the implications of the agreements

Chapter Structure

Section 1: GATT and WTO

Section 2: Agreements and Implications

Case: Business Environment in Post-WTO China and Citigroup

SECTION 1: GATT AND WTO

The rationale of international trade is comparative advantage so that all countries benefit through open and fair international trade. Many countries, particularly South East Asian countries have prospered through exports. In international trade, predictability of rules and regulations governing import, standards, tariffs, customs procedures and so on, are absolutely necessary if there is to be orderly growth of trade. Realising that trade would suffer if there is no stability, leading trading nations entered into the General Agreement on Tariffs and Trade (GATT) in 1947–48 to ensure orderly and transparent international trade. The fundamental principles of such an Agreement are: (i) Most Favoured Nation (MFN) – every signatory will extend to every other signatory member, the same and equal treatment in a non-discriminatory manner. This is of great benefit as all countries whether rich or poor, strong or weak, would be given same treatment by all signatory members and (ii) The second principle is National Treatment which means that imported goods and domestically-produced goods will be treated alike, except for the payment of customs duty at the time of import.

Each country has to import and export goods and services. Like India has to import items like petroleum products, edible oils, pulses, electronics goods, and gold and machinery. To pay for imports, countries have to earn foreign exchange through export of goods and services. These could range from tea to tobacco, rice to yarn, garments, diamonds, engineering goods, leather and tourism to IT services. Besides, exports provide substantial employment opportunities. In fact, there would be severe setback to employment if exports of many of the items are affected.

General Agreement on Tariffs and Trade (GATT) is a multinational treaty that was signed in 1948 by 102 countries with the objective of bringing down tariff and non-tariff barriers to international trade.[1] Until 1994, the main concerns of GATT were to check 'dumping' and unethical business practices. The Uruguay Round Agreements of GATT (held during 1986 to 1994) envisaged an increase in the coverage of the legal provisions and establishment of an institution called the World Trade Organisation (WTO).

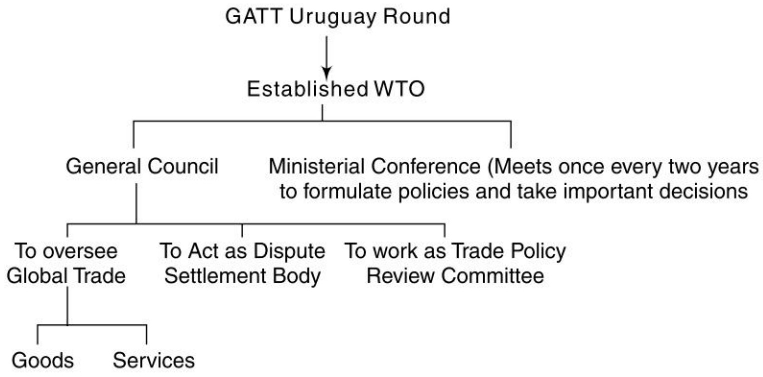
GATT–The Twenty Three Original Signatories

Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxembourg, The Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, South Africa, United Kingdom and United States

Table 16.1 Road From GATT To WTO

Year	Place	No. of Countries Participated
1947	Geneva	23
1949	Annecy	13
1951	Torquay	38
1956	Geneva	26
1960–61	Geneva	62
1964–67	Geneva-Kennedy Round	62
1973–79	Geneva-Tokyo round	102
1986–94	Punta Del Esta to Geneva (Uruguay Round)	123

1. See Oza A. N., General Agreement on Tariffs and Trade, An Explanatory Note in Vikalpa, Journal of IIM Ahmedabad, Vol. 20, No. 3, July–Sept. 1995.



Source: This figure has been drawn based on the information given on wto.org and an article by OZa, Vikalpa, Vol. 20, No. 3, 1995.

Fig. 16.1

The World Trade Organisation (WTO) was formed in 1995 with GATT with the objective to help producers of goods and services, exporters, and importers conduct their businesses internationally. WTO is the only global organisation that deals with the rules of trade between nations.

Ministerial Conference held at least once in two years, would be the primary decision-making body of the WTO. The General Council of the WTO is responsible for overseeing regulatory operations and acts as the body for dispute settlement mechanism.

WTO's agreements are negotiated and signed by a large majority of the nations and ratified in their parliaments. These agreements are the legal ground rules for international business. Essentially, they are contracts guaranteeing member countries important trade rights. They also bind governments to formulate their trade policies within the framework for the benefit of business firms.

The arguments for a country to join WTO can be listed as follows.

1. Disputes are settled officially
2. WTO rules are consumer-friendly
3. Free trade cuts the costs of many goods
4. WTO provides more choice of products

People have different views on the free trading system as envisaged by the WTO. Those who support WTO argue that such a system serves as a forum for countries to arrive at consensus on various trade issues.

The arguments against WTO are:

1. WTO dictates the terms
2. It is for free trade at any cost
3. Small producers find it difficult to compete with MNCs

Multilateral Ministerial Conferences of GATT and WTO

1986–1994: Punta Del Este, Uruguay (September 1986), Montreal (December 1988) Brussels (December 1990) Marrakesh (April, 1994)
Post 1995: Details of Ministerial Conferences – Post-WTO phase:
Singapore (December 1996), Geneva (May 1998), Seattle (November-December, 1999) Doha (Nov 2001), Cancun (Sep 2003), Hong Kong (Dec 2005)

Source: Justin Paul, International Business, 2nd Edition, Prentice-Hall of India, 2005.

4. Indigenous products have no demand in the era of WTO when branded imported items are easily available.
5. Small countries are powerless in the WTO system.

SECTION 2: AGREEMENTS AND IMPLICATIONS

WTO essentially stands for removing non-tariff barriers in the short run and for reducing tariff rates on imports in the long run. Important agreements of WTO are discussed in this section.

(i) General Elimination of Quantitative Restrictions (QRs)

"No prohibitions or restrictions other than duties and taxes whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any contracting country on the importation of any product of any other member country" (GATT, 1947).

Quantitative Restrictions (QR) refers to limits set by countries to restrict imports (or exports). This could be in the form of quotas, licensing (special import licence, restricted list and canalised list). Canalising imports refers to allowing only a few firms to import specific items by the government agency responsible for monitoring the respective sector. Thus, QRs are the measures other than duties, taken to restrict imports.

Import tariffs (duties) per se do not prevent entry of products.[2] On the other hand, QRs can be more trade restrictive than tariff measures. Therefore, WTO does not permit member countries to impose QRs under normal circumstances. However, the countries are allowed to impose QRs in a non-discriminatory manner for any of these reasons: (a) to safeguard the balance of payment position (b) as a safeguard measure when there is serious injury to domestic producers (c) restrictions on any agricultural or fisheries product when there is temporary domestic surplus of the product.

As per the agreement, India removed QRs on 1,429 importable items in 2000 and 2001 that has paved the way to import into India without restrictions.

(ii) Agreement on Agriculture (AOA)

The original GATT was applicable to agricultural trade, but it had loopholes. The agreement allowed member countries to use some non-tariff measures such as import quotas, and to subsidise. As an outcome of this agricultural trade was highly distorted, especially with the use of export subsidies that normally would not have been allowed for industrial products. Therefore, the reductions in agricultural subsidies were agreed in the Uruguay Round, subject to conditions.

The Uruguay Round agreement was the first significant step towards order, fair competition and a less distorted sector. Participants agreed to initiate negotiations for continuing the reform process. Least developed countries do not have to make commitments to reduce tariffs or subsidies.

The objective of the Agriculture Agreement is to reform trade in the sector and make policies more market-oriented in order to improve predictability level for importing and exporting countries alike. As per the agreement, developing countries do not have to cut their subsidies or lower their tariffs as much as developed countries, and they were given extra time to complete their obligations. Special provisions have been made keeping in view the interests of the least developed economies.

The AoA has three basic clauses:[3]

(i) market access

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2. P. Krishna Rao, WTO-Text and Cases, Excel Books, New Delhi, page 25.
3. Rodrigues, Branda and Manoj Kamat, 'Agriculture in India and The WTO' in Development Agenda of Third World Countries (Ed) Stephen Analil, Serials Publications, 2005.

(ii) domestic support
(iii) export subsidies

As per AoA, "tariff alone" is the rule for 'market access' in agricultural products. The commitment required conversion of all non-barriers into equivalent tariff rates i.e., levels of protection. For example, if the previous policy meant domestic prices were 75% higher than the world prices, then the new tariff would be around 75%. (This conversion of quotas and other types of measures to tariffs was called "tariffication".) The newly committed tariffs, covering all agricultural products, came into effect in 1995. Similarly, Uruguay Round participants agreed that developed countries would cut the tariffs by an average of 36% over a period of six years. While developing countries were to make 24% cuts over a period of 10 years, developing nations facing the problem of balance of payment were not required to cut their tariffs. For products whose non-tariff restrictions have been converted to tariffs, governments are allowed to take safeguard measures in order to prevent falling prices or surges in imports that would hurt their farmers. However, the agreement specifies when and how these emergency actions can be introduced.

The Agriculture Agreement distinguishes between support programmes that stimulate production directly, and those that are considered to have no direct effect. 'Domestic Subsidies' that do have a direct effect on production and trade were to be reduced in countries where support exceeded the level specified (using calculations known as "total Aggregate Measurement of Support" or "Total AMS") for the agricultural sector per year in the base years of 1986–88. The subsidy level specified was 5% and 10% of AMS in developed and developing countries respectively. Least developed countries were not required to make any cuts.

There are some categories of support measures that were not subject to reduction. They are (a) Green Box measures (b) Blue Box measures

(a) Green Box measures are the ones with minimal impact on trade and can be used freely. They include government services such as research, disease control, infrastructure and food security. They also include payments made directly to farmers that do not stimulate production, such as certain forms of direct income support, assistance to help them restructure agriculture, and direct payments under environmental and regional assistance programmes.
(b) Blue Box measures include indirect payments to farmers where they are required to limit production, certain government-assisted programmes to encourage agricultural and rural development in developing countries, and other measures when compared with the total value of the product or products supported (5% or less in the case of developed countries and 10% or less for developing countries).

The Agriculture Agreement also require WTO members to reduce their export subsidies. Developed countries are required to reduce their subsidy by 36% and developing countries by 24%.

(iii) Agreement on Textiles and Clothing (ATC) 1995–2004

The member countries of WTO, particularly countries in Europe and America, have removed the quota restrictions on imports of textiles and clothing, as part of the implementation of ATC agreement on 1 January 1995. Before the Agreement came into effect, a large part of textiles and clothing exports from developing countries to the industrial countries was subject to quotas under a special regime.

Till the end of the Uruguay Round, textile and clothing quotas were negotiated bilaterally and governed by the rules of the Multifibre Arrangement (MFA). This provided scope for the application of selective quantitative restrictions when surge in imports of particular products caused serious damage to the industry of the importing country. The Multifibre Arrangement was a major deviation from the basic GATT principle of non-discrimination. On January 1, 1995, it was replaced by the WTO Agreement on Textiles and Clothing, which set out a transitional process for the ultimate removal of these quotas that prevailed in the form of special import licence, canalized items and so on.

Article 3 of WTO deals with quantitative restrictions (or measures with similar effect) other than those under the MFA. Members who had such restrictions in place (which could not be justified under a GATT provision) were required either to bring them in accordance with GATT rules or phase them out within the ten year transitional period.

Article 5 of the ATC contains rules and procedures regarding circumvention of the quotas through trans-shipment, re-routing, false declaration of origin or falsification of official documents. These require consultation and full cooperation in the investigation of such practices by members concerned. Once sufficient evidence is available, possible recourse might include the denial of entry of goods. There is also a provision whereby all members should establish, consistent with their domestic laws and procedures, the necessary legal provisions to address and take action against circumvention.

The Textiles Monitoring Body (TMB) was established to supervise the implementation of the ATC and ensure that they are in conformity with the rules. It is a quasi-judicial standing body which consists of a chairman and ten TMB members, who discharge their functions taking all decisions by consensus. The ten members are appointed by WTO member governments according to an agreed grouping of WTO members into constituencies. There can be rotation within the constituencies. These characteristics make the TMB a unique institution within the WTO framework.[4]

(iv) General Agreement on Trade in Services (GATS)

The General Agreement on Trade in Services (GATS) is the first ever set of multilateral, legally-enforceable rules covering international trade in services. It was agreed by WTO member countries in the Uruguay Round. Like the agreements on goods, GATS operates on three levels: the main text containing general principles and obligations; annexes dealing with rules for specific sectors; and individual countries' specific commitments to provide access to their markets. However, unlike in goods, GATS has a fourth special element: lists showing where countries are temporarily not applying the "Most-Favoured Nation" principle of non-discrimination. These commitments—like tariff schedules under GATT—are an integral part of the agreement. A WTO Council for Trade in Services oversees the operations of the agreement. Even as negotiations on commitments have taken place after the Uruguay Round, GATS requires more negotiations. The goal is to take the liberalisation process further by increasing the level of commitments in schedules.

The agreement covers all internationally-traded services. GATS classifies services into four categories, as given in the following table:

4. *Source:* Prepared based on the information from www.wto.org

GATS Classification of Services

- Services supplied from one country to another (e.g. international telephone calls), officially known as "cross-border supply"
- Consumers or firms making use of a service in another country (e.g. tourism), officially known as "consumption abroad"
- A foreign company setting up subsidiaries or branches to provide services in another country (e.g. foreign banks setting up operations in a country), and is officially known as "commercial presence"
- Individuals travelling from their own country to supply services in another country (e.g. fashion models or consultants), officially called "presence of natural persons"

Source: GATS Agreement, WTO (See www.wto.org).

Most-Favoured Nation (MFN) treatment: MFN means treating one's trading partners equally. Under GATS, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members. (This applies even if the country has made no specific commitment to provide foreign companies access to its markets under the WTO.) MFN applies to all services, but some special temporary exemptions have been allowed.

Transparency: GATS says that governments must publish all relevant laws and regulations so that foreign companies and governments can use them to obtain information about regulations in any service sector. Similarly, governments have to notify the WTO of any change in regulations that apply to the services that come under specific commitments.

Regulations: Since domestic regulations are the most significant means of exercising influence or control over services trade, the agreement states that governments should regulate services reasonably, objectively and impartially. When a government makes an administrative decision that affects a service, it should also provide an impartial means for reviewing the decision (for example a tribunal).

International payments and transfers: Once a government has made a commitment to open a service sector to foreign competition, it must not normally restrict money from being transferred out of the country as payment for services supplied ("current transactions") in that sector. The only exception is when there are balance-of-payments difficulties, and even in such cases, the restrictions must be temporary and subject to other limits and conditions.

(v) Agreement on Trade Related Investment Measures (TRIMS)

The Agreement on Trade-Related Investment Measures (TRIMS) recognises that certain measures can restrict and distort trade, and states that no member shall apply any measure that discriminates against foreigners or foreign products. According to the agreement, the governments cannot impose measures which require particular levels of local procurement by an enterprise ("local content requirements"). It also discourages measures which limit a company's imports or set targets for the company to export ("trade balancing requirements").

(vi) Agreement on Import Licensing

Although less widely used now than in the past, import licensing systems are subject to disciplines in the WTO. The Agreement on Import Licensing Procedures says import licensing should be simple, transparent and predictable, if there are quantitative restrictions. For example, the agreement requires governments to publish sufficient information for traders to know how and why the licences are granted. It also describes how countries should notify the WTO when they introduce new import licensing procedures or change existing procedures. The agreement offers guidance on how governments should assess applications for licences. The agreement sets criteria for automatic licensing so that the procedures used do not restrict trade. The agreement tries to minimise the importers' burden in applying for licences, so that the administrative work does not restrict or distort imports. The agreement says the agencies handling licensing should not normally take more than 30 days to deal with an application—60 days when all applications are considered at the same time. It is now part of the WTO package signed by all WTO members.

(vii) Agreement on the Valuation of Goods at Customs

For importers, the process of estimating the value of a product at customs poses problems that can be just as serious as the actual duty rate charged. The WTO agreement on customs valuation aims for a fair, uniform and neutral system for the valuation of goods for customs purposes—a system that outlaws the use of arbitrary customs values. However, a related Uruguay Round ministerial decision gives customs administrations the right to request further information in cases where they have reason to doubt the accuracy of the declared value of imported goods.

(viii) Agreement on Pre-shipment Inspection

Pre-shipment inspection is the practice of employing specialised companies (or 'independent entities') to check shipment details—essentially price, quantity and quality—of goods ordered from overseas. The purpose is to safeguard national interests like prevention of capital flight, commercial fraud and customs duty evasion.

The WTO agreement recognises that GATT principles and obligations apply to the activities of pre-shipment inspection agencies mandated by governments. The obligations of exporting members towards countries using pre-shipment inspection include non-discrimination in the application of domestic laws and regulations, prompt publication of those laws and regulations and the provision of technical assistance where requested. The agreement establishes an independent review procedure. It is administered jointly by an organisation representing inspection agencies and a body representing exporters. Its purpose is to resolve disputes between an exporter and an inspection agency.

(ix) Agreement on Rules of Origin

'Rules of origin' are the criteria used to define where a product was made. Rules of origin are also used to compile trade statistics, and for "made in …" labels that are attached to the products. This agreement requires WTO members to ensure that their rules of origin are transparent and do not have restricting, distorting or disruptive effects on international trade. The agreement aims for common (harmonised) rules of origin among all WTO members, except in some kinds of preferential trade. For example, countries setting up a free trade area are allowed to use different rules of origin for products traded under their free trade agreement.

(x) Agreement on Technical Barriers to Trade (Technical Regulations and Standards)

Technical regulations and industrial standards are important, but they vary from country to country. Having too many different standards make life difficult both for the producers and the exporters. If the standards are set arbitrarily, they could be used as an excuse for protectionism and become obstacles to trade. The Agreement on Technical Barriers to Trade (TBT) tries to ensure that regulations, standards, testing and certification procedures do not create unnecessary obstacles. The WTO's version is a modification of the code negotiated in the 1973–79 Tokyo Round. However, the agreement recognises countries' rights to set the standards they consider appropriate—for example, for human, animal or plant life or health, for the protection of the environment or to meet other consumer interests. In order to prevent too much diversity, the agreement encourages countries to use international standards wheresover appropriate.

The agreement says the procedures used to decide whether a product conforms with national standards have to be fair and equitable. It discourages any methods that would give domestically-produced goods an unfair advantage. The agreement also encourages countries to recognise each other's testing procedures. This way, a product can be assessed to certify if it meets the importing country's standards through testing in the country where it is made. Manufacturers and exporters also ought to know about the latest standards in their prospective markets.

(xi) Agreement on Anti-dumping

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. It disciplines anti-dumping actions, and it is often called the "Anti-Dumping Agreement". The WTO agreement allows governments to act against dumping where there is genuine injury to the competing domestic industry. The government has to be able to show that dumping is taking place, calculate the extent of dumping (how much lower the export price is compared to the exporter's home market price), and prove that the dumping is causing injury.

GATT (Article 6) allows countries to take action against dumping. The Anti-Dumping Agreement clarifies and expands Article 6, and the two operate together. Anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the "normal value".

Calculating the extent of dumping on a product is not enough. Anti-dumping measures can only be applied if the dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. The investigation must evaluate all relevant economic factors that have a bearing on the state of the industry in question. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.

In other words, WTO Anti-Dumping Agreement covers:

- Detailed rules for calculating the amount of dumping
- Procedures for initiating and conducting anti-dumping investigations
- Rules on the implementation and duration (normally five years) of anti-dumping measures

Under normal circumstances, anti-dumping measures must expire five years after the date of imposition, unless an investigation shows that ending the measure would lead to injury. Anti-dumping investigations are to end immediately in cases where the authorities determine that the margin of dumping is insignificantly small (defined as less than 2% of the export price of the product). Other conditions are also set. For example, the investigations also have to end if the volume of dumped imports is negligible (i.e. if the volume from one country is less than 3% of total imports of that product. —See Article 6, GATT for details.

The agreement says member countries must inform the Committee on Anti-Dumping Practices about all preliminary and final anti-dumping actions, promptly and in detail. They must also report on all investigations twice a year. When differences arise, members are encouraged to consult each other. They can also use the WTO's dispute settlement procedure.

Anti-dumping and countervailing duties are imposed under the Customs Tariff Act 1975 and the Rules made thereunder. The Act and Rules are on the lines of the respective GATT Agreement on anti-dumping and countervailing duties. Government of India has introduced Section 8 (B) of the Customs Tariff Act, 1975, to make provisions for imposition of safeguard duties as per the provisions of the WTO Agreement on Safeguards.[5] The Act provides for imposition of safeguard duties on products being imported in increased quantities such as to cause or threaten to cause serious injury to the domestic industry that produces directly or indirectly a competitive product. The Director General of Safeguards has been appointed to consider complaints received from domestic industry suffering injury from the increased imports, for imposition of safeguard duties.

(xii) Trade Related Intellectual Property Rights (TRIPS)

India has already implemented TRIPS Agreement by launching the product patent system from January 2005 (the country has moved from process patent to product patent regime). Another notable point in this field has been in the passing of TRIPS plus legislation in the field of Copyright Law. The 1994 amendments to the Act of 1957 provide protection to all original literary, dramatic, musical and artistic works, cinematographic films and sound recordings. The most recent changes bring sectors such as satellite broadcasting, software and digital technology under Indian copyright protection.

(xiii) Information Technology (IT) Agreement[6]

During the Singapore Ministerial Conference of WTO, a Ministerial Declaration on Trade in Information Technology Products was adopted. This Declaration aims to expand world trade in information technology products. India participated in the negotiations on the agreement from the early stages and after extensive discussions with trading partners, joined as a participant on April 1, 1997.

(xiv) Regional Trade Arrangements

Although Regional Trade blocks are based on the principle of discriminatory trade, WTO has a special provision for this. Using this condition, many regional trade groups such as North American

5. Narasaiah M.L (2001), World Trade Organisation and the Developing Countries, Discovery Publishing, New Delhi.
6. Pandu Ranga Rao (2002 ed.), WTO & competitiveness, Excel Books.

Free Trade Area (NAFTA), European Free Trade Area (EFTA), Association of South East Asian Nations (ASEAN) and Gulf Co-operative Council (GCC) have been set up. India has been instrumental in setting up the South Asian Association for Regional Cooperation (SAARC), whose major achievement in 1995 was the conclusion of the negotiations on trade preferences within the framework of the SAARC Preferential Trading Arrangement (SAPTA). SAPTA became operational on December 7, 1995 and includes preferential tariff concessions on 226 items and product groups. The Indian Ocean Rim Association for Regional Cooperation was formed along with 13 other countries in the region. Economic cooperation is expected to take place in trade facilitation, promotion and liberalisation, promotion of foreign investment, promotion of scientific and technological cooperation, tourism, the movement of natural persons and service providers, and the development of infrastructure and human resources. An enabling clause to identify other areas of cooperation is also included in the agreement. India has also signed sub-regional agreements with Nepal, Bangladesh, Myanmar and Bhutan and more recently with Bangladesh, Sri Lanka and Thailand.

Case

Business Environment in Post-WTO China and Citigroup[7]

Citigroup was formed by the merger of Travellers Group and Citicorp in 1998. Travellers had extensive knowledge in investment banking, asset management, life insurance and property casualty insurance, as well as consumer lending. Citigroup achieved tremendous success after the merger, a double-digit growth figure, and a 20 percent return on equity. Citibank was one of the first foreign banks to enter the Chinese market. However, it had a limited market access, and could offer limited number of services due to government restrictions.

Post-WTO China

China joined WTO in the year 2001. Before China had joined the WTO, Citibank was only licensed to provide corporate banking services for foreign investment enterprises. Also, banks were allowed to open limited branches in few Chinese cities, and licenses to enter the lucrative retail market were not given.

The terms and conditions of the WTO required China to open its financial system for foreign corporations. However, the pace of liberalisation was uncertain. China's Central Bank was under pressure to meet WTO commitments. But China's state banks were not in good shape, owing to bad management practices. The percentage of non performing assets was also high. So, it was upto the Central Bank to prevent the foreign banks from bulldozing the market.

WTO membership conditions stipulated that all non-geographic restrictions be removed by 2007. However, China's initial regulatory reforms included measures which would retard the expansion of foreign banks. Further, it was expected that People Bank of China (PBOC)[8] would impose a wide range of restrictions with regard to deposits, interest rates on loans, reserve requirements, Capital adequacy ratios, etc. Long waiting lists and high funding requirements were expected to slow down the expansion of banks.

7. This is an original write-up based on the information sourced from the Case Study titled Citigroup in post-WTO China, published by Richard Ivey School of Business, University of Western Ontario, Canada.
8. People Bank of China (PBOC) is the Central bank in China.

Even though Citibank had a good relationship with the PBOC, it had reasons to be concerned, as Citibank was one of the most powerful foreign banks in China and it posed the greatest threat to China's struggling domestic banks. If the PBOC felt that Citigroup was too large and too ambitious, it would take steps to slow down Citigroup's expansion plans.

Impediments to Economic Reforms

Political Challenges

While China had achieved rapid growth, it encountered challenges pertaining to state-owned enterprises (SOE). SOEs still controlled more than 70 percent of all the fixed assets, and 80 percent of all working capital in manufacturing. The percentage of non-performing assets was high and corruption was widely prevalent. WTO membership would further make life difficult, as they would face better-quality imports and competition from foreign-owned corporations, investing in China.

Some social reformers expressed the view that an economic transition would require political reform, with a shift towards democracy, free speech and investigative journalism. It was difficult to advocate an end to communist party's monopoly on power.

Human Resource Challenges

The skills required for corporate management in a free market economy were different from those required for SOEs. The Chinese managers would have to learn a new set of skills and develop a new set of business procedures. The concept of marketing and a concern for customer satisfaction had to be ingrained in managerial decision making. Quality and innovation also needed to be developed. Also, business administration courses needed to be developed in Chinese universities. Also in SOEs, there was distrust among employees and initiatives were not taken to develop trust. Also, trained and experienced employees were difficult to obtain. The mindset of bureaucrats also needed to be changed, and new courses in public administration and economics needed to be developed.

E-Commerce Limitations

China lacked the basic telecom infrastructure and broadband capacity, except for a few major cities. WTO membership was expected to revolutionise the telecom sector.

Regional Disparities

There were high disparities in the growth patterns in China, with the coastal areas where the SEZs were located, being highly developed and the rural areas beginning to stagnate. The gap between these areas presented problems with regard to economic development of the nation as a whole.

Opportunities for Financing Foreign-Owned Corporations

The prospect of joining the WTO brought in huge FDI investments into China. Citigroup could focus on providing foreign owned corporations some services, inspite of the high restrictions. Competition from other foreign banks had become intense. China's high population and high growth rate were attractive to investors, and as the per capita income was less, investment focus was on manufacturing for export.

Opportunities for Investment Banking Services

The privatisation of SOEs provided great investment banking opportunities and IPOs included sale of shares in foreign and Chinese exchanges. Valuation of shares, assets, future profit streems were areas in which banks could focus. However, China's stock market was fragmented, with restriction on ownership of shares. Citigroup invested in financial and real assets, utilizing the deposits and premiums of Citigroup's related divisions.

Opportunities for Other Financial Services

China offered a high domestic savings rate of 40% of the GDP. This was earlier deposited with the state banking systems but the opening up of the financial services market made the foreign banks tap these services. Traditionally, credit cards was a profitable aspect but caution was required in this aspect, as the Chinese government did not want the inflation to increase. Credit, Cards would increase inflation and decrease the savings of the people. The analysts' suggestion was not to undertake development on a major scale. While making its strategic decisions, Citigroup would have to project the growth of the credit card industry as a whole.

Citigroup, by offering a wide range of products on the internet, and by its alliances with leading firms, made rapid advances on providing internet services. The shift in China brought about the practice of home ownership and renting of private spaces. This required financing, which Citigroup provided through one of its divisions. Also the Citigroup Asset Management group, which offered high net worth individual's products was also active in China.

Citigroup Worldwide

Citigroup has a better international presence than its competitors as it is located in more countries. It has a competency in merging markets. However, it faced difficult times in the 1980s because of its decentralized decision making structure, and its attempt to get into commercial real estate lending. It was brought back on its feet by the new CEO, John Reed, who relied on drastic measures, which were quite successful. Reed managed to repair the bank's balance sheet and restore its credit ratings. He achieved this by centralizing the decision making in New York, along with his managers, and made most of the major strategic decisions after extensive discussions.

Strategic Competitive Advantages

Citigroup has a set of competitive advantages which would give it a boost in its plans for the Chinese market. These are explained as follows:

- The sustainable advantage Citibank has to offer is its global network, which is an important factor while providing services to the powerful list of corporate banking clients, and also for its consumer banking services. This is especially strong in emerging markets, which makes it a smart option.
- Citibank has been in these markets for a very long time, in China's case around 100 years. It had to shut shop at the time of communist takeover. It used the first mover advantage to get its foot inside the door. This strategy, as emphasised by John Reed, has created operational expertise, which the other banks have a hard time matching. This is an important aspect for drawing and retaining multinational accounts.
- The bank has developed ties with the local communities and with the central bank. A large chunk of the workforce consists of locals. It also has a reputation for commitment, which makes it popular with the governments. The first mover advantage, coupled with the intent to stay, shows the bank's eagerness to help the financial services industry. It could gain favour in the local markets by gaining political leverage from the central bank. This has helped it tremendously in Taiwan, and in Thailand.
- It is perceived to be strong in corporate banking services. It has been able to innovate constantly on these products, both technologically and financially. This has been proved, both in developed and developing economies, and has been the reason why it has performed extremely well against the local competition. This has been acknowledged with several awards for its services.

- The human resource practice in China, which the bank has steadily developed over the years, is a commanding advantage over the other players. This is true even in Asian markets as a whole. The people who work in Citibank are poached upon by others.
- The advantage in Asia, which Citibank offers, is through its audit and accounting practices. PBOC had worked with Citibank for its internal auditing purposes. It is used as a benchmark for the Chinese local banks. However, this advantage is not long term in nature, as it can easily be copied by other banks.
- Citibank could serve companies which were pursuing aggressive overseas growth strategies, through its competency in the emerging markets. The global relationship banking division is wholly concentrated on this factor.
- The bank has been traditionally against joint venture, unless required under the regulations. The bank is more comfortable with the acquisition strategy as this enables the bank to focus on long term benefits rather than short term ones as offered by joint ventures. There are problems, such as branding, which will remain, but will help strengthen its position as a committed foreign presence.

Unique Strategy for China

The strategy for China is the embedded bank strategy. Through this strategy, it seeks to build the customer base, by offering the products and associating itself with the community. The various initiatives in this aspect include micro finance, affordable housing and small business development programs. It is facing a new set of challenges and opportunities, with China entering the WTO. Some of these issues include how to retain the advantage of being in the Chinese market for so long. China represents a great opportunity and Citibank shows how to capitalise on this spread of globalization.

Note: This case has been written on the basis of published sources mentioned below:
The perspectives and views presented in this case are not necessarily those of Citigroup
or any of its employees.

Sources: David W.Conklin, "Citigroup in Post-WTO China", Ivy Management Services, Richard Ivey School of Business, 9A97G016, Citigroup Annual Reports 2001 and 2002, Young and Cocklin, Citibank N.A in China, Richard Ivey School of Business, Case 9A97G016

Question

How did the China's entry to the WTO system facilitate Citigroup's business?

Objective Type Questions

1. Which of these are NOT agreements under WTO?
   (a) Agreement on Agriculture
   (b) Agreement on Textiles and Clothing
   (c) General Agreement on Trade in Services
   (d) Agreement on Technical Barriers to Trade
   (e) All of the above
   (f) None of the above
2. State True or False
   WTO helps to promote peace

3. State True or False
   Freer trade cuts the costs of living
4. Under Agreement on Agriculture, which are NOT the provisions for Domestic Support?
   (a) The Base Year is fixed at 1996–98.
   (b) Developed countries to reduce the domestic support by 20% over 6 years.
   (c) Developing countries to reduce domestic support by 13% over 10 years.
   (d) All of the above
5. What are the different ways for providing international services, as defined in GATS?
   (a) Cross border supply
   (b) Consumption abroad
   (c) Commercial Absence
   (d) Presence of Natural Persons
6 What are the implications of according 'Most Favoured Nation' under WTO?
   (a) Every signatory will extend to every other signatory member, the same and equal treatment in a non-discriminatory manner.
   (b) One country will be chosen as the most favoured nation.
   (c) No countries can be chosen as most favoured nation.
   (d) All of the above.
7 What are the provisions under WTO for Quantitative Restrictions?
   (a) Quantitative Restrictions may be set on grounds of Balance of Payment difficulties.
   (b) The countries are to set higher limits of QRs to curb imports.
   (c) This is the same as custom duties.
   (d) The limits for QRs are to be increased every year by developed countries.
8. As per GATS, a foreign company setting up subsidiaries or branches to provide services in another country is officially termed as:
   (a) Commercial presence (b) Cross border supply
   (c) Consumption abroad (d) None of these
9. As per WTO requirements, patents are for ____________ years.
   (a) 20 (b) 15 (c) 14 (d) 10
10. The following is the scope of GATS
    (a) Cross border supply
    (b) Consumption abroad
    (c) Commercial presence or presence of natural persons
    (d) All of the above
11. Trade Related Investment Measures (TRIMS) doesn't apply for
    (a) Measures that affect trade in goods.
    (b) Measures that lead to restrictions in quantities.
    (c) Discouraging measures that limit a company's imports.
    (d) Discouraging measures that limit a company's exports.
12. MFA was replaced on 01 January 1995 by
    (a) AOA (b) ATC (c) GATS (d) TRIMS

Review Questions

1. Discuss the Agreement on Agriculture and its implications.
2. Discuss the Agreement on Textiles and Clothing (ATC) under WTO framework.
3. WTO rules make life easier for all. Do you agree with the statement? Why?
4. Discuss the arguments for and against India's membership of WTO.
5. What is meant by Removal of Quantitative Restrictions on imports?

Class/Field Exercise

Watch videos available on WTO site-www.wto.org (Resources/webcasting section), research on WTO and analyse the implications on business environment and opportunities.

Ref: 1. International Marketing by Paul & Kapoor, TMH
3. International Business, Justin Paul, PHI

References

1. Anne O. Krueger (1998), The WTO as an International Organisation, Oxford University Press.
2. Arun Goyal (2001), WTO in the New Millennium, Academy of Business Studies, New Delhi.
3. John D. Daniels, Lee H. Radebaugh (1999), International Business, Addison-Wesley Publication.
4. Narasaiah M.L (2001), World Trade Organisation and The Developing Countries, Discovery Publishing, New Delhi.
5. Pandu Ranga Rao D (ed), WTO & Competitiveness, Excel Books, New Delhi.
6. Justin Paul (2005): International Business, Second Edition, Prentice Hall of India, New Delhi.
7. Website: www.wto.org
8. Website of SAARC

Answers

Objective Type Questions

1. (e)	2. True	3. True	4. (a), Base year 1986–88
5. (c) Commercial presence and Not absence	6 (a)	7 (a)	8. (a)
9. (a)	10. (d)	11. (b)	12. (b)

Chapter 17

India's Trade Policy

Learning Objectives

- to discuss the salient features of changes in trade policy in India
- to understand the issues in foreign trade
- to explain the sector-wise trade policies

Chapter Structure

This chapter examines the changes in the Indian business environment with reference to foreign trade. In particular, it analyses the aspects of economic reforms and tracks the changes in sector wise trade policy over the recent years. The successive governments of the 1990s have followed a uniform policy pattern and though not remarkable, the trade performance has been encouraging. The discussion attempts to show the many efforts that have been made to open up a number of sectors as part of trade liberalisation. Primary reference sources for this chapter are the Ministry of Commerce publications, such as EXIM Policy documents, and annual reports of the government of India.

This chapter is divided into seven sections. Section 1 deals with policy changes, issues and impediments to growth of India's foreign trade. Section 2 looks at the sector wise trade policy perspectives. The background, process and implications of removal of Quantitative Restrictions (QRs) have been discussed in section 3. Section 4 lists special provisions in the WTO agreement while in section 6, salient observations have been drawn form the discussion in the chapter.

SECTION 1: POLICY CHANGES AND ISSUES

With the establishment of World Trade Organisation (WTO) on Jan. 1, 1995, and its attempts to promote free trade, exports and imports have become most important factors in the process of industrialisation of the developing countries.[1] As cited in the earlier chapters, India has taken important policy initiatives since July 1991 to emerge as a significant player in an increasingly inter dependent world economy. The eighth plan recognised that for India, it was not a choice between market mechanism and planning, but that the challenge was to effectively combine the two so that they are complementary to each other. Therefore, the government introduced major reforms to provide greater competitive stimulus to trade and industry. India continued economic reform process with an increased emphasis on improving its industrial production. India's financial services are gradually being liberalised while significant headway has already been made in liberalising telecommunications sector. Other services, such as ports and air, have also been opened up, but private participation remains relatively low. Further, significant administrative barriers still remain in the way of foreign participation. As per the WTO decision, India has already removed the Quantitative Restrictions prevalent on 1429 tariff lines of imports in two stages (on April 1, 2000 and April 1, 2001).[2] Most of the items have been placed under the Open General License (which means the items are freely importable and exportable), after shifting them from Special Import License category (For instance, many FMCG items have been placed under OGL from SIL in EXIM policy 2002–07). Similarly, India has simplified its foreign investment procedures and opened up a number of sectors to foreign direct investment. This aspect is particularly in the case of manufacturing sector where foreign participation can take place automatically upto 51% (in some sectors) or 74% (in case of others). Production in the food-processing sector has grown rapidly following an increased foreign investment. In this sector, upto 50 and 100 per cent participation is allowed automatically to foreigners and non-resident Indians respectively. In the automobile sector, 51 per cent foreign equity participation is granted automatically. Further, upto 100 per cent foreign equity participation is also allowed, if approved by government authorities. This has triggered a high rate of foreign investment, mostly through joint ventures with Indian manufacturers.

1. EXIM Bank, Occasional Paper No. 70, September 1999.
2. Leena, George, Impact of New EXIM Policy, Yojana, June, pp 15-16.

India's share of world exports has drastically declined from 2.53% at the time of Independence to around 0.7% in 2000. This adverse trend can be attributed to the fact that though multilateral negotiations conducted under the aegis of GATT have greatly helped in bringing down tariffs all over the world, similar success has not been achieved on Non-Tariff Barriers. As a matter of fact, quantitative restrictions are not overtly being used by most of the countries to restrict the flow of trade. On the other hand, many countries use standards, subsidies, anti-dumping/countervailing duty as important Non-Tariff Barriers (NTBs) to restrict the flow of trade from countries like India.

There are numerous restrictions on sanitary and phyto-sanitary grounds on India's agricultural products, which are often not supported by adequate scientific justification. Even the environmental bans, like that on Indian marine products harvested without certain environmental protection devices, insisted on by certain trading partners, do not appear to be substantiated by sufficient scientific explanations. The restrictive visa regime in several developed countries has proved to be a disincentive for exports in the services sector, especially in the software sector. Repeated anti-dumping investigations on same items without regard to the special dispensation enshrined in Article 15 of the Agreement on Anti-dumping, have proved to be extremely disruptive to India's prospects.

India has vigorously addressed these problems in the appropriate fore, including the Dispute Settlement Body. Although exports have grown at remarkable rate in the recent past, a slow-down in exports, with consequent widening of the trade gap, could work against its efforts to bring down tariffs. Other important aspects are discussed subsequently.[3]

Bindings

Under the Uruguay Round, India had bound 67% of all its tariff lines, whereas prior to that, only 6% of tariff lines were bound (Bound rates are rates of customs duty 'bound' or fixed at a certain level beyond which the duty cannot be raised. Thus, they are ceilings on tariff rates). The bound rates range from 0 to 300% for agricultural products and from 0 to 40% for other products. Manufactured products were bound at 25% duty in case of intermediate goods and 40% on finished goods. The country is in the process of renegotiating some of its tariff bindings. However, many applied tariffs are below the levels of Uruguay Round agreement.

International Standards in Trade and Industry

There is a greater emphasis on raising the local standards to international levels. The Bureau of India Standards (BIS), responsible for formulating and setting national standards, has been harmonising Indian standards with international standards for the last decade. So far, nearly 3,500 Indian standards have been harmonised with ISO (International Standard Organisation) standards/regulations. Although BIS is the body of national standards of India, standards and certification schemes are also operated and enforced in certain specified sectors by other bodies. For example, Director of Marketing regulates sanitary and phyto-sanitary measures and the Ministries of Health and Food Processing deals with inspection, quality and hygiene of processed foods. The BIS and other expert bodies in the field of sanitary standards participate in the policy-making committees of international bodies such as the International Standard Organisation (ISO). The developing countries are notably outnumbered in the

3. Ministry of Commerce, EXIM Policy Document, 1999 and 2000.

deliberations, at times resulting in stipulation of standards not in tune with their potential. Further, countries like India do not have the access to technologies developed abroad for achieving standards acceptable to importing countries.

Intellectual Property Rights

Developing countries, including India, availed the transition periods provided under Article 65 of the Trade Related Intellectual Property Rights (TRIPS Agreement) to meet their obligations. India has implemented product patent system recently (shift from process patent regime) to comply with the WTO requirement. The 1994 amendments to the Copyright Act of 1957 provide protection to all original literary, dramatic, musical and artistic works, cinematographic films and sound recordings. The most recent changes bring sectors, such as satellite broadcasting, computer software and digital technology, under Indian copyright protection.

Anti-Dumping and Safeguards

Anti-dumping and countervailing duties are imposed under the Customs Tariff Act 1975. The Act and Rules are on the lines of the respective GATT agreement on anti-dumping and countervailing duties. The designated authority strictly follows the time limits and the procedures prescribed under the Indian laws/GATT agreement. Government introduced Section 8 (B) of the Customs Tariff Act, 1975, for the imposition of safeguard duties as per the provisions of the WTO Agreement on Safeguards. The Act provides for the imposition of safeguard duties on products being imported in increased quantities, which may cause serious harm to the domestic industry that directly or indirectly produces a competitive product. The Director General of Safeguards has been appointed to consider complaints received from domestic industry, which is adversely affected from the increased imports, for the imposition of safeguard duties.[4]

Environment

With the rapid surge in international trade and the consequent increase in cross-border movement of products, the linkage between trade and environment has become a relevant issue for the international community. GATT/WTO, being the chief body addressing issues dealing with international trade, has taken cognisance of this point. Already certain agreements within WTO, like the Agreement on Technical Barriers to Trade and the Agreement on sanitary measures, have addressed the environmental issues to a considerable extent.

India's approach on the issue of the relationship between trade and environment has covered two aspects, namely:

(a) International rules should not create unnecessary or unjustifiable obstacles to international trade;

(b) There has to be a clear recognition that environmental standards differ from country to country and that the solution lies in mutual recognition of product-related standards.

4. *Source:* Focus WTO, IIFT Journal, Special Issue on Anti-Dumping.

Information Technology (IT)

During the Singapore Ministerial Conference in 1995, a ministerial declaration on 'Trade in Information Technology Products' was adopted. The declaration aims at expanding world trade in the said products. India participated in the negotiations right from the early stages. Further, after examining the implications of the Information Technology Agreement (ITA) and extensive discussions with trading partners, India joined as a participant on April 1, 1997. India is committed to phasing out import tariffs on the products covered in the agreement. At the same time, India had also raised the issue during multilateral discussion that if the global information technology infrastructure were to be strengthened, the rules for mobility of skilled persons should also be liberalised.

Regional Trade Arrangements

India was quite instrumental in setting up the South Asian Association for Regional Cooperation (SAARC). The major achievement was the conclusion of the negotiations on trade preferences within the framework of the South Asian Preferential Trading Arrangement (SAPTA). SAPTA became operational on December 7, 1995 and it includes preferential tariff concessions on 226 items and product groups. Meanwhile, SAFTA (South Asian Free Trade Area) has also been launched (2005). Cooperation is expected in trade facilitation, liberalisation, promotion of foreign investment, promotion of scientific and technological cooperation, tourism, mobility of persons and service providers, and the development of infrastructure and human resources. An enabling clause to identify other areas of cooperation is also included in the Agreement. Also, India has signed bilateral agreements with neighbouring countries, like Bhutan and Nepal, by providing them preferential access. Commonwealth preferences continue to be extended to Mauritius, Tonga and the Seychelles.

SECTION 2: SECTOR-WISE TRADE POLICIES: RECENT DEVELOPMENTS

Agricultural Sector

The agricultural sector has remained relatively untouched by the reform programmes except the thrust given in the Export-Import Policy 2002–2007. Some progress has also been made in terms of the removal of: (i) controls on the inter-state movement of certain grains and (ii) administered prices. However, controls on the export and import of certain products remain. The government of India has identified potential commodities in various states and Agricultural Export Zones (AEZ) have been set up in order to promote exports.

Food Processing Sector

In the food processing sector, tariff reforms have resulted in the average duties being halved since 1993 (currently, ranging between 15 and 25 per cent). Import licensing restrictions have also been removed. The food processing sector has witnessed increased foreign investment, wherein upto 51 and 100 per cent of participation is allowed automatically for foreigners and non-resident Indians respectively.

Mining and Petroleum Sector

India heavily depends on the import of petroleum. Prices, until recently, were administered but the government has recently placed an emphasis on increased oil exploration domestically to reduce import dependence and is encouraging new explorations by offering investment incentives like tax holidays to companies.

Major policy changes since 1991 include automatic permission for foreign equity participation in the mining activity of 13 minerals. However, the Foreign Investment Promotion Board (FIPB) must approve foreign equity participation in case of over 50 per cent share of participation. Trade reforms include a reduction in tariff rates to around 10 per cent (from 46 per cent in 1993–94) for non-ferrous and iron ores and 13 per cent (from 65 per cent in 1993–94) for coal.

Manufacturing Sector

Reforms have been implemented in the manufacturing sector, including (i) reductions in average tariff rates, (ii) removal of import licensing restrictions, (iii) relaxations in compulsory industrial licensing, and (iv) liberalisation of foreign investment policies. The rules governing foreign investment have also been considerably simplified with an enlarged list of industries, including the automobile sector. (See the website of Engineering Export Promotion Council).

Services Sector

Services sector contributes more than 50% of India's national income. Its overall growth has been fueled by rapid expansion of activities in the area of finance, information technology, commerce and tourism. The software, BPO and KPO sectors have contributed to the growth of the Indian economy in the recent past. Global outsourcing of services has been an important segment of the service sector for many years. Steps have been taken in liberalising telecommunications sector. Many value-added services-including cellular mobile telephone—are now open to foreign equity participation. In the area of financial services, the insurance sector that had been monopolised by the government till, now has been made open to domestic private investors and foreign tie-ups. Under the Financial Services Agreement, the government has offered to remove restrictions on foreign firms in the banking sector.

India has a large pool of well-qualified professionals capable of providing services abroad. GATS (General Agreement on Trade in Services) recognises "movement of natural persons" as one of the modes for supply of services. However, the commitments shown by the developed countries have very little to offer to the developing countries. The present commitments are largely restricted to business visitors and intra-corporate transferees.

SECTION 3: REMOVAL OF QUANTITATIVE RESTRICTIONS (QRS) ON IMPORTS

QR Removal* and Foreign Exchange Reserves

Quantitative Restrictions (QRs) refer to limits set by countries to restrict imports (or exports). These

*Note: QR System is also known as Quota system, which the government have been administering through the Special Import Licence, Restricted list, Prohibited list and Canalised list.

are generally in the form of quotas, licensing requirements or in the form of canalising of imports—i.e., allowing only a few players or entities to import specific things. QRs are thus measures, other than tariffs or duties, imposed to restrict imports (or exports). Under the GATT, imports have to be controlled only through tariffs or customs duties. There are, however, some exceptions to the rule. One exception is that a country can take recourse to QRs on grounds of Balance of Payments (BoP) difficulties. It was under this exception that India had maintained QRs. Till 1993, India's BoP situation had been quite unhealthy. Since 1994-95, there has been steady improvement in the BoP status as indicated by foreign exchange reserves position of the country. This aspect can be observed from Table 17.1.

Table 17.1 Foreign Exchange Reserves and Total Imports in India

Year ending on	Total Foreign Exchange Reserves (Billion US $)	Total imports during the year (Billion US $)
31st March 1993	9.8	21.88
31st March 1994	19.3	23.31
31st March 1995	25.2	28.65
31st March 1996	21.7	36.68
31st March 1997	26.4	39.13
31st March 1998	29.4	41.48
31st March 1999	32.5	42.39
31st March 2000	38.0	42.20
31st March 2001	47.4	46.5
31st March 2002	54.1	51.4
31st March 2003	75.4	59.4
31st March 2004	112	75.3

Source: Compiled from Handbook of Statistics on Indian Economy, RBI, Mumbai, 2002 & RBI Annual Report 2004–2005.

Table 17.1 presents the data on India's foreign exchange reserves and total imports for the period 1993 to 2004. From the table, it can be noted that foreign exchange reserves became quite healthy over the years as compared to the trends in India's total imports. With the improvement in the balance of payments position in the mid 1990s, in general, members of the WTO raised question about India's need to continue Quantitative Restrictions.

By 1997, India had negotiated with most of the trading partners, to arrive at a mutually agreeable solution for phasing out the QRs. Under the Agreements, the QRs were to be withdrawn over a six-year period ending 31st March 2003. USA, however, felt that the period was too long and filed a dispute against India with the WTO. The Dispute Settlement Body of WTO, which was constituted in November 1997, gave its adjudication against India. Although India filed an appeal before the Appellate Body of WTO against the verdict of the panel, they upheld the findings of the dispute settlement body. Accordingly, QRs on the 1429 tariff lines were removed by 1st April 2001 under the agreement (of which QRs on 714 were removed with effect from 1st April 2000).

Phased Removal of QRs

India had been following consistent policy for gradual removal of restrictions on imports ever since the economic reforms were initiated. There used to be a fresh list of items allowed for importing under OGL (Open General License) every year. The process gathered momentum during the second half of 1990s. Year-wise details on type of non- tariff barriers and progress towards their removal is given in Table 17.2. As given in the table, on 31 March 1997 import of 6649 tariff lines (as per Harmonised System of India Trade Classification) out of total number of 10,202 was already free. It can be further seen from the table that consequent to improvement in Balance of Payment (BoP), import restrictions on 488 tariff lines were removed in 1996–97, 132 in 1997–98 and 1274 in 1998–99. The process of removal of import restrictions on BoP grounds completed on 31.3.2001 (as cited earlier in the chapter).

Table 17.2 Different Types of Non Tariff Barriers (NTB) imposed on India's imports (1996–97 to 2001–02*)

NTB/Year	1.4.1997	1.4.1998	1.4.1999	1.4.2000	1.4.2001
Prohibited	59	59	59	59	59
Restricted	2322	2314	1183	968	479
Canalised	129	129	37	34	—
SIL	1043	919	886	226	—
Free	6649	6781	8055	8854	9611**
Total	10202	10202	10220	10141	10149

Source: Indian Economic Survey 2001–02, Government of India, Page 142.
*As per Harmonised System of India Trade Classification, HS-ITC classification of export & import.
**Including 29 tariff lines, which are shifted to state trading.

India's imports have been progressively liberalised. The level of tariff lines, which were made 'free import' category, as on 1.4.1996, was 61%. This percentage has increased to around 95 per cent as on 1.4.2001. Action has been completed on removal of restrictions on tariff lines (2714 items), and has been notified to WTO under the BoP cover. Table 17.2 shows that the number of freely importable tariff lines had increased from 6161 to 9611 as on 01.04.2001 over a period of five years from 1996. There were 2,984 tariff lines under the restricted list on 01.04.1996, which got reduced to 1183 on 01.04.1999, 968 on 01.04.2000, and finally 479 on 01.04.2001. Further, Special Import License (SIL) has become part of history with effect from 01.04.2001. QRs are, however, still being maintained on about 5 per cent of tariff lines (538 items) as permissible under Article XX and XXI of GATT on grounds of health, safety and moral conduct.

Removal of QRs: Implications

With the removal of QRs on imports into India, consumers benefit as they get a wider choice of goods and services at a lower cost. Secondly, freer trade brings down prices and helps in keeping the level of inflation low as an advantage to the society. Thirdly, the government gets revenue from customs duties on imports—e.g. things, which were being bought in the markets abroad and brought into the country through undisclosed channels, can be brought through legal channels, thus generating revenue for the country. (A case in point could be that of freeing of gold imports, which has resulted in gold now being imported through legal channels, resulting in substantial revenue earning through customs duty for the government). Fourthly, it would lead to easier access to imported raw materials and capital goods for the domestic manufacturers leading to faster industrial growth. Finally, competition from imports can lead to upgradation in the quality of even domestic products and increased productivity.

As mentioned above, removal of quantitative restrictions will have an impact on prices. When the movement is from regulated regime to free trade environment, imports increase and the market share of domestic producers tend to decline. With the increase in imports, there is a possibility of the domestic prices being depressed to the advantage of consumers. Competition from imports can lead to an increase in the quality of even the domestic products. However, it is widely suggested that Indian industry has to be on a sound footing to face the competition from the rest of the world, especially from the MNCs. A large number of companies may sink and others, who are quality-conscious and competent, may emerge as leaders.

The reservation of items for the Small Scale Industry sector has become meaningless after the lifting of quantitative restrictions on imports. On this ground, many people have generally expressed the concern for the small enterprise development in India. However, government's decision to reduce customs duties on a host of inputs used in the manufacture of final products by the small-scale sector is expected to improve its price competitiveness. It may, thus, help the industry to compete against cheaper imports, particularly from countries like China.

As a matter of fact, in order to offset the adverse implications of removal of QRs, duties on some items have been revised upwards to safeguard the interests of the domestic industry.

The applied rates of duties have also been raised to the bound levels for most of the items. India has generally bound its tariffs on primary agricultural commodities at 100%; on processed items at 150% and on edible oils at 300% and can raise its applied rates in case of any surge in imports. But import duties have to be fixed keeping in mind domestic availability of the goods under consideration and also the interests of the consumers.

SECTION 4: SPECIAL PROVISIONS IN THE WTO AGREEMENT

There is need for balance between the interests of the consumers and that of the domestic producers, which has to be maintained by government. For this purpose, WTO has made special provisions based on which the member countries will have to take action. The relevant points in this regard are given in the Chart 17.1.

Chart 17.1 shows the special provisions in the WTO agreement and the special actions, which can be taken by the member countries. For example, WTO permits a member country to raise the applied tariff at any time, provided they do not exceed bound rates (Provision 1 in the chart). Similarly, according to the chart, Article VI of GATT permits for imposition of anti-dumping duties, if an imported product is sold at less than its normal value. Also, article XIX of GATT allows countries to impose countervailing duties, if exporting country subsidises a product and the product causes material injury to domestic industry.

Chart 17.1 Special Provisions and Permitted Actions in the WTO Agreement

Provision in the WTO Agreement	Permitted Action
1. Tariff protection	Applied tariff can be raised at any time provided they do not exceed bound rates
2. Article VI of GATT and Agreement on implementation of Article VI (Anti-dumping Agreement)	Anti-dumping duties can be imposed if a product is dumped in the importing country at less than its normal value provided it causes material injury to domestic industry.
3. Article VI of GATT and Agreement on Subsidies and Countervailing Measures (ASCM)	Countervailing duties can be imposed if the exporting country subsidises a product provided it causes material injury to domestic industry.
4. Article XIX of GATT and Agreement on Safeguards	Safeguard action (Imposition of duties or temporary QRs) can be taken when there is a surge in imports causing or threatening to cause serious injury to domestic industry.
5. Article XX of GATT	As a general exception, measures can be taken to protect human, animal or plant life or health; to protect public morals; conservation of exhaustible natural resources etc.
6. Article XXI of GATT	Measures can be taken under security exceptions.
7. Article XVIII: B of GATT	QRs can be imposed whenever Balance of Payment position deteriorates

Source: Compiled from EXIM Policy Document 2001 and 2002, Government of India.
Note: Bound rates are rates of customs duty "bound" or fixed at a certain level, beyond which the duty cannot be raised. Thus, they are ceilings on tariff rates.

Chapter Summary

The salient observations emerging from the different discussion points, covered in the chapter, are listed below:

(i) Though the negotiations conducted under the aegis of GATT and WTO have helped in reducing tariff rates, many countries use Non-tariff barriers such as standards and countervailing duties to restrict the flow of trade. This aspect continues to hamper the prospects of India's export performance.

(ii) Quantitative Restrictions on imports of 95% tariff lines have been removed as part of trade liberalisation in India. Also, the customs duties on most of the items have been brought down. At the same time, there is special emphasis on export promotion activity, according to the EXIM policy. These policy measures have been expected to have significant impact on the industrial sector in the country.

(iii) While trade liberalisation measures have gained significant momentum over the recent years, there is also a need for maintaining balance between the interests of consumers and domestic producers. Taking this aspect into account, the government has to monitor the price and quantity of commodities being imported. This necessitates that the government resorts to appropriate action, on the basis of special provisions and permitted actions in the WTO agreement.

Case

Finolex's Focus on Exports

Pune-based Finolex is the market leader in the Indian cable industry providing a range of products. The main activity of the company is to manufacture and market cables that are used in wide range of electrical and telecommunication applications. With more competitors entered into the market, the company suffered a major setback from dwindling demand for its jelly-filled telephone cables (JFTC). As a result, production of communication cables was of 3,154 TCKM (Thousand Crore Kilometres) against production of 6,674 TCKM in 2001–02. The sales were lower primarily due to substantial reduction in the procurement quantity of JFTC by its major customer, Bharat Sanchar Nigam Limited (BSNL).

The top management of the company was earlier happy with the sales in the domestic territory. The company carried out international market research and came to know about the opportunities for sales in overseas markets because most of the countries had opened up their economies and liberalised imports. To overcome domestic stagnation in demand for JFTC, they started exporting this product into foreign countries. The product has been according higher attention in the international markets in the recent years.

Question

Discuss the reasons for formulating export business plan by Finolex cables.

Source: Economic and Political Weekly, January 17, 2004 and Website of Finolex Group.

Objective Type Questions

State True or False

1. Removal of QRs does not mean duty free imports.
2. WTO stands for World Trade Officials.
3. Consortiums are developed to pool financial and managerial resources, and to lessen risks.
4. Exporting can either be direct or indirect.
5. All imported goods are subject to payment of custom duty/additional customs duty or tariff.
6. Globalisation brings with it many new technologies.
7. World Trade organisation was formed in 1995, with General Agreement on Tariffs and Trade (GATT) as its basis.
8. It is the government generally, but on few occasions, an individual firm can also fight antidumping directly with WTO.
9. Quantitative restrictions are imposed by countries primarily to limit imports.
10. Bound rates are maximum tariffs imposed by member countries of WTO.

Fill in the Blanks

1. Nearly 3,500 Indian Standards have been harmonised with ____________ standards/regulations internally.

2. During the ___________ ministerial conference of WTO in 1995, a declaration on 'Trade in IT products' was adopted.
3. ___________ sector contributes more than 50% of India's national income.
4. Export Promotion Capital Goods scheme is known as ___________.
5. DEPB stands for Duty Entitlement ___________ Book scheme.

Review Questions

1. Discuss and debate the issues and impediments to growth of India's foreign trade.
2. Analyse the sector-wise trade policies in India.
3. What do you understand by the term 'Removal of Quantitative restrictions'?

Class/Field Exercise

1. Visit the website of Ministry of Commerce Government of India, http://commerce.nic.in, and analyse the importance and implication of latest foreign trade policy.
2. Visit the website of inistry of Commerce, Goverment of India http://commerce.nic.in/trade/international_ta.asp
   http://commerce.nic.in//trade//international_ta_indasean.asp
   Discuss the impact of India's Free Trade (FTA)/Preferential Trade Agreements (PTA) with other countries including with the ASEAN.

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Answers

True or False

1. True	2. False	3. True	4. True	5. True	6. True
7. True	8. True	9. True	10. True		

Fill in the Blanks

1. ISO	2. Singapore	3. Service	4. EPCG	5. Passbook

Chapter 18

External Sector—BoP, Currency Convertibility, ADR-GDRs and FEMA

Learning Objectives

- to learn the meaning of the terms like Balance of Payment and 'Capital Account Convertibility'
- to distinguish between ADRs and GDRs
- to understand the changes in FEMA, over FERA
- to study the recent policy changes in the external sector

Chapter Structure

Section 1: Balance of Payment, Current and Capital Account Convertibility

Section 2: ADR and GDR

Section 3: Foreign Exchange Management Act

Section 4: Recent Policy Changes

Case: The 1997 Collapse of the Thai Baht

The crossing of the 140 US$ billion mark in India's Foreign Exchange reserves has triggered a debate on whether the *time is ripe for the country to go in for Capital Account Convertibility (CAC)*.

Lets us start by defining the concepts: Balance of payment record of a country has two accounts (a) Current Account, (b) Capital Account. While Current account in the balance of payment record consists of mainly exports and imports, Capital account refers to financial investments, deposits and loans. However, current account includes invisible items viz, receipts and payments for services such as travel, insurance, transportation etc.

SECTION 1: BALANCE OF PAYMENT (BOP), CURRENT AND CAPITAL ACCOUNT CONVERTIBILITY

The term **'Balance of Payment'** refers to the yearly financial statement of a country for the transactions in the external sector with the rest of the world. The BoP table has got two sides viz, credit and debit, hence it can be conceptualised as 'balance sheet' of the country with the rest of the world.

Currency convertibility means freedom for withdrawal of foreign exchange from authorised dealers for payment abroad. Full current account convertibility refers to the permission to withdraw foreign exchange without ceilings for the transactions listed under the current account of the BoP table. So as the meaning of Capital Account convertibility, for example, India is yet to implement full Capital Account convertibility. But, the country has adopted partial capital account convertibility and liberal current account convertibility systems, which means the Reserve Bank has fixed ceilings on withdrawal of foreign exchange for the transactions falling under the capital account (See Table 18.1 for understanding the items under current and capital accounts. The data on the Balance of Payment for India pertaining to 2004 are given in Table 18.1). The data show that there has been US$ 6431 million deficit in the current account and surplus of US$ 32175 million in the capital account. Overall, there has been surplus of US$ 26,159 million in the Balance of Payment statement of India in 2004–05.[1]

The **capital account** is an accounting measure of the total domestic currency value of financial transactions between domestic residents and the rest of the world over a period of time. Capital account can be divided into three categories:

(i) Direct Investment

FDI is the investment by foreign companies in real assets like building, factories and so on, to take advantage of various market imperfections. However, equity stake, which is 10% or more by a foreign company has also been considered as part of Foreign Direct Investment inflow in many countries (as defined by US Department of Commerce).

(ii) Portfolio Investment

FII is the investment by foreign financial assets such as stocks and bonds that do not involve a transfer of management control.

(iii) Other Capital Flows

Represent claims with a maturity of less than one year and include bank deposits, short-term loans, short-term securities, money market investments and so on.

1. Reserve Bank of India Bulletin, December 2005.

In other words, 'capital account transactions' include investment by residents in shares, debt securities, branches or subsidiaries of parent firm abroad, investment in real estate abroad by residents, repatriation of foreign investment and non-resident deposits, loans to non-residents etc.

According to ***Tarapore Committee report*** on capital account convertibility to the Reserve Bank of India: *Capital account convertibility is the freedom to convert local financial assets into foreign financial assets and vice-versa at market determined rates of exchange. It is associated with changes of ownership on foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on or by the rest of the world. Capital account convertibility can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions, which are of a prudential nature.*[2]

The old law on foreign exchange—the Foreign Exchange Regulation Act, 1973—controlled all the foreign exchange transactions, regardless of the quantum. Unmindful of the expensive international travel costs, it allowed only up to $250 per day and many transactions required the blessings of the RBI, some capital account transactions requiring multiple approvals at different stages. The law had draconian penal provisions and was quasi-criminal in nature. The Foreign Exchange Management Act, 1999 (FEMA) changed the very focus of the exchange control law. From one of 'controlling' and 'permitting', it was conceived of as a piece of legislation 'to facilitate' external payments and promote the orderly development of the foreign exchange market.

Approaches to the Capital Account Convertibility

There are three different ways to implement Capital Account Convertibility.[3]

1. The opening up of the capital account based on distinctions between residents and non-residents (an approach followed by India).
2. Initially opening the inflow side and later liberalising outflows (same as (i) but the opening up is not restricted between residents and non-residents).
3. An approach that simultaneously liberalises controls of inflows and outflows (an approach followed by Argentina, Peru, and Kenya).

Table 18.1 India's Overall Balance of Payments in Dollars

(*in US$ Million*)

Items / Year 2004–05	2004–05 Credit	Debit	Net
1	2	3	4
A. CURRENT ACCOUNT			
I. MERCANDISE (Exports Receipts & Import Payments-Goods)	**80831**	**118961**	**–38130**
II. INVISIBLES (a + b + c)	**77500**	**45801**	**31699**
(a) Services			14630
(i) Travel			–497
(ii) Transportation			509
(iii) Insurance			294

(*Contd.*)

2. Sourced from Tarapore Committee Report on Capital Account Convertibility submitted to Reserve Bank of India.
3. ADB Institute (2000): Policy Recommendation, for Preventing Another Capital Account Crisis.

(*Contd.*)

(iv) G.n.i.e			142
(v) Miscellaneous			14182
of which: Software Services			16626
(b) Transfers			21048
(i) Official			589
(ii) Private			20459
(c) Income			–3979
(i) Investment Income			–2848
(ii) Compensation of Employees			–1131
Total Current Account (I + II)	**158331**	**164762**	**–6431**
B. CAPITAL ACCOUNT			
1. Foreign Investment (a + b)	**46150**	**34206**	**11944**
(a) Foreign Direct Investment (i + ii)			3037
(i) In India			5526
Equity			3353
Reinvested Earnings			1816
Other Capital			357
(ii) Abroad			–2489
Equity			–1408
Reinvested Earnings			–700
Other Capital			–381
(b) Portfolio Investment			8907
In India			8907
Abroad			—
2. Loans (a + b + c)	**30831**	**19170**	**11661**
(a) External Assistance			1922
(i) By India			–104
(ii) To India			2026
(b) Commercial Borrowings (MT & LT)			5947
(i) By India			1034
(ii) To India			4913
(c) Short Term To India			3792
3. Banking Capital (a + b)	**24306**	**20304**	**4002**
(a) Commercial Banks			4107
(i) Assets			2619
(ii) Liabilities			1488
of which: Non-Resident Deposits			–1067
(b) Others			–105
4. Rupee Debt Service	**—**	**417**	**–417**
5. Other Capital	**9147**	**4162**	**4985**
Total Capital Account (1 to 5)	**110434**	**78259**	**32175**
C. Errors & Omissions	**415**	**—**	**415**
D. Overall Balance	**269180**	**243021**	**26159**
(Total Capital Account, Current Account and Errors & Omissions (A + B + C)			

Source: Compiled from Reserve Bank of India Bulletin, December 2005, Vol. LIX No.12, Page S 1068.

Advantages and Disadvantages of Full Convertibility in Capital Account

The advantages and disadvantages of full capital account convertibility can be specified at follows:

Advantages[4]

- Corporates are allowed to freely open offices abroad for promoting their businesses.
- Banks are allowed to borrow from overseas market and deploy their funds outside India. This will strengthen and result in the growth of Indian banks.
- Individuals are allowed to invest in assets in financial markets abroad, which will encourage investments.
- Greater confidence levels of global investors in India.

Disadvantages

- While convertibility is generally beneficial, it also greatly heightens a country's vulnerability to reversals in capital flows that can precipitate severe currency and balance of payments crisis.
- The composition of capital flows must also be closely monitored, otherwise it can undermine the very purpose of the capital account convertibility.
- In 1996, five Asian economies (South Korea, Indonesia, Malaysia, Thailand and the Philippines) received net private capital inflows amounting US$ 93.0 billion. One year later (in 1997), they experienced an estimated outflow of $105 billion, amounting to more than 10 per cent of the combined GDP of these economies! Consequently, three of these economies (Indonesia, Thailand, and South Korea) are mired in a severe economic crisis, the magnitude of which would have seemed inconceivable even to the most knowledgeable and insightful observers of the region.

SECTION 2: ADR AND GDR

In the backdrop of the looming foreign exchange crisis in India in 1990–91, the government launched a number of liberalisation measures aimed at globalising the Indian economy. These included facilitation of External Commercial Borrowings and raising of resources for Indian companies from external markets. The Foreign Exchange Regulation Act (FERA) 1973 was liberalised and simplified to strengthen the Indian economy and to facilitate flow of investment into India. As the part of changing policies, FEMA came into being in 1999. Reduction of customs duty, delicensing of imports and exports, partial Capital Account Convertibility are the major steps taken in and from 1991. This facilitated inflow of foreign investment both direct and portfolio and the government allowed Indian companies to tap international market for raising funds through euro issues under Global Depository Receipt route.

Depository Receipts (DRs)

Depository Receipts are securities that represent ownership of securities held by a depository. Usually the country of residence of the issuer of the underlying securities is different to the country in which the receipts are issued. A depository receipt (DR) is a negotiable receipt, resembling stock certificates,

4. Students Economic Forum, Monthly Theme Letter, South Indian Bank, 2003.

that is issued for convenience of investors overseas. A DR for bond certificate exists and known as Foreign Currency Convertible Bonds (FCCB). However, in most cases, DR refers to a case of stock certificates. A DR is issued based on an underlying stock and can be converted into stocks. A single DR may represent one or more shares, or it can represent a fraction of a share.

There are a number of forms of DRs including American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Euro Depository Receipts (EDRs) and the Indian Depository Receipts (IDRs).

American Depository Receipt (ADR)[5]

One ADR may represent a portion of a foreign share, one share or a bundle of shares of a foreign corporation. If the ADRs are "sponsored," the corporation provides financial information and other assistance to the bank and may subsidise the administration of the ADR. "Unsponsored" ADRs do not receive such assistance. ADRs are subject to the same currency, political, and economic risks as the underlying foreign share. Arbitrage keeps the prices of ADRs and underlying foreign shares. American Depository Shares (ADS) are a similar form of certification. ADRs are listed in NYSE (New York Stock Exchange) and holder gets voting right in the company. DR in the form of share certificate is called as American Depository Share (ADS).

Global Depository Receipt (GDR)

A receipt denoting ownership of foreign-based corporation shares which are traded in numerous capital markets around the world other than USA. The most common places of trading is on London Stock Exchange and Luxemburg Stock Exchange (LSE). Normally, holders do not have voting rights in the case of GDRs, since LSE does not insist on this.

Issue Structure of GDR/ADR

The FCCBs and GDRs/ADRs may be in any freely convertible foreign currency. The ordinary shares underlying the GDRs and the shares issued upon conversion of the FCCBs will be dominated only in Indian foreign currency.

The following issue should be decided by the issuing company in consultation with the lead manager to the issue namely:

(a) Public or private placement
(b) Number of GDRs/ADRs to be issued
(c) Issue price
(d) The rate of interest payable on FCCBs
(e) The conversion price, coupon, and the pricing of the conversion options of the FCCBs

Listing of GDRs/ADRs

The GDRs/ADRs can be listed on any of the overseas stock exchanges like LSE, NYSE or Over The Counter Exchanges (OTCE).

5. Justin Paul, ADR and GDR-Basics, Business Deepika, 2005 January.

After completing all the formalities for listing its securities, including that of entering into the listing agreement, the securities of the company are listed and traded at the concerned stock exchanges. Before listing, the company enters into a listing agreement with the concerned stock exchanges. Almost all the stock exchanges have a standard listing agreement (which is amended from time to time by issuing circulars by each of the stock exchanges). The companies, which are listed on stock exchanges, have many obligations to discharge.

Reasons for Listing of ADRs/GDRs

Internationalisation

One increasingly popular way for emerging firms to raise more capital is to issue depository receipts in the form of ADR/GDR or to cross-list in an international exchange. This is referred to as internationalisation.

To Raise Funds

Listing enables to raise funds for expansion at lower cost of capital. Listing also enables them to tap capital markets for future funding needs.

1. Capitalise on the publicity of an IPO to attract attention from the investment community.
2. Provides access to one of the largest pools of capital in the world.
3. Create, by having US shares, a currency, which can be used as a high-standard, financing option in future acquisitions.

Other Reasons for Listing ADRs/GDRs

- Enhancement of corporate image in the eyes of the public, stakeholders, employees/professionals, banks/financial institutions and suppliers.
- Increased marketability of shareholdings
- Enhancement of company value
- Stronger financial positioning
- Sharing of success with stakeholders
- Re-examination of company direction based on corporate vision/mission

Table 18.2 Comparison between ADRs and GDRs

	ADR	GDR
Centre	The NYSE is the largest stock exchange in the world both by value and turn over; foreign equities play a minor role.	The LSE is not as large as the NYSE overall, but is the global center and for international equities, which dominate in turnover.[6]
Instrument	No legal or technical difference between an ADR and a GDR.	Unlike the NYSE, the LSE makes no demands requiring companies to give holders the right to vote. The NYSE insists on this point.
Disclosure	Comprehensive disclosure about the firm required for listing.	Detailed information required on the company, but less demands for GDR listing.

(Contd.)

6. LSE stands for Luxemburg Stock Exchange.

(*Contd.*)

GAAP	Foreign companies listing in the US must reconcile their accounts to US GAAP.	LSE satisfied with a statement of the difference between the UK and Indian Accounting Standards.
Cost	US listing could be expensive. Total initial costs likely to be in the range of US$ 10,00,000 to US$ 20,00,000.	GDR listing on the LSE is comparatively inexpensive. Initial costs likely to be in the range US$ 2,00,000 to US$ 4,00,000.
Liability	Legal liability of both a company and its individual directors increased by a full US listing.	Legal liability of a company and its directors is less than that of an ADR.

SECTION 3: FOREIGN EXCHANGE MANAGEMENT ACT (FEMA) 1999

This section deals with the definitions of the concepts and the policy changes made under the Foreign Exchange Management Act (FEMA) which replaced the Foreign Exchange Regulation Act (FEMA). The objective is to provide better understanding about the changes made in FEMA by the Government of India in lieu with the era of globalisation. The main difference between FERA and FEMA is that the unauthorised forex transactions (offences) were subjected to criminal law under FERA while it is considered only as civil offence now under FEMA.

Some Definitions[7]

This Act is effective from 1st June 2000 vide G.S.R. No. 371(E) dated 1st May 2000. It extends to whole of India. It shall also apply to all the branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention thereunder committed outside India by any person to whom the Act applies.

1. Authorised Person

Authorised person means any authorised dealer, money changer, off shore banking unit or any other person for the time being authorised under section 10(1) to deal in foreign exchange or foreign securities.

2. Capital Account Transaction

It means a transaction which alters the assets and liabilities, including contingent liabilities outside India of persons resident in India or assets or liabilities in India of the persons resident outside India, and includes transactions referred to in section 6(3). These are—

Transfer or issue of any foreign security by a person resident in India.
Transfer or issue of any security by a person resident outside India.
Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India.
Any borrowing or lending in foreign exchange in whatever form or by whatever name called.
Deposits between persons resident in India and persons resident outside India.

7. Compiled from FEMA, 1999 Document, Government of India.

Export, import or holding of currency or currency notes.

Transfer of immovable property outside India, other than a lease not exceeding five years by a person resident in India. Acquisition or transfer of immovable property in India other than a lease.

Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—

By a person residing in India and owed to a person outside India

By a person resident outside India

3. Currency

It includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers' cheque, letters of credit, bill of exchange, promissory notes, credit cards or such other similar instruments.

4. Current Account Transaction

It means a transaction other than a Capital Account transaction and includes—

Short term banking and credit facilities in the ordinary course of business.

Payments due as interest on loans and as net income on investments.

Remittances for living expenses of parents, spouse, and children residing abroad.

Expenses in connection with foreign travel, education and medical care of parents, spouse and children.

5. Residential Status

Person Resident in India

- A person residing in India for more than one hundred and eighty two days during the course of the preceding financial year but does not include—
- A person who has gone out of India or who stays outside India, in either case: for or on taking up employment outside India or for carrying on, outside India, a business or vocation, or for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period.
- A person who has come to or stays in India in either case otherwise than for or on taking up employment outside India or for carrying on, outside India, a business or vocation, or for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period.
- Any person or body corporate registered or incorporated in India an office, branch or agency in India owned or controlled by a person resident outside India.
- An office, branch or agency outside India owned or controlled by a person resident in India.

From FERA to FEMA

The present FEMA is a liberal form of the earlier FERA. FEMA extends to whole of India. The Act is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments for promoting the orderly development and maintenance of foreign exchange market in India. Section 5 of FEMA removes the restriction on drawal of foreign exchange for the purpose of current account transactions. As India in 1994 had adopted Article VIII of IMF Regulations, it was mandatory to remove the restrictions. The contravention of FEMA is not considered as a criminal offence and only civil proceedings are applicable. Imprisonment is considered only as a last resort when the recovery of fines has failed. Therefore, FEMA is more humane and rational as compared to FERA. Other salient features of FEMA are outlined below.

(a) The distinction based on citizenship has been abolished and that based on residentship has been introduced.

(b) Export of services are not covered under section 18 of FERA whereas Section 7 of FEMA has adequately covered this area. In the era of Information Technology and Internet, this provision assumes greater significance.

(c) Realisation, repatriation and surrender of foreign exchange is now being governed by Foreign Exchange Management Rules, 2000. Some of the important rules are—

Regulation 5—Any foreign exchange due or accrued as remuneration for services rendered or in settlement of any lawful obligation or an income on assets held outside India or as inheritance, settlement or gift should be sold to an authorised person within a period of seven days of its receipt and in all other cases, within 90 days of its receipt.

Regulation 6—Any person who has drawn exchange for any purpose but has not utilised it for the same or any other purpose permissible under the provisions of FEMA or rules and regulations made thereunder should surrender such foreign exchange or unutilised foreign exchange to an authorised person within a period of 60 days from the date of acquisition. Where, however, the exchange was drawn for travel abroad, the unutilised exchange in excess of the limit upto which it can be retained, should be surrendered to an authorised person within 90 days from the date of return to India or if it is travellers' cheque, then within 180 days from the date of return to India.

(d) Resident Foreign Currency Account (RFC)

A person resident in India is permitted to open, hold and maintain with an authorised dealer in India RFC account out of foreign exchange which is—received as pension, superannuation, monetary benefit from his employer outside India.

Realised on conversion of assets and repatriated to India.

Received or acquired as gift or inheritance from a person outside India.

(e) Possession and retention of foreign currency

There is no restriction on possession of foreign coins by any person. Any person resident in India is permitted to retain in aggregate foreign currency not exceeding US $2000 or its equivalent in the form of currency notes, bank notes, travellers' cheque. A person resident in India but not permanently resident therein is permitted to possess foreign currency notes, bank notes and travellers' cheques without limit if the foreign currency was acquired when he was resident outside India and was brought into India and declared to customs authorities.

(f) A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.

SECTION 4: RECENT POLICY CHANGES

India has been following gradual capital account liberalisation and consider it as a process rather than an event. There has been structural changes in the external sector policy of the central bank (Reserve Bank). The Exchange Control Department of RBI has been renamed as Foreign Exchange Department, indicating the change in the intent of the government. The objectives of these steps have been to dismantle controls and to create facilitating business environment to all engaged in external transactions. The important policy measures adopted by Reserve Bank in this context are given below.[8]

(i) Overseas Investment
Steps were taken to encourage the strategic presence of Indian Corporates Overseas, as part of furthering the process of capital account liberalisation. Indian companies are now free to invest upto their net worth outside India without any ceiling.

(ii) External Commercial Borrowing (ECB)
Revised ECB rules have been implemented effecting from February 1, 2004 to facilitate corporates to access ECB for undertaking real investment activity in India and for overseas direct investment in joint ventures and wholly owned subsidiaries. The maximum amount of ECB that can be accessed under the automatic route has been enhanced to US $500 million (from US $50 million previously) per financial year. Higher amount can be accessed with prior approval of the RBI.

(iii) Liberalised Remittance of US $25,000 per annum by Resident Individual. This has been liberalised further.
Resident individuals were allowed in 2004 upto US $25,000 per annum for any permitted purpose both under current and capital account. Residents were also permitted to acquire property overseas and open accounts with banks outside India.

(iv) Foreign Investment
Foreign Direct Investment has been permitted in 21 activities under the automatic route by a resident outside India or an incorporated entity outside India. Foreign Institutional Investors (FIIs) registered with SEBI and Non-resident Indians are eligible to purchase shares and convertible debentures under the portfolio investment scheme subject to certain limits.

(v) ADRs/GDRs
An Indian corporate can raise foreign currency resources abroad through the issue of American Depository Receipts (ADRs) or Global Depository Receipts (GDRs) subject to conditions.

(vi) Students
Indian students studying abroad are treated as Non-resident Indians (NRIs). They are eligible for all the facilities available to NRIs.

(vii) The system of self write-off and self extension of due date for export realisation for exporters was introduced.

8. Compiled from Shyamala Gopinath (2005): Foreign Exchange Regulation Regimes in India: From Control to Management, Reserve Bank of India Bulletin, March, Vol LIX No.3, pp 231–235.

Case: The 1997 Collapse of the Thai Baht

Based on the rising income, fuelled by the export led growth of Thailand, there was considerable demand for real estate, especially in Bangkok, during 1995–96. Overambitious and speculative construction companies undertook excessive construction, and supply of real estate far outstripped the demand. The construction companies could not sell the real estate they built, and went bankrupt.

Main Factors that Led to Collapse of the Thai Baht in 1997

(a) Role of Banks

Banks that had significant exposure to construction found their borrowers defaulting. Bad loans reached $30 billion! As a result, many banks folded.

(b) Role of US$ Denominated Loans

Most of the loans were denominated in US$. Construction companies had to service their huge debt in US$. This caused a huge demand for US$.

(c) Role of Huge Imports

Thailand made huge imports to ramp up infrastructure and bought capital machinery for their growing factories. Despite strong export growth, imports grew faster. Thailand ran up a huge (8.1% of GDP) current account deficit. This too led to a strong demand for US dollars.

(d) Role of Currency traders

Currency traders reasoned that the demand for dollars would rise due to :

(1) Huge imports

(2) Debt servicing of dollar denominated loans

As a result, the currency traders started selling the baht short, in huge amounts.

Fall of the Thai Baht

Purchasing Power Parity theory establishes the link between money supply, inflation and the exchange rate. The theory is based on the principle:

Should the growth in money supply in a country exceed the growth in the supply of goods, there will be more money chasing fewer goods. This will result in suppliers raising prices and hence each good will become more expensive. Thus, a basket of goods which earlier cost say Rs 9,000 would now cost Rs 10,000, meaning that inflation of 11.11% has occurred. If the same basket of goods cost $ 200 in the US, the original exchange rate would be 1$ = Rs 45, and the new exchange rate would be 1$ = Rs 50.

	Pre inflation	Post inflation
Price of a representative basket of goods in India (Rs)	9,000	10,000
Price of the same basket of goods in the US ($)	200	200
Resultant exchange rate	45.00	50.00

The sudden collapse of the Thai baht cannot be explained by the PPP theory. The fall in the Thai baht was not due to the increase in money supply, but was due to investor psychology and currency speculation.

The Role of Speculators

Speculators played a significant role in the fall of the Thai baht.
Currency speculators could see two phenomena taking place simultaneously in Thailand:

1. Loans were denominated in US$ and had to be serviced in US$.
2. Huge imports needed to be financed in US$.

Thus, they saw that the demand for US$ would increase and the demand for Thai baht would fall, forcing the Thai baht to be devalued. In order to profit from this anticipated devaluation, the currency speculators started selling the baht short. Huge short selling become self fulfilling, and the Thai baht collapsed.

Although the speculators were not responsible for the underlying reason for the weakness of the Thai baht, they certainly played a significant role in pushing the baht to collapse.

Steps that the Thai Government Could Have Taken

The Thai Govt. should have regulated the lending norms being followed by the Thai banking system better. Two norms in particular, that would have controlled credit to the construction industry in a big way, would have been:

1. Increase in the Central bank's lending rate pushing bank interest rates up, and making borrowing less attractive.
2. Increase in borrower's equity margins, curtailing speculative borrowing, as the borrower's stake in the projects planned would be high.

Impact of the Baht Fall on Thai Importers and Exporters

The collapse of the Thai baht impacted both importers and exporters:
Imports become more expensive because more Thai baht was required to import the same goods. Thus, local prices of imported goods increased significantly (in line with the change in the exchange rate).

Exporters got more Thai baht for every dollar of exports. This tremendously benefitted those exporters whose products were made from domestically sourced inputs, such as agri produce. For example, an exporter of oranges who bought oranges at 5 baht per dozen and sold them at 7 baht, gained 840% due to the devaluation of the baht from 1$ = 25 baht to 1$ = 55 baht, as can be seen below:

	Jan-97	Jan-98
Input price 5	5	
Incidental costs	1	1
Mark up @ 20%	1	1
Selling price in baht	7	7
Profit from trade	1	1
Exchange rate	25	55
Selling price in US $	0.28	0.28
Baht encashed upon sale	7	15.4
Profit from currency devaluation		8.4
Total profit	1	9.4
Increase in profits		840.0%

As an alternate, the exporter reduced his US$ denominated selling price, thus expanding his market. Thus, Thai exports became more attractive in other parts of the world.

However, for exports with a lot of import content, the baht devaluation simultaneously made the inputs more expensive, and the benefit to the exporter was offset to the extent of the increased input costs. On the whole, whether the exporter benefited or lost from the baht devaluation, depended largely on the import % content of his exported product.

Similarities Between the Collapse of the Thai Baht and the Korean Won in 1997

There are great similarities between the fall of the Thai baht in 1997 and the fall of the Korean won around the same time. The similarities are:

(a) **Excessive and unserviceable debt:** Large scale imprudent investments by industry, based on unrealistic projection of future demand conditions, leading to bankruptcy of the borrowers as well as the collapse of the lenders.

(b) **Imprudent lending norms:** Lenders did not properly evaluate the credit worthiness of the borrowers. Borrowers' projections were overly optimistic and lenders failed to exercise restraint.

(c) **Failure of the Government:** Government failure had a significant role to play. In Korea, the excessive bank lending was at the direction of the government. In Thailand, government failed to prevent excessive bank lending.

(d) **US dollar denominated debt:** The debt was denominated in US dollars and had to be serviced (principal and interest) in US dollars, and not in the local currency. This led to a huge demand, because the debt itself was huge.

(e) **Foreign investor expectations:** Foreign investors concerned with the spectre of possible bankruptcies pulled out of the local stock and bond markets, causing the local currency to fall (foreign investors sold the local currency and purchased US$ to take them out of the country.

(f) **Actions of Currency traders:** Currency traders saw that the local currency was falling/was expected to fall. They took advantage of the situation and sold the local currency short. This put further pressure on the local currency, and it fell further. The expectations of the currency, traders became self fulfilling and the currency collapsed.

Questions

1. Why did Thai baht collapse during South East Asian currency crisis in the year 1997?
2. What was the impact of the currency crisis and devaluation on importers and exporters in Thailand?

Chapter Summary

To conclude, there is no absolute 'comfortable' foreign exchange figure; nor is market sentiment predictable. Global financial markets are volatile, and subject to the influence of several factors—political, country, economic, and so on. Speculation cannot be eliminated from the system. Exchange rate fluctuations sometimes leads to panic situations as happened in the South-East Asian countries. It might work as a factor unsettle the overall economy. The move towards CAC thus calls for a conservative, cautious and calibrated approach and clinical analysis of data on the global and local markets.

It is worth voting that the developed countries hardly maitain controls or Capital account. At the same time, most of the developing countries maintain restrictions on capital account.*

Objective Type Questions

Name the Following:

1. What does FEMA stand for?
2. Name the currency of Japan.
3. Name the currency of Brazil.

Multiple Choice Questions

1. Disadvantage of fixed exchange rate system is:
   (a) Risk that the government will alter the exchange rate.
   (b) MNCs can engage in international trade without worry.
   (c) Exchange rates are held constant.
   (d) Rates are maintained within boundaries.
   (e) None of the above.
2. Which is the characteristic/s of the freely floating exchange rate system?
   (a) Exchange rate values are determined by the market forces.
   (b) Country having this system is more insulated from unemployment problems faced by other countries.
   (c) Country having this system is more insulated from inflation faced by other countries
   (d) Only (a) and (b)
   (e) All of the above
3. The ADR of an Indian Company is convertible into 2 shares of stock. The share price of the firm was Rs 1,250 when BSE closed. When US markets opened, the exchange rate was 1$ = Rs 43. The price of this ADR should be $ ________
   (a) $ 29.07 (b) $ 60.16 (c) $ 14.53 (d) $ 34.16
   (e) None of the above
4. Forward transactions involve exchange of currency at ________ rate.
   (a) Swap rate (b) Reverse transaction rate
   (c) Forward rate (d) Spot rate
   (e) None of the above
5. Which of the following is the rate at which a banker is willing to buy foreign currency?
   (a) Spread rate (b) Cross rate (c) Offer rate (d) Bid rate
   (e) Ask rate

*See International Business, Justin Paul, Fourth Edition, Prentice Hall and International Financial Management, Apte, McGraw-Hill, for more information.

State True or False

1. Currency futures are traded on an exchange in standardised form and fixed quantity.
2. Currency futures are mostly settled with a difference, without delivery of currency
3. If the real interest rate in a country is low, then the currency of that country is weak.
4. Strengthening of the foreign currency is good from the point of view of the importer, while it is bad from the point of view of the exporter.
5. IMF lends money to countries to ease pressure on Balance of Payment.

Review Questions

1. What is meant by 'Capital Account Convertibility'?
2. Discuss about the advantages and disadvantages of Capital Account Convertibility.
3. Distinguish between ADRs and GDRs.
4. What are the major changes made in FEMA in comparison to FERA?
5. Discuss the process of listing as ADR and GDR?
6. Do you think that the recent policy changes in the external sector would help Indian companies in long-run? Validate your view points.
7. Analyse the data given in the Balance of Payment table and debate on whether Indian economy is moving on the right direction based on the balance in current and capital accounts for the year?

Class/Field Exercise

1. Visit the website of Reserve Bank of India, Federal Reserve bank of USA, and Bank of Japan and analyse the data on Balance of Payment for last 2 years, State whether there is surplus/deficit in Current and Capital Accounts in India, US and Japan respectively.
2. Choose a company that has listed its stock in your home country as well as at a foreign exchange in the form of American Depository Share/Receipt either at NASDAQ or at New York Stock Exchange (example, listing of Infosys on National Stock Exchange of India and NASDAQ). Collect the data for last 3 weeks or 3 months from loca stock exchange and American stock exchange websites nd examine whether they move in tandem. You may estimate co-relation coefficient to see the degree of relationship too.

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Answers

Objective Type Questions

Name the Following

1. Foreign Exchange Management Act.
2. Yen.
3. Real.

Multiple Choice Questions

1. (a) 2. (e) 3. (e) 4. (c) 5. (d)

State True or False

1. True 2. True 3. False 4. False 5. True

Chapter 19

Global Outsourcing

Learning Objectives

- to understand the recent developments with reference to Global Outsourcing
- to learn about the implications of the Business Process Outsourcing

Chapter Structure

Section 1: Introduction

Section 2: Business Process Outsourcing

Section 3: The O utsourcing Debate

Case: Monitor Group Outsourcing Jobs to India

SECTION 1: INTRODUCTION*

In a world dominated by Internet, Intranet and the IT revolution, business and knowledge no longer have to be homegrown. In this increasingly competitive world, it can be contracted, to reduce the cost and maximize the profit, without compromising on quality and time. Such a contract is known as outsourcing, which is a powerful management tool for redefining and re-energising any organisation. It is useful, not only for maximising the present profits of the organisation, with the existing clientele, but it also relieves and enables employees to work on higher value added jobs. It offers online support services that use the Internet as a platform to build the desired recognition value in the eyes of customers, through good customer servicing. Outsourcing business process helps in taking care of daily routines, and concentrates on the new business prospects. This process reduces overheads, and increases profit and time to concentrate on new business avenues. The chapter looks at the background of the meaning, and the extent of global outsourcing in the current economic scenario. It elaborates upon the rationale for outsourcing and illustrates its advantages through the use of economic theory. The current debate on outsourcing, with its differing views, is discussed and analysed.

Rationale for Global Outsourcing

Why do everything yourself, when someone else can do it at low cost? In the current scenario, the theory says exactly the same. The global market today is highly competitive and continuously changing. A company must, thus, focus on improving productivity and at the same time, cut down costs. This is the basic premise of outsourcing. Outsourcing works because what is non-core for one organisation, is core for another. In brief, business process outsourcing can be seen as a process in which a company delegates some of its in-house operations or processes to a third party. Thus, it is a transaction through which one company acquires services from another, while maintaining ownership and ultimate responsibility for the processes. The company then informs its provider what it wants, and how it wants the work to be performed. The main motive for business process outsourcing is to allow the company to invest more time, money and human resources into core activities and building strategies, which fuel company growth.

SECTION 2: BUSINESS PROCESS OUTSOURCING

In today's business environment, outsourcing is often not a decision that needs to be justified. BPO companies are often considered to provide more flexible, faster, cheaper and effective services. They help free up a company's capital, and reduce costs. The operations or processes being outsourced vary from manufacturing, to customer service, to software development, and much more. Most of the companies, that are looking to outsource, are multinationals, or companies from western countries, and most of the BPO units are in countries such as India, China, Malaysia and even Russia.

Outsourcing is a combination of execution, expertise and leadership. The company's proposition is to deliver value to the clients, by bringing operational excellence and functional knowledge to their critical business processes. Outsourcing includes serving several industries, like travel, insurance, financial services, healthcare, professional services, manufacturing, distribution and retail, and providing

*Dr. Justin Paul and Tapish Mehta co-authored this chapter. Information collected by Prashant Mehra and Nayantara Verma are duely acknowledged.

essential corporate functions, such as finance and accounting, human resources (payroll and benefits administration), research and analytics. Likewise, companies are outsourcing chunks of their administrative work and supporting systems.

According to Webster's 10th Dictionary, the word ***outsourcing*** was coined in 1982. It can be defined as the transfer of an organisation's entire non-core, but critical, business process/function to an external vendor who uses an IT-based service delivery. By doing so, BPO helps an organisation to concentrate on its core competencies, improve efficiency, reduce cost and improve shareholders' value.

Though IT outsourcing has been happening for so many years, an increased momentum has been witnessed since the late 1990s, due to the rise of internet and communication technologies. Several global giants from various industries have begun to realise the importance of BPO, and have started outsourcing their non-core business functions. This has given rise to many specialised BPO vendors across the globe, with India being a major hub, owing to its large computer-literate, English-speaking population, low billing rates, strategically favourable time zone and high quality. In India, the BPO market is expected to grow exponentially in the coming years.

The controversy that outsourcing has resulted in job losses in the USA, is largely seen as more political than economic in India. Ever since the US Senate passed the Bill on banning government outsourcing to foreign countries in January, 2004, there has been a lot of resentment in Indian IT industry. By no stretch of imagination can the estimated 245,000 employees, now working in business process outsourcing in India, pose a threat to the 100 million workers in the US services sector. American businesses themselves, do not want to be restrained in any way from tapping cheaper sources outside the United States. The major US concerns comprise of the prediction that by 2015, roughly 3.3 million US business-processing jobs will have moved abroad. Research suggests that the number of US service jobs lost to off-shoring will accelerate at the rate of 30 to 40% annually, during the next five years.

These fears are without proper basis as a large percentage of jobs in US require the consumer and the retailer to be present in the same place. Any job losses must be seen as a part of economic restructuring, with which the US economy is well acquainted. Liberalised, competitive economies can generally cope with such restructuring. History suggests that over the medium to long term flexible job market and the mobility of US workers will make it possible for the US to create new jobs faster than off-shoring eliminates them.

Most of the jobs created in India are either in call centres or at IT firms. But call centres companies in both Britain and US suffer from rising staff turnover and struggle to recruit more people. In fact, 'not moving work abroad' would make the companies of developed countries less competitive. By focusing on creation of jobs, they could miss the chance to raise their productivity.

Similarly, the loss of call-centre jobs is a particular concern in Britain's less prosperous regions. Outsourcing does not mean net job losses to Britain. Losses from Britain companies sending work to places like India have been outweighed by gains from foreign companies sending work to Britain. A report by Advanced Institute of Management Research says that as companies increased their outsourcing operations over the past 20 years, Britain greatly benefitted from it. British companies save a minimum of 10 million pounds for every 1,000 jobs they move offshore, particularly to India (estimate by the ICICI One Source, an outsourcing agency of India's ICICI Bank).

India's population is just below 1.1 billion today, the second largest in the world after China, increasing roughly at the rate of 1.5% per year. Most importantly, India has a young population. It is estimated that between 2003 and 2020, India will be adding about 250 million workers to the labour pool. The $3.6 billion outsourcing industry in India has emerged as a single biggest employment generator in recent years. In terms of total cost and availability of skilled and semi-skilled manpower, it is difficult for smaller European countries to compete with countries like China, India and the Philippines.

There are roughly 200 Fortune 500 companies, which outsource work to India. According to NASSCOM (National Association of Software and Service Companies) estimates, over 50% of the Fortune 500 companies have incorporated offshore outsourcing into their strategies, and around 80% of these now use India as their development base. The leading companies in India, in both the IT and BPO industries are fighting hard to win a broader variety of work, particularly higher value activities. Examples include EXL Services, carrying out a broad range of insurance work for British and American firms. ICICI One Source, another Indian BPO Company provides research services for consultants and investment bankers. Wipro and EXL services are applying the same management disciplines, that GE applies to its industrial businesses to the way they provide services.

After the success of IT and ITES, Indian pharma companies are now beginning to recognise the opportunity that outsourcing brings about. The costs of manufacturing, conducting clinical trials and research are at least 50% lower in India than those in the US. Indian companies have started looking at a space between full-time equivalence manufacturing (full time of a facility pledged to the client) and contract research (where a common pool of resources maybe tapped). However, this is as yet an emerging opportunity. India currently has a presence in manufacturing formulations, manufacturing patented products for the formulated market, exporting bulk drugs and contract research. With an estimated USD 55 to 65 billion worth of drugs expected to go off-patent within the next 2 to 3 years, India could potentially capture a good size of this.

Rationale Behind Outsourcing

According to Forrester Research, 3.4 million jobs will be outsourced by 2015. That may sound enormous, but it implies an annual outflow of only 0.5% of the jobs in the industries affected. In an average year, the American economy destroys some 30 million jobs, and creates slightly more, dwarfing the effects of off-shoring. For example, American radiologists need not be condemned to flipping burgers when their work is shipped to Chennai. They can turn their skills to the obesity epidemic, or to the burgeoning field of plastic surgery. There is, surely, more than enough work to be done. But what is the reason behind using outsourced model, by the traditionally vertically integrated firms, at an increasing rate. The analysis revealed that three main factors are responsible for this change, and they can be identified as:

1. *The emergence of world-class service providers*. Often, these companies get started, responding to the needs of one or more current customers. But once they do, the marketplace gets defined, and the power of the free-market economy takes over. Before long, it becomes difficult for any organisation to justify in-sourcing when their capabilities are tested against a competitive market of specialised providers.
2. *Technology*. Technology makes much of the work of the modern organisation “placeless.” It no longer matters where information is processed, where accounting is done or where an 800 number call is answered. Technology is the leading area for outsourcing, but it is just as important as the top enabler of outsourcing. Once the physical barrier of where the work is done is broken, breaking the organisational barrier is a lot easier.
3. *Competition.* As competition (local, global, bricks and clicks) intensifies, organisations must simultaneously get more efficient and more effective to survive. The idea that in today’s hyper-

competitive environment any organisation can go it alone, even the largest and best funded, is simply naive.

Exporting jobs helps to create a balanced global audience. The need to export is particularly true of the technology sector, because the United States is the leader in technological advances. This offers the greatest bargaining power, which equates to greater gains. US companies have a limited customer set, unless they contribute to the improvement of global technology, or at least introduce beneficial elements to other societies and cultures. The overseas markets that might be considerd as "taking away our jobs" are product markets in themselves. Out of India's one billion population, 300 million is classified as middle class. This is larger than the entire US population, and represents an enormous marketing opportunity. In China, with a population of 1.2 billion, only about 5% (65 million) are considered middle class. Yet, given that China is early in its explorations into the market economy, this is a significant potential market. Sweetening the pot, India and China offer preferential treatment to companies that participate in their local economies, such as reduced entry barriers, lower taxes or tariffs, and better currency exchange rates.

The basic premise that stems from the free-trade axiom is that when a rich country sends blue-collar jobs overseas, it creates opportunities back home for workers to move up the skill ladder. The more recent corollary is that sending service jobs overseas would do the same for white-collar workers back home. But the rising number of skilled, white-collar jobs migrating from rich nations to developing countries are raising fears that, well-paid workers in developed countries will have trouble finding equally well-paid computer, design and medical jobs at home.

Outsourcing—Gains and Gainers

It becomes essential to study its advantages, and contrast them with it's often harped upon downsides. For much of the developing world, outsourcing is providing hope and vision, after decades of disappointing economic development strategies, pushed by the major industrial nations, including import substitution policies. In a global economy based on skilled services, outsourcing has become the backbone of many efficient, well-organised enterprises. By allowing companies to devote scarce resources to their own unique core skills and products, outsourcing can increase revenue, improve cost-effectiveness, and enable organisations to better manage their assets, and redefine their markets. Some clear gains or advantages from outsourcing include:

- **Cost saving:** The foremost reason, and the one driving the outsourcing boom, cost saving. For every dollar of corporate spending that is outsourced, US companies save 58 cents, most of this coming from labour savings, due to the lower wage rates prevalent in the developing nations. This also means that companies in such nations can hire better-qualified workers for lesser, and spend more on supervision and training. Offshore workers are often more highly motivated than workers in the US and perform better, particularly in low skilled jobs that lack prestige and suffer from high turnover in the US. Wage differentials tend to be compelling for skilled jobs too. For software developers for example the ratio between US and India is about 8:1. Thus, cost saving continues to accrue as the companies go higher up on the skills ladder, with their offshore outsourcing.
- **Higher performance:** Not only does outsourcing imply lower costs, in a large number of cases, it also means superior performance and the pairing of savings with distinctive skills. Asia's manufacturing operations attain high levels of performance, and many other skills are more abundant

in Asia than in the developed world. China, for example, produces 350,000 graduate engineers every year, compared with 90,000 for US engineering schools. Most leading IT outsourcing firms operate at the highest degree of expertise, compared to internal IT departments in the US. China and Taiwan are also developing world class design expertise in specific technologies.

- **Better deal for consumers:** As companies pass on the savings they get from lower costs, in the form of lower prices for their goods, consumers benefit. Global sourcing of components has reduced the cost of IT hardware by upto 30 percent since 1995, boosting demand and adding as much as $230 billion to the US GDP in that period. Lower prices for medical practices and technologies have made them affordable for more people.
- **Increased efficiency:** Companies that do everything themselves have much higher research, development, marketing and distribution expenses, all of which must be passed on to customers. An outside provider's cost structure and economy of scale can give the firm an important competitive advantage.
- **Repatriated profits:** Many Indian outsourcing firms are owned in whole, or in part, by US companies, such as GE and EDS, and repatriate some of their earnings. Operations owned by foreign (mostly US) companies generate 30 percent of the Indian offshore industry's revenues. In this way, an additional four cents of every dollar spent on outsourcing returns to the US economy.
- **Redeployed labour:** The direct benefits to a country, strongly into outsourcing, like the United States, total about 67 cents for every dollar. Also, the savings made through outsourcing can be invested in new business opportunities, and this investment will boost productivity and create new jobs. In the U.S., as jobs in call centres and repetitive IT functions go offshore, opportunities to train labour and invest capital to generate opportunities in higher value added occupations, such as research and design, are appearing.
- **New markets:** Outsourcing and expanded trade facilitate the development of new markets, new trade items, an exchange of knowledge, service and commodities. Exporting jobs helps to create a balanced global audience. The markets to which a country outsources, ultimately, through development, become product markets for goods of developed nations.
- **World economy:** From a marketing perspective, global outsourcing expands supply and distribution channels, product recognition and loyalty. It also expands market opportunities and supports greater choice. Diversification of currency, costs, infrastructure, and the development base keeps a global company viable in the changing world economy. Single country shifts do not damage corporate solvency, cash flows, or balance sheets as significantly as the dependence on a single economy or market. The risks are shared, and therefore, so must be the benefits.
- **Start new projects quickly:** A good outsourcing firm has the resources to start a project right away. Handling the same project in house might involve taking weeks or months to hire the right people, train them and provide the support they need. And if a project requires major capital investments (such as building a series of distribution centres), the startup process can be even more difficult.
- **Level the playing field:** Most small firms simply can't afford to match the inhouse support services that larger companies maintain. Outsourcing can help small firms act "big", by giving them access to the same economies of scale, efficiency and expertise, that large companies enjoy.

Outsourcing—Losers

The downsides of global outsourcing can be specified as follows.

(i) Outsourcing work that was previously done in house results in a large number of workers being displaced and losing their jobs.

(ii) Companies tend to overestimate the savings to be had from going abroad and fail to recognize the problems, such as dealing with inventory, obsolescence and currency exchange rates.

(iii) For many manufacturers, the importance of direct labour is declining rapidly. Since it often accounts for just 7 to 15 percent of the cost of goods sold, hard-goods and high-tech manufacturers often say that wage rates are hardly the most critical determinants of their overall economic performance.

For the outsourcing of manufacturing operations in particular, the following concerns are raised:

- Exposure to supplier risks and issues of quality control.
- The danger of suppliers reaping undue advantages by imitating superior products or technologies.
- A possible change in supplier behaviour from collaborative to opportunistic.
- Difficulty in measuring actual costs of the supplier, typically above baseline costs, due to the experience curve.
- Potential problems with taking an outsourced function back, or substituting the supplier when the outsourcing agreement terminates.

It is essential for organisations to identify, exploit and protect their core business. They should retain or insource those manufacturing functions that are critical to the product, and those the company is distinctively good at making. Thus, only those manufacturing functions should be outsourced in which suppliers have a distinct comparative advantage.

SECTION 3: THE OUTSOURCING DEBATE

The practice of outsourcing has, of late, been the subject of intense debate. The primary contention being, is outsourcing just a new way of doing international trade, or is it something to fear as being fundamentally damaging to the economies of developed nations? The forces of outsourcing are being blamed for the relentless export of jobs from the rich to the poor countries, whereby outsourcing becomes a shorthand for the process by which good jobs in America, Britain or Germany become much lower-paying jobs in India, China or Mexico. The rising number of skilled, white-collar jobs migrating from rich nations to developing countries is raising fears that, in fact, well-paid workers in developed countries will have trouble finding equally well-paid computer, design and medical jobs at home.

Research suggests that the number of US service jobs lost to offshoring will accelerate during the next five years. Several US states are considering legislation to prohibit or severely restrict their state governments from contracting with companies that move jobs to low-wage developing countries, and labour unions, notably the Communications Workers of America, are lobbying the Congress to prevent offshoring. America's loud debate about off-shoring has its echo in Britain. The loss of call-centre jobs is a particular worry in Britain's less prosperous regions. Call-centres currently employ around 500,000 people. Their rapid growth in the past decade has been a lifeline to many run-down manufacturing areas, that have suffered a haemorrhage of industrial employment.

The argument against outsourcing can be refuted through a consideration of the following factors:

1. A large percent of jobs in the United States are in service industries such as retailing, catering, tourism and personal care, that require the consumer and producer to be present in the same place and therefore, by their very nature, cannot be moved abroad.
2. Any job losses must be seen as part of an ongoing process of economic restructuring, with which the US economy is well acquainted. Even when the economy is growing, mass layoffs, usually from restructuring, are much higher than the job losses predicted from offshoring. In 1999, for instance, 1.15 million workers lost jobs through mass layoffs, out of a total of 2.5 million lost. Liberalised, competitive economies, with flexible labour markets can usually cope with such restructuring. History suggests that, over medium to long term, flexible job market and the mobility of US workers will make it possible for United States to create new jobs faster than offshoring eliminates them. United States has the highest rate of re-employment of any OECD country, by a factor of almost two. The pattern of job growth in the United States has been consistent over time. Over the past 20 years, some 2 million manufacturing jobs moved overseas. But the service sector, over the same period of time, created 13 times as many jobs as were lost in the manufacturing sector.
3. The population of the United States is aging. At current productivity levels, the country will need 5 percent, or 15.6 million, more workers by 2015, to maintain both its current ratio of workers to the total population, and its living standards. By 2015, despite current fears about job losses as a result of offshoring, the US economy will need more, not fewer, workers. Outsourcing is one way to meet that need, and could also help lower the cost of ageing, especially in health care. US's health care spending is rising at 12% a year.
4. As jobs in call centres, back-office operations, and repetitive IT functions go offshore, opportunities to train labour and invest capital to generate opportunities in higher value-added occupations, such as research and design, will appear. The Bureau of Labour Statistics estimates that from 2000 to 2010, there will be a net creation of about 22 million new jobs in the US economy, mostly in business services, health care, social services, transportation and communications.
5. The industries said to be badly hurt by the migration of job overseas, report a shortage of workers at home. Most of the jobs created in India are either in call centres or in IT firms. But call centre companies in both Britain and US suffer from rising staff turnover, and struggle to recruit more people. Even a modest rise in the demand for IT workers in rich countries will create shortages, and therefore openings for Indian, Chinese and Russian engineers.

According to McKinsey Global Institute estimates, as much as $1.46 in new economic value is created for every dollar spent by American companies offshore. Counting the benefits such new business brings to Indian workers, firms and governments; the study estimated that India gains a net benefit of at least 33 cents from every dollar the US sends offshore. America, meanwhile, achieves a benefit of at least $1.13 for every dollar spent.

Though people might suffer from short term disruptions, these should be set against the consequences of resisting change. Not moving work abroad would make the companies of developed countries less competitive, weaken the economy and endanger more jobs, and make them miss the chance to raise their productivity by focussing on the creation of jobs with higher value. Public policy should not be allowed to interfere with the process of trade and the openness of the economy.

To address the issues of those losing their jobs however and mitigate the effects of the transition without great cost to the economy, training programmes and generous severance packages, perhaps accompanied by innovative insurance programmes, should be given. Building on proposals by other economists, MGI estimates that for a small percent of the savings from offshoring, for example, firms could insure all full-time workers that lost their jobs as a result.

The sentiments in US have been reflected vociferously in Britain. But outsourcing does not mean a net job loss to Britain. Losses from British companies sending work to places such as India have been outweighed by gains from foreign companies sending work to Britain. A report by Advanced Institute of Management Research says that as companies increased their outsourcing operations over the past 20 years, Britain greatly benefitted from it. If Britain is to retain its edge in business services, its companies will need to do more, rather than less, offshoring. In order to remain competitive, they need to do as much as possible, in the cheapest locations possible without loss of quality. This will mean losing lower skilled jobs, but that loss will eventually be offset by a gain in higher paid jobs, as British firms specialise further in higher-value and more innovative services. Just as London has continued to thrive as a financial centre despite competition from cheaper locations, similarly Britain's business services will continue to prosper in the age of offshoring.

India's Perspective

India has made a strong niche for itself in the Information Technology Enabled Services and Business Process Outsourcing sectors. The $3.6 billion outsourcing industry in India has emerged as the single biggest employment generator in recent years, and is expected to reach an annual turnover of $ 13.8 billion, or nearly half of the global offshoring market by 2007. India is the most preferred choice for global companies when it comes to outsourcing. In a study by the Hewitt Associates of US on global sourcing trends and outcomes, India got 60 percent preference amongst the global companies, while its closest competitor was China, with 32 percent preference. Today, companies outsource to destinations like India because they see value in their investments in terms of quality service and financial spending. By outsourcing to quality and lower cost operations, these companies are able to lower overhead costs, compress time-to-completion with efficient time difference management, and focus on core competencies.

In the 1990s, India was able to respond very quickly to the growth in demand for IT services. It had a sizeable number of English speaking people, who were available in the job market at a low cost and were willing to work hard. There were also a lot of entrepreneurs and managers who could quickly make inroads, and take advantage of this new business opportunity. This was coupled with some initiatives by the government, like the formation of software and other industrial parks. This helped to give the Indian IT sector a kick-start. Of course, India was not the only country that did this. Ireland has long been a popular destination for software services, but is being overtaken by India, courtesy the size of India's manpower. In terms of total costs and availability of skilled and semi-skilled manpower, it is difficult for smaller European countries to compete with countries like China, India and the Philippines.

The BPO sector in India has been growing at almost 60 to 70 percent per annum. BPO export revenues, according to NASSCOM figures, grew from $2.4 billion in 2002–03 to $6 billion in 2005–06. According to NASSCOM, each day, nearly 200 people join the Indian ITES-BPO industry. BPO offerings are becoming more comprehensive. From managing repetitive, transactional chores like Payroll and Accounts Receivable, BPOs have enhanced their service portfolios by also handling knowledge based activities like Budgeting or Resource Planning, giving customers access to a complete menu of end-to-end processes in functional areas such as HR, Finance and Customer Care Growth. As pointed out in the McKinsey Institute study, the US economy benefits in outsourcing in more ways than one. One estimate says that General Electric (GE), which employs 18,000 workers in India, saves $350 million per year through outsourcing. A NASSCOM report estimated 60 per cent savings in costs for companies outsourcing to India. There exist 185 Fortune 500 companies which outsource work to India. Information Technology Enabled Services (ITES) provides opportunities for MNCs to reap the surplus in the service sector, that did not exist earlier. The companies engaged in production of value-added services, from medical transcriptions to software programming, require skilled labour which countries like India have in abundance. In fact, Indian call centres have higher productivity, as compared to those in the USA or UK.

The business proposition of BPOs is to take over the non-core processes of companies and bring in the best practices. From outside, companies are using BPO to reach a wide range of goals. What was once viewed, primarily, as a way of reducing expenses, has now emerged as a means of achieving productivity gains. Short-term innovation cycles enhance customer intimacy, and enter new markets. According to National Association of Software and Service Companies (NASSCOM) estimates, over 50 per cent of the Fortune 500 companies have incorporated offshore outsourcing into their strategies, and around 80 per cent of these now use India as their development base.

Of late, India is bearing witness to a fourth wave of BPO start-ups, many of them funded by American venture capitalists, experimenting with remote delivery from India of all sorts of work, from hedge fund administration to pre-press digital publishing. The leading companies in India, in both the IT and BPO industries, are fighting hard to win a broader variety of work, particularly higher value activities. Examples: EXL Services carries out a broad range of insurance work for British and American firms. ICICI One Source, another Indian BPO company, provides research services for consultants and investment bankers. Not only are they aiming to lower the cost of western white-collar work, from software programming to insurance underwriting, but to improve its quality as well. Firms, such as Wipro and EXL Services, are applying the same management disciplines to the way they provide services, that GE applies to its industrial businesses.

In the short run, the gains from outsourcing might be concentrated, however, in the long run; it holds promise for India and other developing nations. One of the longer term potential benefits of IT industry development (and globalisation processes) is competency capacity building, which can spill over into other sectors, boost the local economic dynamism and competitiveness, and thereby facilitate processes that impact poverty. Offshoring also has demonstration and empowerment effects, and helps to inspire the country's youth and people, both in urban and rural areas. It results in people developing awareness about computers and Internet, although they are not involved in the IT industry themselves.

Although the IT industry has been around for a few decades in India, it has only been sizable for a very short period. Mastering all parts of the value-added chain is a process that takes time. The Indian firms have fared quite well so far. They have been very flexible, and have moved into different areas, in the low and medium level of the value-added chain. Slowly, they have also started making inroads into the high-end level. Most of the high value-added services involve R&D and software product development. . Many Indian firms are rather good at being flexible, taking advantage of new business opportunities, ramping up manpower, being responsive in terms of prices, and improving in quality. They have also managed to form mutually beneficial strategic alliances with multinationals and their local subsidiaries.

The outline of a distinct brand of Indian competitiveness, in performing carefully defined, rules bound, repetitive white collar business work, appears to be taking shape. Already the Indian IT firms, along with some of the foreign companies in India, boast of the world's most impressive set of international quality certifications for software engineering. In the long term, India's success at winning global white collar work of higher value will depend largely on two things: the supply of high quality technical and business graduates, and an improvement in its infrastructure.

Case

Monitor Group Outsourcing Jobs to India

Mark Fuller had co-founded Monitor Group in 1983 in the US with his colleague Prof. Micheal Porter. The company had grown from a boutique strategy consulting firm to a group of affiliated companies that advised clients on strategic and financial matters, managed capital and developed executives. Monitor had taken up its first project in India in 1990 and had been operating with a consulting office in Mumbai since 1994. Advances in information technology and telecommunication made it conceivable that this workforce could tackle the research request of managers anywhere in the world.

Strategy Consulting

The heart of the Monitor is its strategy consulting practice, and any geographic shift would have to be based on a detailed understanding of strategy consulting.

- Buyers of strategy consulting services were typically chief executives, their direct reports, or general managers of divisions of multi-unit corporations.
- Projects differed dramatically in their content and character. Projects were categorised in three main types Brain projects, Grey Hair projects and Procedure projects.
- Brain projects required the smartest and most creative personnel, were tailored to the client's circumstances and offered little opportunity to leverage senior consultant with junior personnel.
- Grey Hair projects involved problems that were familiar to experienced consultants even if they were new to the client.
- Procedure projects involved familiar problems whose solutions could be programmed, with steps parsed out to junior staff.

Primary Activities

Though each project was different, strategy consultants undertook a common set of primary activities. These include:

- Sales
- Project design
- Project execution
- Advice delivery
- After sales service

Support Activities

- Human resource
- Knowledge creation and management
- Infrastructure

Business Research

As developers of advice, strategy consultants conducted business research, but business research was also a separate industry.

Syndicated research was provided under long-term contracts and often involved high upfront costs to setup information technology and to collect, analyse and distribute data.

Customised research involved lower costs and was priced on a project-by-project basis, with price varying according to the need to collect primary data, the cost of specific data and the expected cost of labour involved in the project.

The Monitor Group

Monitor had grown to become a family of professional service firms linked by ownership, personnel relationship and intellectual property. Monitor's units fell into three categories:

Advisory services included the core strategy consulting practice as well as a set of smaller units focused on marketing, pricing, planning and economic development.

Capability development units trained executives, built clients' external networks, helped to design internal organisations and developed custom software to support decision making.

Capital services advised clients on mergers, acquisitions and corporate finance activities. An affiliated private equity fund, Monitor Clipper Partner, took direct stakes in companies.

Monitor's focus was mainly on strategic consulting practice in which projects differed based on content and character. Monitor group also pursued work in business research which was instigated by firm's continuous need for accurate and timely information for decision making globally. Monitor offered two different types of research services, which are syndicate services being standard data sets and customised services which tailored to specific needs. This research work was very labour-intensive.

Monitor in India

Fuller and his team knew that India offered a vast, educated, ambitious workforce at relatively low wages. Mr. Fuller had decided that the leadership in the office in Mumbai would be solidified and reporting relationships would be clarified. And Monitor would also change their focus from foreign multinational clients that wanted to do business in India to outsource all sorts of work to India wherever possible (research work, preparing consulting reports, typing, etc.) which they obtain in the US from their clients seeking strategy consulting advice.

During this discussion with his managers in India, about Monitor and India, Fuller put forwarded another important proposal—making India the hub of business research conducted by Monitor for clients around the globe (Outsourcing of jobs to India). The back-office operations of Monitor were also considering India as a prospective place to shift these activities.

An option for entering and tapping the enormous opportunities in India was to outsource some work to existing business research firms in India like Office Tigers etc. Another approach was to found and strengthen a Monitor business unit capable of conducting research in India; this could be done either by building from scratch or acquisitions. But in this case Monitor would have to make some key choices as to their target segment in India and whether it is exclusively for Monitors Indian clients or others too.

The major question here is whether a business research unit will function effectively and efficiently in India?

Some of the major advantages and disadvantages of Monitor opening its own research centre (to outsource the work they get from clients in the US and other places) and strengthening its back office activities in India are:

Advantages

- Vast highly educated, ambitious and English speaking workforce (India produces maximum number of engineers and management graduates in the world);
- Low wage rate, compared to countries like US;
- Advances in information technology and telecommunication make it possible for the workforce to tackle research problems from anywhere in the world sitting in India;
- The research teams would also help Monitor understand the local environment better;
- The growing Indian economy.

Disadvantages

- Low labour productivity;
- Cultural differences;
- Lack of business infrastructure;
- Difficulty to match the product and quality to that of western standards;
- Rising wage rate in India.

The best option for Monitor was to have their own research company in India despite some of the disadvantages.

Their target market include MNCs wanting to enter India: Monitor's own clients from US and the rest of the world seeking consulting services and Indian companies that want to go global.

There is continuous increase in the FDI inflow in the world, although there has been temporary halt because of Great Recession 2008–09, Therefore the market for business research will increase a lot.

Questions

1. Should Monitor consider strengthening their business research unit in India? Do you recommend them to recruit more people in India for doing 'Business Research in India' for their global clients?
2. Do you think that the large educated workforce available at a lower wage rate in India would add to Monitor's advantage?
3. Do you think that a group like Monitor has opportunities in a country like India in the outsourcing segment?

Chapter Summary

After its success in outsourcing, IT and IT enabled services, Indian pharma companies are now beginning to recognise the opportunity that outsourcing presents. The largest driver for outsourcing in pharma is the need to bring down costs. The untapped potential of the large pool of low-cost, English speaking technical manpower that India provides, is now coming into the world view of the Big Pharma. The costs of manufacturing, conducting clinical trials and research are atleast 50% lower in India than those in the US. The pharma industry in India is said to be poised where the IT industry was 25 years ago.

Indian companies have started looking at a space between full-time equivalence contract manufacturing (full time of a facility pledged to the client) and contract research (where a common pool of resources maybe tapped). However, this is as yet, an emerging opportunity. The global pharma outsourcing market is estimated at $48 billion, and all Indian contract research organisations would not even add up to 1% of the market.

In order to ensure that outsourcing industry contributes in the maximal possible way to the growth of economy, the authorities must act as facilitators. This implies a stronger emphasis on IT in education, and integration in modern global knowledge-based economy.

Outsourcing provides the US and European countries with opportunities bigger than merely sending low value, labour-intensive activities abroad. While the operating savings are real, offshore companies, to which these countries outsource, can also deliver superior performance, even in highly skilled activities, and a better platform for entering new markets, and encourage a cycle of gains in productivity, lower prices, greater investment and new jobs. The ability of multinationals and companies in richer nations to offer better wages and jobs to those in the developing countries, is putting pressure on emerging market governments, to pursue liberal economic policies, especially spending more on education and maintaining open borders with the outside world, for trade and foreign investment.

Objective Type Questions

Fill in the Blanks

1. KPO stands for ______________.
2. ITES stands for ______________.
3. According to ______________ estimates over 50% of fortune 500 companies have incorporated offshore outsourcing into their strategies.
4. BPO stands for ______________.

Review Questions

1. Discuss the pros and cons of Global Outsourcing.
2. How did 'Global Outsourcing' process help business in India?
3. Discuss about the sectors that got the benefit of outsourcing and the type of jobs created in India?

Class/Field Exercise

Business Process Outsourcing: The Top Rankers

WNS and Wipro Spectramind have emerged as top two companies in India in the BPO sector, according to a survey done by NASSCOM. The basis of ranking is the revenues generated by the BPO companies and is given below in the Table 1.

Table 1 List of top 15 BPO companies in India

1.	WNS Group
2.	Wipro Spectramind
3.	Daksh e-Services
4.	Convergys
5.	HCL Technologies
6.	Zenta
7.	ICICI Onesource
8.	MphasiS
9.	EXL
10.	Tracmail
11.	GTL Ltd.
12.	vCustomer
13.	HTMT
14.	24/7 Customer
15.	Sutherland Technologies

World's Best BPO Vendors

Owing to the huge opportunity that lies in the BPO sector, large corporations have ventured into the business and have set up BPO operations all over the world. There is a strong competition among these multinationals and many organisations such as the Outsourcing Management Institute, the Chief Resource Officer Institute, DataQuest and BPOrbit release BPO rankings each year. The Black Book of Outsourcing by Doug Brown and Scott Wilson provides a list of world's best BPO vendors (See the Table 2). The parameters used for ranking these vendors include customer satisfaction, employee satisfaction, reviews of global consulting firms, performance with respect to other vendors and client performance ratings.

Table 2 World's Best BPO Vendors

No.	Vendor
1	IBM Global/Daksh
2	Accenture
3	Hewlett Packard
4	MphasiS
5	Ernst & Young/Capgemini
6	Wipro Spectramind
7	ICICI One Source
8	eFunds Global Outsourcing
9	Convergys
10	Affiliated Computer Systems

Source: The Black Book of Outsourcing by Doug Brown and Scott Wilson

Group Work

Select 3 companies from the each of the above table, visit their websites, and collect the information on what type of jobs they undertake (companies in Table 1) and outsource (from Table 2). Also discuss the cost/benefit of this kind of outsourcing business.

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1. Priya P. and Kannan N. (2005): Global Competitiveness in Business Process Outsourcing, in S. Ganesan and Justin Paul (edited) Business Management Practices, Policies and Principles.
2. Justin Paul and Tapish Mehta (2005): Outsourcing—Who Wins and Who Gains?, Financial Express, July 4.
3. Justin Paul (2007): International Business, Prentice Hall, 3rd Edition.
4. Seth, Rastogi (2006): Global Management Solutions, Thomson Learning.
5. Goldman Sach (2004): BRIC Report.
6. NASSCOM (2002 and 2003): Annual Reports and Estimates.

Answers

Fill in the Blanks

1. Knowledge Process Outsourcing
2. Information Technology Enabled Services
3. NASSCOM
4. Business Process Outsourcing

The McGraw-Hill Companies

Chapter 20

Multinational Companies and Foreign Direct Investment

Learning Objectives

- to study the link between multinational firms and FDI
- to learn more about the FDI and MNCs in emerging countries like India and China

Chapter Structure

Section 1: **MNC—Definition and Categories**

Section 2: **Multinational Corporations in India**

Case: Wal-Mart's FDI in China

SECTION 1: MNC – DEFINITION AND CATEGORIES

A multinational corporation (MNC) or multinational enterprise (MNE) or transnational corporation (TNC) or multinational organisation (MNO) is a corporation or enterprise that manages production establishments or delivers services in at least two countries. The major sources of Foreign Direct Investment (FDI) are MNCs.

Multinational corporations (MNC) can be categorised into *three* broad groups:

1. Horizontally integrated multinational corporations manage production establishments located in different countries to produce the same or similar products (for example, McDonalds).
2. Vertically integrated multinational corporations manage production establishment in certain country/countries to produce products that serve as input to its production establishments in other country/countries (for example, Adidas).
3. Diversified multinational corporations manage production establishments located in different countries that are neither horizontally nor vertically integrated, (for example, Microsoft).

Multinational corporations can nevertheless have a powerful influence in international relations, given their large economic influence in politicians' representative districts, as well as their extensive financial resources available for public relations and political lobbying.

Multinationals have played an important role in globalisation. Given their international reach and mobility, prospective countries, and sometimes regions within countries, compete with each other to have MNCs locate their facilities (and subsequent tax revenue, employment and economic activity) within. To compete, the governments offer incentives to MNCs such as tax breaks, governmental assistance or improved infrastructure etc. This process of becoming more attractive to foreign investment can be characterised as a push towards greater freedom for MNCs.

Criticism against Multinational Corporations

Because of their size, multinationals can have a significant impact on government policy primarily through the threat of market withdrawal. For example, in an effort to reduce healthcare costs, before the implementation of WTO Product Patent laws, some countries had tried to force pharmaceutical companies to license their patented drugs to local competitors for a very low fee. When faced with that threat, multinational pharmaceuticals firms have simply withdrawn from those markets, which led to limited availability of advanced drugs. Essentially, when companies are faced with the option of losing their core competitive advantage (technology) and losing a national market, they choose to withdraw from the national market and that often causes governments to change policy. Countries that have been most successful in this type of battle with corporations are large, such as India, South Africa and Brazil.

Some multinational companies try to affect government policy through lobbying and donations to politicians that management feels will be more supportive of corporate goals. Corporate lobbying on a range of topics, from tariff structures to environmental regulations occurs. There is no unified multinational perspective on any of these issues.

At the same time, multinational corporations pay higher wages, and have significantly better environmental records than local firms.

The Form of FDI: Acquisitions vs Greenfield Investment

Acquisition is more appropriately termed as international acquisition. An international acquisition is a cross-border investment in which a foreign investor acquires an established local firm and makes the acquired local firm a subsidiary business within its global portfolio. Acquisition may be 100% or buying majority or minority stake. Some firms also use this as a strategy to establish international joint venture firms, which can also be included under Foreign Direct Investment.

Greenfield Investment may be defined as FDI in which investment involves the establishment of a completely new operation in a foreign land. Acquisition generates cash flow in a shorter time than in the case of Greenfield investment, since the acquired firm, by definition does not have to build from ground. Furthermore, acquisition deals may be more attractive than Greenfield investment since license acquisition offer immediate access to the local firm existing resources such as land, manufacturing facilities, distribution channels, supply networks, skilled labour and customer base.

FDI in China

China continues to attract record levels of investment from foreign multinationals. A country that attracted a negligible amount of foreign capital just 20 years ago was world's largest recipient of foreign direct investment in the last few years. Extensive infrastructure investment and an expanding real estate market continue to drive foreign investment, but the manufacturing industry still accounts for 70% of FDI. Service sectors like finance, insurance, transportation and utilities are also quickly attracting investment. The structure with service, research and development and mergers and acquisitions are under spotlight.

A survey by Price Waterhouse Coopers (PWC) in 2006 showed that a large number of chief executive officers plan to invest in China in the next three years to win customers in the world's fastest growing economy. PWC & Goldman Sachs have also forecasted that China would replace USA in the ranking in terms of total GDP and USA would be in 2nd position and India would emerge as No. 3 by early 2040s. As per 2008 IMF & World bank ranking, USA, Japan and China are the top three countries in terms of total GDP (national income).

SECTION 2: MULTINATIONAL CORPORATIONS IN INDIA

Economic Reforms in India

After nearly two decades of industry-oriented planning, India accorded due importance to the agricultural sector in the late 1960s, in response to massive food shortages. The consequence of this policy shift was the Green Revolution in the early 1970s. The reforms process in the 1980s was aimed mostly at opening up the economy. The much discussed economic reforms of the 1990s, the first sustained effort at restructuring the economy, came in response to balance of payments crisis in 1991. The government reacted by sweeping macroeconomic and structural changes. Direct tax rates were reduced for both individuals and corporate entities. Tariff rates too were reduced, licensing was eliminated and firms in most sectors were allowed to start operations without government approval. The impact of de-licensing was most evident in sectors like steel, automobiles, FMCG and consumer electronics which witnessed a surge in entry of new firms. Over time, capital account restrictions were eased to allow Indian companies to raise capital abroad and acquire firms in other countries.

The government also made it easier for MNCs to invest in India. Today, India welcomes foreign investment in virtually all sectors except defense, railway transport and atomic energy. In sectors like road and port infrastructure, mining of gold and minerals, and pharmaceuticals, MNCs can own up to 100% without government approval. In certain other lines of business like generation of power and development of integrated townships, 100% foreign ownership is possible with government approval. Finally, in sectors like media and insurance, MNCs are restricted to minority stake, and are expected to obtain government approval prior to initiation of business.

Foreign Direct Investment and India's Economic Reforms

As measured by the quantum of FDI inflow, global response has been, by and large, positive. One has to understand the nature and ex post views of the MNCs investing in India. Are they large MNCs or are they largely in sectors like financial services? Are they entering largely by way of joint ventures where the investment is split between MNCs and local firms? What determines the choice of the entry mode? Are MNCs that are in operation in India meeting their expectations about performance, thereby signalling to others that investment in India are worthwhile?

Characteristics of MNCs in India

Origin and Size

Interestingly, only a small fraction of the MNCs investing in India is large. An overwhelming majority of them are small, about 76% of them having fewer than 10,000 employees worldwide. Most of the larger affiliates are concentrated in the infrastructure and machinery and equipment sectors. The intermediate goods sector and the IT sector account for the bulk of the small firms. A significant proportion of the MNC affiliates in India, contribute to a significant proportion of the worldwide turnover—greater than 5%—of the parent MNCs.

Most of the firms contributing significantly to the parents' global output are in the IT and machinery and equipment sectors. Most of the firms investing in India are from the USA and Western Europe, together accounting for 78% of the firms. MNCs from Germany (11%) and the UK (9%) are the leading European investors. This pattern of investment is consistent with India's trade patterns. The majority of the North American firms, almost all of which are from the USA, on the other hand, have invested in the IT and financial services sectors. Much of the investments of Japanese and East Asian firms have been concentrated in the "old economy" machines and equipment sector and in the "new economy" IT sector. It is hardly surprising that not many MNCs invested in India until 1994, i.e., during the first four years of economic liberalisation, investment into India picked up only after 1994. This is consistent with the slow yet steady liberalisation of FDI regulations and the capital account of the balance of payment in India since 1991.

Emerging Market Experience

Research shows that the substantial number of the MNCs either did not have any emerging market experience before entering India, or their experience was limited to one of the four major regions with developing countries/emerging markets, namely, Asia (other than Japan), Eastern and Central Europe, Latin America and Africa. However, two-thirds of the MNCs investing in the pharmaceutical sector had significant operational experience in all the four regions.

Sector Focus

The majority of the MNCs investing in India are focused on a single activity or product, while others are diversified into related business sectors. This suggests that only MNCs with clear business focus enter India, possibly with a well-defined business strategy, whether seeking resources or markets.

Mode of Entry

Most of the MNCs enter into India either with greenfield projects or with joint ventures with local firms. MNCs investing in the basic consumer goods sector prefer greenfield to joint ventures (JV), as do those investing in the pharmaceutical sector. Entry mode for these sectors is consistent with the hypothesis that MNCs with high proprietary "technology" would prefer to enter an emerging market on their own (Greenfield).

Market Orientation

Nearly 60% of the output of the IT sector in India is exported. This is consistent with India's reputation as a IT hub catering to the rest of the world. On the other hand, MNCs in all other sectors sell 60 percent or more of their output in the local market, confirming the popular wisdom that the size of the Indian domestic market plays a significant role in attracting FDI.

Another notable point is that, MNCs which entered India by way of JVs cater more to the local market, while MNCs with greenfield entries cater more to overseas markets. This is entirely consistent with the literature which argues that MNCs aiming to cater to the local market are more likely to tie up with local partners to develop business contacts and distribution networks. MNCs with focus on the global market, on the other hand, are more likely to retain complete control to ensure that the quality of the products meets global standards.

Resources

Notably, brand is viewed by a significant proportion of the MNCs in India as the most important resource necessary for success. Most of these firms belong to the primary, basic consumer goods, financial services and pharmaceutical sectors. The eight resources deemed most important for success by the MNC affiliates are brand, business network, distribution network, equity, machinery and equipment, managerial capability, marketing capability and technological know-how. Importantly, most of these are intangible resources.

Factor Markets and Institutional Environment

Labour

Research shows that there has been a noticeable improvement in the quality of labour available locally across the board. MNCs investing in the primary, intermediate goods and IT sectors experienced the most significant improvements in labour quality.

Institutional Environment

The perception about the institutional environment in India, however, is not too optimistic. The MNCs felt that the only perceptible improvements were with respect to procurement of business licenses, real estate and visa and work permits. The MNCs that entered India by way of acquisition have reported that the legal institutional environment in India did not improve even after economic reforms. MNCs that entered India by all other modes, including Joint Venture, however, experienced an improvement in the legal institutional environment.

The experience of the JVs highlights the importance of local partnership in emerging markets. The East Asian MNCs, in addition, felt that there was an improvement in the support of the central government's institutions and policies for FDI, as well as in the legal institutional framework associated with procurement of real estate.

Product Markets

MNCs investing in all sectors were favourably impressed with the direction and pace of change in the quality of range of products produced in India.

Technology

A negligible proportion of the firms spend a significant fraction of their turnover on research and development. They are not keen to transfer technology. In other words, abstracting from the relative contribution of different entry modes to spillovers, the absolute level of knowledge and know-how spillover from FDI is not significant in India. Interestingly, even MNC affiliates whose parent firms have R&D intensive products do not spend a noticeable proportion of their turnover on research and training in India. This suggests that by and large MNCs use India as a manufacturing base for low-end generic or downstream products.

Not surprisingly, two-thirds of the MNCs that invested in sectors like IT and pharmaceuticals—sunshine sectors in India which can gain significantly from technology spillovers—are likely to receive significant technological resources from their parent firms.

In keeping with the literature, MNC entry by way of greenfield projects is likely to be more beneficial for India in the form of greater spillovers.

Performance of MNC Affiliates

Couple of research papers show that, overall, most MNCs were satisfied with their own performance, relative to their initial expectations. MNCs that entered India by way of greenfield projects were by and large happy with their performance. In comparison, MNCs that entered by way of JV were less successful.

Case

WAL-MART's FDI in China

By 2005, China's retail sector was opened for all although Chinese allowed foreign players a way back after their liberalisation of economy in 1978 but there were some trade barriers which kept the global companies at bay, but after an agreement with WTO in 2001 it came up with no intervention and restriction policy for the retail sector (other sectors too)—FDI in the retail sector was allowed without stringent rules and distribution rights were granted.

China presented an attractive and strategic location for global giants in retail because of the following reasons:

- It was strategically located for logistics and supply of goods,
- Almost every low-cost goods produced was either housed or shifted its base to China.
- Global supply chain now passed through China due to low cost production.
- China's size and population suggested a good market.
- An emerging middle class was optimistic and was eager to spend money.

The Wal-Mart : The American Multinational

Wal-Mart stores were started in semi-rural areas by Mr. Sam Walton of Arkansas in the USA; the first store was opened on 12 July 1962 in Rogers, Arkansas. According to Mr. Sam Walton, the future of retailing lies in "**discounting**" strategies; strategies applied by Wal-Mart to remain in the market were:

- Discounting;
- Opening stores in rural, backwater towns which were ignored by other retailers;
- Opening of stores aimed at saving people's money: by offering low price and high quality. This consequently led to the opening of stores in semi-urban and lesser known areas;
- Making it the preferred store by keeping prices low, and providing high quality of merchandise, assortment of goods, store environment, customer support, and availability of free parking;
- Giving what customers wanted.

Everyday Low Prices

This business strategy drew millions of customers at its door who were frustrated with constantly changing prices. The other features of this strategy consist of the following steps:

- Monitoring the prices of its competitors to offer the lowest;
- Roll-back philosophy—continuous cost-cutting pressure on suppliers also emphasised its supplier for cutting cost in production;
- Providing special buy logo on certain items to attract customers.

Success Model

Wal-Mart was very successful in their home country US, because they practiced better management strategies such as

- **Ten-feet rule**—Greet the customer and ask for help required.
- **Slow-down rule**—Answer the request from customers at the end of the business hours.
- **Exceed your customers expectation**—no customer was allowed to leave the store unsatisfied.
- **Showing respect for individual**
- **Striving for excellence**
- **Customer-friendly approach**—helping out customers in purchasing, being pleasant and polite and customers preferences were taken care of.
- **Good HR Practices**—All employees were treated alike.
- **Cost-efficient**—No hefty spending was done on business trips by their managers or top officials.

- **Small town location**—In several ways Wal-Mart avoided direct competition to remain in the market; also when a store serving small population is opened, there is no space for other to come in; when one area is served, Wal-Mart spread out its stores filling up the gaps. Thus, Wal-Mart saturated its market and effectively barred new competition from entry.
- **Relentless cost control**—Every penny saved in operating costs will result in lowering the prices.
- **Partnership with suppliers**—With its size of operation and chain of stores it could leverage its huge purchasing power in negotiations with suppliers; the suppliers also secured its sale by associating with the giant so Wal-Mart had high bargaining power in terms of lower prices, quality and punctual delivery. Indeed Wal-Mart forced its suppliers to search hard ways to eliminate inefficiency in their own processes in order to drive costs to a minimum and to improve the quality of goods.
- **Unrivalled distribution and logistics management—**This created a central distribution centre which served nearby stores not more than a day's travel, hub-and-spoke like model, kept inventory rate half of sales rate, maintained its own dedicated transport fleet to serve stores to achieve shorter lead times.
- **Use of technology**—They used computer way back in 1980's to track and analyse the sales data and transmit orders to the suppliers, later on moved to barcodes through which it collected market intelligence, first to use satellite technology to connect to all stores and supplies and track down inventory, ship movement, purchase orders, track sales etc.
- **A culture that reduced agency costs—**Employees were motivated to perform their best; a happy employee will serve the customer willingly. Employees had stock option in their company, there was profit sharing plans for all ranks, job switch (internal) options, no unionisation of workforce, surpassing middle men and going for purchase directly, open door policy for complaints and sharing of financial figure built trust and belongingness between the employee and the employer.

Entry into China

Wal-Mart entered into China because of:

- Largest population base in China (1.3 billion)
- Relaxation on regulatory front allowed high FDI and general business environment

China's Retail Industry

Retail sector in China is highly disorganised with large number of small players. Until 1980 most of the stores were state-owned, and production and distribution were governed by central planning. By the end of 1996, the role of non-state and private investors had grown to account for 72.6% of consumer goods sale.

Since 1990s, retailing had become highly competitive, and new shopping malls, shopping centres and hypermarkets appeared in almost all major cities and provinces. During this time, a much of the logistics supplies remained under the control of state and locals.

With the China's entry into the world trade organisation in December 2001 all restrictions concerning geographical expansion, product range and ownership structure were lifted; it also forced the opening up of the distribution and logistics sector, giving foreign companies more control over wholesaling and distribution.

Wal-Mart's Poor Show in China

Wal-Mart was unable to replicate its success model in China; a lot many factors led to the downfall of this giant retail sector. The reasons were:

- **Look of understanding of the market Wal-Mart**—Did not understand the market properly.
- **Restriction to several areas**—Wal-Mart was not allowed to open the stores in the urban areas of Shanghai.
- **Fragmented market**—Although China was highly populated, the real buyers were scattered far away.
- **Income disparity**—There was a big gap between the rich and poor, the widely dispersed consumption pattern in terms of both scale and variety meant to a retailer that it was almost impossible to develop a uniformed national merchandising or marketing strategy, which was one of the Wal-Mart's competency.
- **Local protectionism**—Trucks were stopped at city borders and subjected to tolls that local trucks were not required to pay; local governments also had incentives to protect local firms and suppliers.
- **Infrastructure deficiency—**Lack of expressways, proper highways, high toll rates, not well connected rail, sea and road network amounted in delay, loses and increase in the price of the product.
- **Lack of IT network**—One of the main contributor of Wal-Mart's success in US was the use of satellite for tracking down all logistics, sales, inventory—but in China the internet was slow, and use of satellite was not permitted, this impaired the retailer's efficiency in communicating and in real time monitoring.
- **High competition—**High competition existed before Wal-Mart's entry.
- **Chinese did little of shopping**—Both in small number and also in terms of sales, purchase was often impulsive than planned.
- **Local customs and preferences**—In China people preferred alive animals for indication of fresh meat; some of the items which were in demand were not with Wal-Mart, e.g. eels, frogs, etc. Diminished economies of scale and interrupted supply chain meant higher costs in satisfying Chinese consumer.
- **Shoplifting**—This had always been a problem with chain stores; further, it got severe in the cases where the employees were also involved.

Moreover, the highly fragmented market, impaired distribution network and unique consumer behaviour in China pushed Wal-Mart's operating costs higher and worked against a straight duplication of home model; it was impossible to cut the role of the middle man and the role of labour union. The support for the supplier, local competition, and indifferent attitude of government had a toll on Wal-Mart's business in China.

Questions

What can Wal-Mart do now? Debate on the following points:

- Get into alliance or partnership with local logistics and supplier—Yes/No
- Attract customer by aggressive advertising—Yes/No
- Take along small stores and provide them its product which will act as their local outlets – Yes/No
- Give extra preference to local taste and customs—Yes/No
- Wal-Mart China should become a global warehouse providing supplies to its US stores as manufacturing cost is low in China—Yes/No
- Have a further thorough study of the market—Yes/No
- A success model of one place cannot be replicated to other place—Yes/No

Chapter Summary

India has come a long way since 1991 insofar as quantum of FDI inflow is concerned.

However, there are two important issues, namely, (i) the experience of MNCs that have invested in India and the relationship between their performance and experience with the operating business environment and (ii) the extent of spillovers in the form of transfer of technology and know-how.

The importance of the former is that the satisfaction of expectations of the MNCs that are already operational within India is, for obvious reasons, an important pre-condition for growth in FDI inflow. Transfer of technology and know-how, on the other hand, is also likely to have an impact on India's future growth as the quantum of FDI inflow. India's future growth will also depend on the global competitiveness of its firms.

Review Questions

1. Discuss the categories of multinational companies.
2. Distinguish between the forms of FDI flow.
3. Discuss the characteristics of MNCs in India.
4. What does explain the FDI flow to China.

Class/Field Exercise

1. Carry out an analysis of MNCs operating in emerging markets/countries with specific reference to India and China.
2. Visit www.drjustinpaul.com site, click on blog and express your view on the blog items titled:
   (a) China, US and India as top 3 by 2040?
   (b) What are the secrets of success of Japanese multinationals?

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PART Eight

Social Environment

Chapter 21

Social Environment in India and China

Learning Objectives

- to understand the problems of social sector
- to learn the current issues in social sector in the two developing countries, India and China
- to examine the social environment of business and the linkage between society and business

Chapter Structure

Section 1: **Social Environment**

Section 2: **Poverty and Poverty Alleviation Programmes**

Section 3: **Labour and Employment**

Section 4: **Women in Workforce**

Section 5: **Child Labour**

Section 6: **Education**

Section 7: **Health, Population and Family Welfare**

SECTION 1: SOCIAL ENVIRONMENT*

This chapter deals with the social sector in two of the emerging economies of the world, namely India and China. It addresses some of the social issues faced by these countries and the efforts of the respective governments to empower and uplift the people of these two countries. It has been observed that a substantial amount of aid is made available for the social development of these countries and a number of international organisations are working in conjunction with the governments of these countries to provide the people with a better standard of living.

The social sector is viewed as one of the most important sectors in the developing economies of the world. It involves various programmes and policies of the government which are aimed at improving the standard of living of the citizens of that country through better availability of public services.

The social sector broadly refers to the services available in the following fields:

- Poverty and poverty alleviation programmes
- Labour and employment
- Development of women and children
- Education
- Health
- Population and family welfare
- Empowerment of the socially disadvantaged
- Public amenities in rural and urban areas

The main problem that is faced by most of the developing countries of the world is their ever growing high population, leading to high pressure on the land and agricultural sector. In such a scenario, the role of the government in providing the basic facilities, to the entire population, assumes a huge significance.

According to the UN Human Development Index (UNHDI), a country is ranked on its ability to provide to its citizens the three basic amenities of life, viz., longevity and health, education and a decent standard of living. These form an integral part of the social sector and thus, the relative level of social support for the citizens of that country can be measured using these indicators.

The main objective of this chapter is to learn the problems and issues in the social sector with a global perspective and discuss the state of the social sector in India and China (a country which has a comparable population and which, in recent times, has shown rapid economic development, fuelling speculation about its possible entry into the league of developed nations). Let us compare the prevailing practices in India and China since both the countries face the problem of population explosion, which leads to the need for a social security system.

SECTION 2: POVERTY AND POVERTY ALLEVIATION PROGRAMMES

According to the World Bank, poverty is hunger, lack of shelter, inability to access medical help and education. Poverty is powerlessness, lack of representation and freedom. Existence of poverty calls for action, a call to change the world so that many more may have enough to eat, adequate shelter, access to education and health.

*Two sections in this chapter was co-authored by Dr. Justin Paul and his former students Abhishek Maiti, Anubhav Khanna and Vandana Mohan.

Poverty can be looked at through various indicators like levels of income and consumption, social indicators, and indicators of vulnerability to risks and of socio-political access.

Measuring Poverty

Measuring Poverty at the Country Level

Poverty is commonly measured based on incomes or consumption levels. A person is considered poor if his or her consumption or income level falls below some minimum level necessary to meet the basic needs. This minimum level is usually called the “poverty line”.

Measuring Poverty at the Global Level

For the purpose of global aggregation and comparison, the World Bank uses reference lines set at $1 and $2 per day (more precisely $1.08 and $2.15 in 1993 Purchasing Power Parity terms). It has been estimated that in 2001, 1.1 billion people had consumption levels below $1 a day and 2.7 billion lived on less than $2 a day.

New Directions in Poverty Measurement

Mostly poverty measurement has been focused on the income levels. It is important to study other dimensions of poverty as well. The World Bank has prepared a report on this—‘World Development Report (WDR)’. It emphasises the need for social development based on education, health, access to services, infrastructure and so on.

Trends in Poverty Over Time

Living Standards have improved over the last few decades. The proportion of the developing world’s population living in extreme economic poverty, using the reference lines defined earlier, had fallen from 28 per cent in 1990 to 21 per cent in 2002. Infant mortality rates in low and middle-income countries have fallen from 86 per 1,000 live births in 1980 to 60 in 2002 while life expectancy had risen from 60 to 65 between 1980 and 2002. Adult literacy has also improved, though serious gender disparities remain. Male adult literacy (Age 15 and over) rose from 78% to 83% between 1990 and 2002 while female literacy rates rose from 62% to 70%.

Wide Regional Disparities are still persistent. There has been rapid growth in China and Asia and Pacific region in the recent years. But in Sub-Saharan Africa, GDP per capita shrank and poverty rose from 41 per cent in 1981 to 46 per cent in 2001.[1]

Millennium Development Goals (MDGs)

Although the overall poverty levels have fallen, the cause of worry is that this development is uneven across the world. Responding to such concerns in September 2000, 189 countries signed the Millennium Declaration, which led to the adoption of the Millennium Development Goals (MDGs). The MDGs are

1. World Development Report, World Bank 2003–04.

a set of eight goals for which 18 numerical targets have been set and over 40 quantifiable indicators have been identified. India and China are signatories to Millennium Development Goals.

The goals are:

- Eradicate extreme poverty and hunger
- Achieve universal primary education
- Promote gender equality and empower women
- Reduce child mortality
- Improve maternal health
- Check the spread of HIV/AIDS, malaria, and other diseases
- Ensure environmental sustainability
- Develop a global partnership for development.

Based on the above mentioned goals and the expected scenario, the Global Monitoring Report 2004 suggests areas for particular attention.

Priorities for Developing Countries

- Improving the business environment for private sector activity
- Strengthening capacity in the public sector and improving the quality of governance
- Scaling up investment in infrastructure and ensuring its effectiveness

Priorities for Developed Countries

- Sustaining stable and strong growth in the global economy
- Providing more and better aid
- Improving policy coherence for development

Priorities for International Financial Institutions

- Refining and strengthening institutional roles in low-income countries
- Furthering progress on the results agenda
- Improving selectivity and coordination of agency programmes

India

In India, poverty is estimated by the Planning Commission on the basis of large-scale quinquennial Sample Survey on Household Consumer Expenditure conducted by the National Sample Survey Organisation (NSSO). The last official estimates of poverty relate to 1999–2000. There has been significant decline in the people living below the poverty line (BPL) from 51.3 per cent in 1977–78 to 26.1 per cent in 1999–2000. But the country suffers from wide regional disparities and between rural and urban population. The Tenth Plan (2002–2007) has a target of reduction in poverty ratio.

The strategy for poverty alleviation follows a two-fold process. First is to provide greater opportunity to poor to participate in the growth process and the second is to have social security programmes which are specifically strengthened for the weaker sections of the society. The National Rural Employment Guarantee Bill, 2004 was introduced in Parliament in December 2004.

Some of the poverty alleviation programmes being carried out are National Food for Work Programme, Swaranjayanti Gram Swarozgar Yojana (SGSY), Sampoorna Grameen Rozgar Yojana (SGRY), Pradhan Mantri Gramodaya Yojana (PMGY) and Rural Employment Generation Programme (REGP) to name a few.

China

China has achieved remarkable success in its efforts in reducing poverty. China's official estimates of income poverty show an extraordinary drop from 260 million poor in 1978 to 42 million in 1998.

In 1986, the State Council's Leading Group for Poverty Reduction was established to coordinate targeted interventions against poverty. In 1994, China had launched the ambitious Poverty Reduction Plan to eradicate poverty.

Undoubtedly economic growth has been a major contributor in the success of the programme. The greatest advances against poverty came in the early 1980s, when rural economic reforms spurred rapid agricultural growth.

However, there have been regional disparities and slow down in the poverty reduction programme. The richer coastal provinces—benefited from increased trade and foreign investment—have grown faster than the poorer central and western provinces. China's poverty programme has tried to address the growing disparities by channeling resources to poor regions—through subsidised loans from the Agricultural Bank of China, a food-for-work infrastructure programme run by the Planning Commission and grants by the Ministry of Finance. This has been done away with and now the Chinese government is encouraging efforts like microfinance operations, regulated by the Agricultural Bank of China, to improve targeting.

SECTION 3: LABOUR AND EMPLOYMENT

It is important to provide work opportunities to people as this help them earn income to meet the material needs and provide them with a sense of dignity and purpose of life. Efficient labour markets contribute to the cause of poverty reduction while contributing to the economic growth and development.

The global employment situation improved slightly in 2004. Global unemployment stood at 184.7 million at the end of 2004, down from 185.2 million in 2003. It marks only the second time in the past decade that there was a year-over-year decline in total unemployment. In addition, the global employment-to-population ratio stabilised in 2004 at 61.8 per cent, from 61.7 in 2003.

Some of the major issues that would be affecting the labour market policies in the following years are:

- Tsunami and earthquake disaster
- HIV/AIDS
- Promoting the agriculture sector for poverty reduction
- Addressing the employment impact of '*outsourcing*'
- Creating better jobs in the informal economy
- Tackling the youth employment challenge

The International Labour Organisation has identified 20 indicators of the Labour Market.[2] They are:

- Labour force participation rate
- Employment-to-population ratio
- Status in employment
- Employment by sector
- Part-time workers
- Hours of work
- Informal sector employment
- Unemployment
- Youth unemployment
- Long-term unemployment
- Unemployment by educational attainment
- Time-related underemployment
- Inactivity rate
- Educational attainment and illiteracy
- Manufacturing wage trends
- Occupational wage and earning indices
- Hourly compensation costs
- Labour productivity and unit labour costs
- Labour market flows
- Poverty and income distribution

Labour markets work best when there is an institutional environment that allows adjustment flexibility for firms while ensuring income, social and employability protection for workers. In the developed world, the maintenance of employment protection rights and therefore, also employment stability is at the core of the employment system. It appears that there is a trade-off between employment and social protection meaning that we need to carefully look at the employment protection and labour protection policies. The developing countries, as they are operating very often in unstable environments, have to find ways to stabilise and gradually formalise their labour markets further in order to climb higher up the development ladder. Labour market stabilisation implies the introduction of labour standards and labour market institutions.

India

As per the results of the 55th Round of the National sample survey, the rate of growth of employment on Current Daily Status (CDS) basis declined from 2.7 per cent per annum in 1983–1994 to 1.07 per cent per annum in 1994–2000. One of the reasons for the decline in the overall growth rate of employment can be attributed to the fact that there has been a near stagnation of employment in agriculture. As a result, share of agriculture in total employment dropped from 60 per cent in 1993–94 to 57 per cent in 1999–2000 and 55% in 2004–05. On the other hand, employment growth in all the sub-sectors within services (except community, social and personal services) exceeded 5 per cent per annum.

It is important that the growth rate of employment should increase consistently. Some of the strategies which can be followed are:

2. Sourced from ILO website.

- Special emphasis to promote public investment in rural areas for absorbing unemployed labour force for asset creation.
- Identification of reforms in the financial sector to achieve investment targets in the Small and Medium Enterprises (SME) sector.
- Large-scale employment creation in the construction sector, especially for the unskilled and semi-skilled.
- Necessary support to services sectors and greater focus on agro-processing and rural services.

China

In China, there is a large working population, while the average educational level of the people is relatively low resulting in a very prominent problem of unemployment. In 2003, the total urban and rural employed population reached 744.32 million of which the urban employed population was 256.39 million, accounting for 34.4 per cent, and the rural employed population was 487.93 million, accounting for 65.6 percent.

The government has a proactive employment policy and the employment principle is "*workers finding their own jobs, employment through market regulation and employment promoted by the government*." Employment is promoted by developing the economy, and improving the social security structure. The government has also formulated a set of policies for promoting the re-employment of laid-off persons. In the social security system the government has established the system of three guarantees, namely, guarantee of basic subsistence allowance for laid-offs from state-owned enterprises, guarantee of unemployment insurance and guarantee of minimum subsistence allowance for urban residents.

SECTION 4: WOMEN IN THE WORKFORCE

Quantitative increases in women's economic participation in the past two decades have not generally been matched by qualitative improvements. One of the priorities of the Chinese government is, therefore, to improve the quantity and quality of employment for women. In addition, the Copenhagen Declaration on Social Development commits governments to "formulating or strengthening policies and practices to ensure that women are enabled to participate fully in paid work and in employment".[3]

India

Employment of women in the organised sector (both public and private) in 2004 at 4.99 million constituted 18.8 per cent of the total organised sector employment compared to 18.1 per cent in 2002. Several initiatives are being taken to upgrade skills of women through training.[4]

China

The state promotes women's equal right with men to work. In May 2001, the Chinese government promulgated "The Program for the Development of Chinese Women (2001–2010)," which set the goal

3. UNDP Human Development Report, 2003.
4. Economic Survey, Govt. of India, 2004–05.

of promoting women's employment. The employed female population in China's urban and rural areas increased from 291 million in 1990 to 337 million in 2003. Governments at all levels have actively developed and expanded trades and fields suitable for women to work in.[5]

SECTION 5: CHILD LABOUR

There are thousands of children engaged in child labour. Of those, most of them work in hazardous situations or conditions, such as in mines, with chemicals and pesticides in agriculture or working with dangerous machinery. They are everywhere but invisible, toiling as domestic servants in homes, labouring behind the walls of workshops or hidden from view in plantations.

Child Work

Children's participation in economic activity, that does not negatively interfere with education, can be positive. Work that does not interfere with education (light work) is permitted from the age of 12 years under the International Labour Organisation (ILO) Convention 138.

Child Labour

This means all children below 12 years of age working in any economic activities, those aged 12 to 14 years engaged in harmful work, and all children engaged in the worst forms of child labour.

India

Interpolation of census figures by the National Labour Institute indicates that out of 203 million children between the ages of 5 and 14, 116 million are in school, 12.6 million are in full-time employment, and the status of 74 million is unknown. Most, if not all, of the 87 million children, not in school, do housework, work on family farms, work alongside their parents as paid agricultural labourers, work as domestic servants, or are otherwise employed. As many as 100 million boys and girls are believed to be working in homes and factories across India, many under conditions akin to slavery.

Government has adopted two schemes, namely, National Child Labour Project Scheme (NCLP) and Granting Aid to voluntary organisations for taking up action-oriented programmes in the field of rehabilitation of child labour.

China

For the year 2000, the ILO projected 92,24,000 economically active children, 44,69,000 girls and 47,55,000 boys between the ages of children, 44,69,000 girls and 47,55,000 boys between the ages of 10-14, representing 7.9% of this age 14, representing 7.9% of this age group. There are no reports of violations of child labour laws in the urban and industrial sectors, but in poorer, isolated areas, child labour in agriculture is widespread. Child labour in the footwear industry has also been identified as a growing practice.

5. China Govt. White Paper www.china.org.in

SECTION 6: EDUCATION

Promoting education is central to the World Bank's mission of poverty reduction. The World Bank has been helping advance education in developing countries since 1963 and today remains the world's single largest provider of external funding for education.

The Bank's support for education has a dual focus: to help countries achieve universal primary education and equally, build the skills imparted at the secondary and tertiary levels, which are vital to compete in today's advanced knowledge-driven global markets.

As of June 30, 2004, 89 low and middle-income countries were implementing a total of 142 World Bank-financed education projects worth about \$8.5 billion. Lending for education amounted to \$1.7 billion in the year ended June 30, 2004. Helping countries put in place sound education policies is a top priority, with emphasis on education quality.[6]

As with all World Bank assistance, lending is only one part of a broader package of the services. The Bank complements its finance with policy advice; analysis; sharing of global knowledge and best practice; technical assistance and capacity building; and support for consensus-building. The Bank is also at the forefront of global efforts to advance education. The past few years have seen marked progress toward 'Education for All'—an international commitment first made in 1990, as the Bank has worked vigorously with country and global partners to map out the path to the 2015 goal and put in place the Fast-Track Initiative.

India

The primary aim of the government in this regard is to achieve 100% literacy rates among the population. Although literacy has been growing constantly in India since Independence, it has only reached a level of 64.8%, as indicated by the last census. This is primarily because the population has been growing at a faster rate, but the absolute number of illiterates has decreased in the last census as compared to the previous years. The gender gap in literacy is also reducing as is the rural-urban divide in this area.

The education policy is divided under the following heads in India:

Elementary Education

The aim is to provide Universal Elementary Education. To this end, a Constitutional Amendment was passed and a Bill was introduced in Parliament containing the detailed implementation mechanism.

Sarva Shiksha Abhiyan (SSA) was launched in order to provide quality education to all children between the ages of 6 and 14 by improving the performance of the school system by investing the ownership and responsibility of the school in the community. Additional support has been extended to the National Programme for Education of Girls at Elementary Level (NPEGEL), under the umbrella of the SSA, in order to bridge the gender gap at the elementary level.

The enrolment in schools was seen to increase at the primary and upper primary levels and the drop out rate was seen to decrease. The absolute number of teachers has increased but the pupil-teacher ratio has been seen to remain constant.

Some of the schemes introduced by the Central Government in order to encourage enrolment in elementary education programmes were:

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6. Sourced from www.unicef.org

- District Primary Education Programme to provide access to primary education for all children.
- Mid-day meal scheme to boost education by improving enrolment, attendance and retention.
- Mahila Samakhya for the education and empowerment of women, especially those from socially and economically marginalised groups.

University and Higher Education

Total student enrolment in Universities increased as did the number of women students. Accreditation of universities and colleges was made mandatory and guidelines for opening centers of Deemed Universities were simplified.

Technical and Professional Education

The AICTE has delegated the power to approve of diploma level technical institutes to the state governments. Also, the focus has been on building up of strong ties between the educational institutions and the industry.

Adult Education

The National Literacy Mission, the Universalisation of Elementary Education and the non-formal education are the three instruments by means of which the government wishes to attain a sustainable level of literacy. These programmes are aimed mainly at propagating education in the 15 to 35 age-group. The Total Literacy Campaign (TLC) is one of the main aims of the National Literacy Mission and aims at achieving 100% literacy in the target age group. The TLC has two main aims, namely:

- Imparting functional literacy and reaching first the self-reliant level and then moving towards continuing education
- Upgradation of life and occupational skills

China

China has a law which calls for nine years of formal education for all children. However, this law has been implemented with certain provisions for the backward regions of China, which allows the implementation of the nine-year standard to be flexible.

At each level of education, there are a substantial number of dropouts. This is mostly because of the increasing cost of education in China. The local government authorities charge a certain amount from the school, which is then passed on to the students.

The State Education Commission (SEC) is the chief administrative organ which oversees education in China. The SEC formulates and enforces policies and laws concerning education, and coordinates the various governmental agencies' operation of the individual schools. The influence of the SEC is felt mostly in the institutions of higher education, as the governance and management of primary and secondary schools is left to the local governments.

Students in the vocational and technical secondary education stream enter a vocational or technical school, which train medium-level skilled workers, as well as managerial and technical personnel. Technical schools train intermediate technical personnel. There is a third category called *School for Skilled Workers* that typically trains graduates for positions involving production and operation skills.

The designation of "*Key School*" exists for selected schools at every educational level in China: elementary, secondary and higher. In addition, there are various levels of the "key" designation itself: There are national key institutions, municipal key institutions, and district key institutions. All key schools enjoy priority funding as well as the privilege of recruiting the best students. Entry into such schools is based on examinations and academic performance. For such schools, success is usually measured in terms of the percentage of its graduates entering colleges and universities, especially the key colleges and universities.[7]

Adult education is also an important issue in China. The media used are radio/TV Universities, specialised schools and colleges (different institutions for peasants, workers, and staff members) and through correspondence courses.

With regard to education budget, financial allocation by the government is still the major source. At present, funds needed by schools directly controlled by the central government come from the central financial pool; for schools controlled by local governments from local finance; schools sponsored by public institutions are mainly financed by the sponsor institutions and subsidised by local governments and funds needed for schools operated by social partners and celebrities are raised by the sponsors themselves (including collecting tuition from students and soliciting contributions).

SECTION 7: HEALTH, POPULATION AND FAMILY WELFARE

One of the main problems facing the world today is that of the spreading AIDS epidemic. International health organisations are concerned about the incidence of HIV in a large percentage of the population in African and Asian countries. Large amounts of money are being spent in order to spread information about the fatal nature of the disease and to support research working to find a cure for it. The growing population in developing and less developed countries is also a cause for concern for these organisations since a large amount of funds is required to support the social infrastructure needed to deal with this phenomenon.

India

Although the health services have improved over the past few decades, the focus has shifted towards providing healthcare to the underprivileged sections of the society. Some of the other issues that need to be addressed are the shortages of manpower, services and drugs in many hospitals as well as the large rural-urban divide in the availability of health services.

Some of the issues addressed under the 10^{th} Plan were emergency and disaster management (in situations like the tsunami that had hit the south and south-east Asia), health insurance for the needy and free emergency (life-saving) services to all those below the poverty line.

Several centrally-sponsored schemes for the control of infectious diseases like malaria, dengue, encephalitis, tuberculosis, leprosy and AIDS were introduced. Also, measures were introduced to deal with non-communicable diseases like blindness, cancer and mental disorders.

By 2050, India is expected to be the most populated country in the world. In order to combat this problem, effective steps have to be designed. The current growth in the population is due to high fertility (contraception needs are unmet) and a very high proportion of the population in the reproductive age group. The long term aim is to achieve population stabilisation by 2045.

7. Sourced from www.china.org.com/e-white China Government White Paper.

Some of the other schemes introduced are with regard to the reduction of maternal and infant mortality and financial assistance to mothers belonging to households below the poverty line and who have attained the age of 19.

The Universal Immunization Programme was also a step taken to reach out to women and children in far-flung areas of the country in a measure taken to eradicate the instances of polio (Pulse Polio Immunization Programme).

China

China has made significant achievements in the past decades in reducing fertility, maternal mortality ratios and infant mortality rates.

The Ministry of Health has numerous collaborative programmes with the WHO. Those which are relevant to safe motherhood include programmes on reproductive health, nutrition, vaccination, health promotion and health care delivery.

The Chinese Government has drafted several policies to complement existing projects in the promotion of safe motherhood. The Programme for the Development of Chinese Women identifies areas to enhance the role of women in society and to safeguard women's rights to health and safety. Among the objectives of the Action for Children's Development Programme is the reduction of China's infant mortality rate by at least one-third.

Nutritional deficiencies are prevalent in certain areas and among certain population groups. A large percentage of pregnant women are reported to be anemic (deficiency in blood count). Malnutrition among children was seen to increase sharply in nine provinces but dropped significantly in the urban areas.

The government has passed a law to curb the population situation and provide couples of childbearing age with various contraceptive options and family planning services.

A number of projects are being carried out in collaboration with international agencies like UNICEF and WHO in order to address the growing problem of AIDS, diabetes, tobacco consumption, hepatitis, tuberculosis and to prevent the recurrence of SARS, which had paralyzed life and trade in most parts of south and south-east Asia in 2003.

Empowerment of the Socially Disadvantaged

The socially disadvantaged classes in India are divided into the scheduled castes, the scheduled tribes and other backward classes, a division not found in China. The government has been working towards the empowerment of these classes through reservation policies regarding employment in the public sector and within educational institutions.

India

Several programmes for the upliftment of persons with disabilities, children in need of care, the aged, minorities, scheduled castes and tribes and other backward classes have been undertaken by the government.

These schemes consist of scholarships for students from backward classes, income generating schemes for the needy, educational development of the underprivileged classes, upgradation of technology for trades predominantly practiced by minority communities, ensuring adequate food supply in remote areas, protection of the rights of the socially backward classes, rehabilitation of the physically and mentally challenged people.

Public Amenities in Rural and Urban Areas

The responsibility for the availability of amenities in rural and urban areas falls on the governments of the various countries. However, in several nations, local bodies along with organisations like the WHO are working to provide facilities like clean drinking water and basic sanitation to people living in remote areas. The basic aim is to improve the quality of life of the people and to provide them with a decent standard of living.

India

The government has tried to provide safe drinking water in all rural and urban areas since this has an impact on the infant mortality rate, longevity, death rate and productivity.

Some of the schemes aimed at this are:

- Accelerated Rural Water Supply Drinking Water
- Pradhan Mantri Gramodaya Yojana-Rural Drinking Water

These schemes involve the affected community and create a sense of ownership among the people, thus leading to better maintenance and usage by them. Some of the issues thus addressed are the regulation of ground water withdrawal, water harvesting and soil and water conservation.

China

Several programmes are being carried out with the help of funds from the World Bank, UNICEF and the Chinese Government in order to provide safe drinking water to the rural and urban centers.

The protection of water quality and enforcement of water quality standards are under the State Environmental Protection Administration, or SEPA jurisdiction. SEPA, however, has to rely on local Environmental Protection Bureaus (EPBs) within municipal and district governments to enforce regulations, especially because government restructuring has reduced the size of SEPA by 40%. Responsibility for water quality management is further fragmented by the fact that surveillance of drinking water quality is the responsibility of the Ministry of Health (MOH, situated in Beijing). The MOH monitors drinking water quality and waterborne diseases, primarily through the supervision and monitoring of environmental sanitation and health in public places and drinking water sources. There is need for formalised coordination between SEPA, the MOH, and local EPBs, which would lead to efficient system.

Chapter Summary

The social sectors in India and China both have to work towards the upliftment of the people. In spite of the economic growth in both the countries, some of the important issues that need to be addressed are:

- Reduction in the number of people living below poverty line
- Improving working conditions and providing employment opportunities
- Stabilisation of the population

- Development of women (India has a Gender Development Index (GDI) of 103 while China has a GDI rank of 71)
- Supply of proper sanitation and drinking water facilities in rural as well as urban areas
- 100% literacy among the population
- Immunization of all children and eradication of diseases like polio, tuberculosis and addressing the issue of AIDS

India and China are required to lay down effective social security measures like old age and disability pensions. Currently, India has reservations for people with disabilities in public sector organisations and in educational institutions. It should also provide insurance schemes, in collaboration with insurance companies, for work related injuries and medical problems. The government can also look at providing basic amenities and housing security for the urban and rural poor and maintain an effective Public Distribution System to provide food to all. The social sector is one of great importance since it deals with the living standards and facilities available to its people, its most important resource.

Objective Type Questions

Fill in the Blanks

1. The employed female population in ______________ urban and rural areas increased from 291 million in 1990 to 357 million in 2003.
2. Literacy has reached a level of ______________ %, in India, as indicated by last census.
3. ______________ is the chief administrative organ which oversees education in China.

Review Questions

1. Elucidate the issues and impediments of social sector in India.
2. How do you assess the performance of China with reference to the social sector?

Class/Field Exercise

Visit the website of United Nations and World Bank. Collect the information on the social welfare/ development projects being implemented in India and China under the aegis of organisations such as UNDP and UNESCO (www.unesco.org is the website of UNESCO).

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Answers

Fill in the Blanks

1. China's
2. 65
3. State Education Commission (SEC)

Chapter 22

Corporate Governance and Corporate Social Responsibility

Learning Objectives

- to understand the dimensions of Corporate Social Responsibility
- to learn how 'Corporate Social Responsibility' can be built into management practices
- to discuss the meaning of the term 'Corporate Governance' and its implications

Chapter Structure

Section 1: Corporate Social Responsibility

Section 2: Cases:

1. **Bank of India**
2. **Bharat Petroleum**

Section 3: Corporate Governance

Section 4: Cases:

1. **Infosys**
2. **Reliance**

SECTION 1: CORPORATE SOCIAL RESPONSIBILITY

Corporate Social Responsibility (CSR) can be described as an approach by which a company:

- recognises that its activities have a wider impact on the society and that development in society, in turn, supports the company to pursue its business successfully; and
- actively manages the economic, social, environmental and human rights impact of its activities.

This approach is derived from principles of sustainable development and good 'Corporate Governance.'

The concept of "governance" is not new. It is as old as human civilization. It is the process of decision making and implementation. Governance can be used in several contexts such as corporate, international, national and local. Good governance requires that institutions and processes try to serve all stakeholders within a reasonable timeframe.

Accountability is a key requirement of good governance. Not only governmental institutions, but also the private sector and civil society organisations must be accountable to the public and to their institutional stakeholders. Who is accountable to whom varies depending on whether decisions or actions taken are internal or external to an organisation or institution. In general, an organisation or an institution is accountable to those who will be affected by its decisions or actions. Accountability cannot be enforced without transparency and the rule of law.

In the last twenty years, multinational corporations have played a key role in defining markets and influencing the behaviour of a large number of consumers. The rules of corporate governance have changed too. And there has been a range of reactions to this change. On one hand, globalisation and liberalisation have provided a great opportunity for corporations to be globally competitive by expanding their production-base and market share. On the other hand, the same situation poses a great challenge to the sustainability and viability of small industries, particularly in the context of the emerging discontent against multinational corporations in different parts of the world. Labourers, marginalised consumers, environmental activists and social activists have protested against the unprecedented predominance of multinational corporations.[1]

The ongoing revolution in communication technology and the effectiveness of knowledge-based economies have created a new model of business and corporate governance. A growing awareness about the need for social responsibility and the new economy framework have paved the way for a new generation of business leaders concerned about the response of the community. It is in this context that we need to understand the perspectives about corporate social responsibility.

There are three emerging perspectives pertaining to corporate social responsibility:

One, a business perspective that recognises the importance of '*reputation capital*' for capturing and sustaining markets. Thus, corporate social responsibility is basically a new business strategy to reduce investment risks and maximise profits by taking all the key stake-holders into confidence.

The second is an *eco-social perspective*. The proponents of this perspective recognise that social and environmental stability and sustainability are two important pre-requisites for the sustainability of the market in the long run. They believe that increasing poverty can lead to social and political instability. Such socio-political instability can, in turn, be detrimental to business. Seen from the eco-social perspective, corporate social responsibility is both a value and a strategy to ensure the sustainability of

[1]http://www.atse.org.au/publications/focus/focus-fitzpatrick2.htm

business. It is a value because it stresses the fact that business and markets are essentially aimed at the well-being of society. It is a strategy because it helps to reduce social tensions and facilitate markets.

For many corporate leaders, *optimisation of profits* rather than the *maximization of profit* is the key. Hence there is a shift from accountability to shareholders to accountability to stakeholders (including employees, consumers and affected communities). There is a growing realisation that long-term business success can only be achieved by companies that recognise that the economy is an "open subsystem of the earth's ecosystem, which is finite, non-growing and materially closed". (Herman E Daily in 'Sustainable Growth? No thank you' in *The Case of the Global Economy*, (Eds.) Jerry Mander, Edward Goldsmith; Sierra Book Club, 1996).

The third perspective is called as *rights-based perspective* on corporate responsibility. This perspective stresses that consumers, employees, affected communities and shareholders have a right to know about corporations and their businesses. Corporations are private initiatives, true, but they are increasingly becoming public institutions whose survival depends on the consumers, who buy their products, and shareholders who invest in their stocks. This perspective stresses *accountability, transparency and social environmental investment* as the key aspects of corporate social responsibility.[2]

During the late 1960s and 1970s, corporate social responsibility had emerged as a top management concern in both the United States and Europe. Today, it is back on the agenda of many CEOs. This time, it is also on the agenda of governments, both national and local, as well as NGOs, consumer groups, investors, etc.

As the world business environment changes, the factors contributing for success and competitiveness also become subject to changes. Building strategic relationships with customers, suppliers, employees, communities and other stakeholders (the corporate eco-system) has become central to competitiveness and even survival. Building these relationships can form the foundation for a new, progressive and people-centered corporate strategy. This brings us to the increased importance of corporate social responsibility (CSR). An increasing number of companies are finding that it makes good business sense to fully integrate the interests and needs of all stakeholders into corporate strategies. Over the long term, this approach can generate more profits and growth. It implies that management's task is to seek an optimum balance in responding to the diverse needs of the various interest groups affected by its decisions. By including society—this stakeholder model assumes that enterprise has a social responsibility.[3]

The observations that can be made about the concept of social responsibility can be listed as follows:

- Corporate social responsibility is fundamentally a philosophy or a vision about the relationship of business and society. It is most effectively treated as an investment. It is a process of continuous improvement, which begins small, grows and expands over a period of time. It has been referred to as "caring capitalism" in contrast to "financial capitalism".
- It can be linked to profitability, as there can be no social responsibility without profits. Profits are essential not only to reward investors but also to provide jobs, pay fair wages, and contribute to the prosperity of the communities in which the business operates.

There are five key dimensions of corporate social responsibility. The following paragraphs describe these dimensions, give examples of best practices, and indicate how management attention to these

[2]Website: www.sustainability.com
[3]World Business Council for Sustainable Development Report, Corporate Social Responsibility, 2004.

elements can enhance growth and profitability. CSR is really about how to manage these five dimensions as responsibilities.

(i) Customers

Successful companies build lasting relationships with customers by providing them superior quality, reliability and service. Probably the most important reason why western companies are capturing markets across the countries is the priority which they give to developing close and responsive relationships with their customers.

Similarly, the ethical conduct and environmental consciousness of companies make a difference in purchasing decisions. The reputation of companies in these and other areas does influence consumers' choice of brands and producers and often leads to switching brands even if there is a price differential. There is something even spiritual about this service-centered concept and the organisational implications.

(ii) Employees

Socially responsible businesses are contributing more to provide work which is meaningful and helps employees develop and realise their potential. They provide fair wages, a healthy and safe work environment. Management practices and human resource policies often include empowerment of employees; better balance between work, family, and leisure; greater work force diversity; continual education and training; and concern for job security.

The practices, which provide higher quality of life in the workplace, have a very direct impact on profits through increased productivity, greater innovation, and more committed people at all levels. Furthermore, many companies find that caring for employees results in greater customer satisfaction.

(iii) Business Partners

The relationships with business partners, such as suppliers and in some cases even competitors, can be critically important to competitive success. By developing long-term relationships with business partners, firms would be able to reduce complexity and costs.

A legend in Hewlett Packard, a company noted for its good supplier relations, is a purchasing agent who told the President that he had just negotiated a great contract with a supplier with prices reduced by 20%. The President questioned whether the supplier could make a fair profit at that price, and eventually called in the supplier to renegotiate a fairer (higher) price. Not surprisingly, the supplier became a very loyal and valuable partner to Hewlett Packard.[4]

(iv) The Environmental Protection and Sustainable Dimension

Corporate Social Responsibility in this context means creating value by doing more with less over the full life-cycle of the product by:[5]

[4]Friedman, M., (1970) The Social Responsibility of Business is to Increase Its Profits. Reprinted in Hoffman, W. M.
[5]Frederick, R. E., (1995) Business Ethics. Readings and Cases in Corporate Morality. McGraw-Hill Inc.

(a) reducing toxic dispersion;
(b) enhancing material recyclability;
(c) maximising sustainable use of renewable resources by reducing energy inputs

There are also a number of environmental management tools and concepts developed by business firms throughout the world. These tools include life cycle assessment and costing, environmental management standards, eco-labeling, and recycled-content standards. Multinational corporations are also encouraged to apply the environmental criteria to investments abroad as to those in their home country. An emerging concept to link economic and environmental interests and thus make the market system work for the benefit of the whole of society is the definition of pricing tools such as environmental taxes to more accurately recognise and reflect the environmental costs of the production, recycling and disposal. In some companies, accounting methods are being revised to make this possible. Advocates of such environmental accounting insist that the social costs of consumption (ex: tobacco) should be included in the price of such goods sold.

(v) Communities[6]

Business operates in local, regional, national, and global context. Companies can make more important contribution to the society, and especially to local communities. The long-term success of a business can be linked to health, stability, and prosperity of the communities in which it operates. Community-focused businesses like banks, retailers, and newspapers cannot prosper in declining localities. The problems of education, health, crime, unemployment and drugs dramatically affect business in the long run. The more the number of corporates responsible for the society, the less would be the evils in the society.

SECTION 2: CASES

Case 1: CSR at Bank of India

At Bank of India, corporate social responsibility is basically the care and concern for the deprived in particular and the community at large. Social responsibility is a function of the banking industry where by the Bank focuses on those below poverty line and the communities that qualify for schematic lending under the various government sponsored programs. The focus is on ensuring that they become self-sufficient and can achieve the desired goals to improve their living standards. The Bank has a policy of recruiting the blind and disabled and also has a committee to monitor and prevent any sexual harassment at the work place. Employees always volunteer to support NGOs in noble causes such as Eye donations/Blood donation camps.

The top management not only involves in such a cause but also actively supports it. Well known NGOs who have been on the scene for quite a number of years and doing services to the community over the years are supported in their cause. The programs are monitored by the zonal offices spread over 43 zones that ensure the end of the funds donated to the NGOs. The relationship with some of the NGOs is on a continuous basis like that with the cancer foundation. The Bank is truly a bank of India, as the name indicates, with over 2600 branches and 43 zonal offices and has a good representa-

6. Dasgupta A (2006): Corporate (Social Responsibility. Overview and Issues in Justin Paul and S. Ganesan (Ed.), Management strategies and Policies in the 21st Century, Allied Publishers.

tion both in metro, urban and rural India. It is, therefore, natural that CSR should spread across state borders and is not limited to where the Bank is headquartered.

Business ethics and governance are separate issues. The money contributed towards CSR activities are monitored by the concerned zonal offices and the NGOs are asked to submit receipts and photographs justifying end use of funds. Employees have always contributed whenever there has been a major disaster by donating a day's wages, which along with the Bank's contribution, collectively works out to a few million rupees. Their employees are involved in a systematic monitoring of the activities for which the funds have been donated. The objective is to ensure that there is total involvement of both the management and the employees while the mission would be to succeed in making life better for poorest of the poor and the downtrodden.

As part of its centenary celebrations, the Bank of India has adopted 101 villages. Employees too are very considerate when it comes to serving a social cause and the Officers' association and the Unions have always been organising blood donation drives, adoption of village and free cancer detection camp.

Question

Discuss The rationale behind the implementation of Corporate Social Responsibility at Bank of India.

Source: Compiled from 'The Economic Times', January 18, 2006.

Case 2: Bharat Petroleum and Social Responsibility

Do we reach out to the people? Are our efforts visible in the far flung villages in backward areas of the country? Bharat Petroleum (BP) believes that the answer to these questions is yes. Bharat Petroleum energises the lives of Indians in one way or the other. The corporation has invested heavily in staff, customers, stakeholders and society and this is "because they care".

The essence of Corporate Social responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of work force, their families as well as society at large.

Any business needs a stable social environment that provides a predictable climate for investment and trade. At the same time society also has expectations from the business. In this manner, businesses and society are interdependent and businesses must take full account of the societal expectations. Increasing regulatory pressures could be one of the reasons for undertaking CSR activities. However in this day and age, CSR is increasingly being viewed not only as making good business sense, but also as contributing to long-term prosperity of the companies and ultimately their survival.

The challenge for successful company in Indian and global economy is to build and maintain efficient, effective and fair relationship with its global and local stakeholders. An increased brand value, greater access to finance, stronger risk management and corporate governance, healthier and safer work place, motivated people, customer loyalty and enhanced confidence and trust are the benefits of excellent CSR.

As corporates grow in strength in a rapidly globalising environment, their contribution to the development of the society becomes increasingly pertinent. The emergence of CSR has been critical for millions of people left below the poverty line.

Bharat Petroleum receives complete support and direction from board of directors for its CSR activities, with director (HR) at the helm of affairs. D M Reddy, executive director, states that "Corporate Social Responsibility is one of the prime focus areas of a corporation. The whole approach towards contributing to society is very scientific and well thought out. In all such endeavors, the benefits should trickle down to as many people as possible. A corporation should look forward to long term relation with the community whose life it touches. Through community development initiatives, corporations can strive to evolve community holistically in all spheres, viz. health, education, infrastructure, income generation, vocational guidance. Having contributed towards a society after assessing the needs, a corporate can ensure a proper feedback system to realise the impact of its contribution. Based on studies, it can review its approach and implement new strategies."

Social Service Activities Undertaken by BP

Infrastructure Development—like provision of tube wells, bore wells, dug wells for drinking water and irrigation, construction of multi-purpose community center to accommodate school (non-formal education), balwadi (primary education), health centre, community centre, construction of sanitation block to promote hygiene, provision of alternate sources of energy, solar energy-based street lights and lighting for village and community centre.

Education Support—provision of uniforms, notebooks, stationery, teaching material, educational aids, sweater and food supplements, educational scholarships to children from the economically backward classes for pursuing their studies, till complete their education, aptitude testing and vocational guidance for higher secondary children through experienced psychologists.

Health Care—regular health checkup for villagers by doctors, provision of free medicines for minor ailments, guidance on family welfare and general health care, free medical dispensaries, cataract surgery and intra-ocular lens treatment.

Skill Enhancement—adult education, modern farming practices, distribution of fruits' saplings, veterinary camps, cattle camps, distribution of smokeless *chulhas*, training on income generation vocations, helping women promote awareness on social issues, organising regular lectures for women on family life and education.

Question

Why should an organisation like Bharat Petroleum involve in undertaking social activities?

Source: Compiled from The Economic Times, January 18, 2006.

SECTION 3: CORPORATE GOVERNANCE

Corporate governance is a field in management that explores the ways to secure efficient management of corporations by the use of mechanisms, such as organisational designs and legislation. It is concerned with striking the balance between economic and social goals and between individual and communal goals. The corporate governance framework is to encourage efficient use of resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.

Corporate governance is about commitment to values and about ethical business conduct. It is about how an organisation is managed. This includes its corporate and other structures, its culture, policies and the manner in which it deals with various stakeholders. Accordingly, timely and accurate disclosure of information regarding the financial performance, ownership and governance of the company is an important part of corporate governance. This improves public understanding of the structure, activities and policies of the organisation. Consequently, the organisation is able to attract investors and enhance the trust and confidence of the stakeholders. This is the system by which companies are run, and the means by which they are responsive to their shareholders, employees and society.

Corporate Governance—New Developments

Corporate governance guidelines and best practices have evolved over a period of time. The Cadbury Report on the financial aspects of corporate governance, published in the UK in 1992, was a landmark. It led to the publication of the Viénot Report (Visit http://www.pariseuroplace.net/files/rapport_vienot1_fr.pdf for full report) in France in 1995. Over the past decade, various countries have issued recommendations for corporate governance. Compliance with these is generally not mandated by law, although codes that are linked to stock exchanges sometimes have a mandatory content. The Sarbanes-Oxley Act, which was signed by the US President George W. Bush into law in July 2002, has brought about sweeping changes in financial reporting. This is perceived to be the most significant change to federal securities law since the 1930s. Besides directors and auditors, the Act has also laid down new accountability standards for security analysts and legal counsels. The Sarbanes-Oxley Act was enacted in response to Enron, Health-South and several other recent episodes involving corporate fraud, mismanagement and abuse of power. The act is primarily legally binding only to publicly-traded companies but a small part of it is legally binding for unlisted and not-for-profit companies. In November 2003, the U.S. Securities and Exchange Commission (SEC) approved changes to the NASDAQ listing requirements. The changes focused mainly on board independence, independent committees of the board, audit committee composition, code of business conduct and ethics and related party transactions.

The Higgs Report on non-executive directors and the Smith Report on audit committees, both published in January 2003, form part of the systematic review of corporate governance being undertaken in the UK and Europe. This is in light of the recent corporate failures. Enhancing the effectiveness of the non-executive directors and switching the key audit relationship from executive directors to an independent audit committee are part of this. These recommendations are intended as revisions to the Combined Code on Corporate Governance. In April 2004, the governments of the 30 OECD countries approved a revised version of the OECD's Principles of Corporate Governance adding new recommendations for good practice in corporate behavior with a view to rebuilding and maintaining public trust in companies and stock markets. The revised principles call on governments to ensure effective regulatory frameworks and on companies to be more accountable. The principles include enhanced role for shareholders in executive compensation, greater transparency and effective disclosures to counter conflicts of interest.

In India, the Confederation of Indian Industry (CII) took the lead in framing a desirable code of corporate governance in April 1998. This was followed by the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance appointed by the Securities and Exchange Board of India (SEBI). The recommendations were enshrined in Clause 49 of the Listing Agreement of every Indian stock exchange. An important decision taken in this regard in India is that all listed companies should have 50% independent directors on their board. In addition, the Department of Company Affairs, Government of India had constituted a nine-member committee under the chairmanship of Mr Naresh Chandra, former Indian ambassador to the US, to examine various corporate governance issues, and the major recommendations have been implemented.

Corporate Governance—Major Factors[7]

Typical corporate governance measures include appointing non-executive directors, placing constraints on management power and ownership concentration, as well as ensuring proper disclosure of financial information and executive compensation. While new regulatory proposals and rating systems are valuable to investors, they are no guarantee that companies are well run. Some of the key issues that investors consider while evaluating corporate governance are:

1. Accountability of Board of Directors

Board of Directors (BoD) is the link between managers and shareholders. A board in many cases serves as the governance mechanism for problems inherent to many organisations. The problems could be between the firm's owner, its shareholders who are unable to control management directly and the management who in many cases are not vigilant enough when it comes to other people's property. Boards are generally made of a mixture of insiders and outsiders.

Normally, directors on the board are elected by stockholders to establish corporate management policies and make decisions on major issues pertaining to the company, such as dividend policies. As such, the BoD is potentially the most effective instrument of good governance. Investors should examine to see who sits on the board. Big investors seek out companies with plenty of independent directors who have no commercial links to the firm and who demonstrate an objective willingness to question the decisions of the management. A minority of independent directors make it difficult for the board to operate outside the sphere of management influence.

2. Financial Disclosure and Controls

Corporate structure should include an audit committee composed of independent directors with significant exposure on financial transactions. Ideally, the committee should have the sole power to hire and fire the company's auditors and approve non-audit services from the auditor. Top management compensation should be determined by measurable performance goals (shareholder return etc.), and, ideally, the compensation rate should be set by an independent compensation committee and fully disclosed.

3. Stock Options

Management power can become entrenched by strong takeover defense provisions. Sometimes directors—especially executive directors—have the habit of granting generous stock options to top managers. While stock options offer managers an incentive to perform well, overloaded stock-option accounts create the possibility of unwanted share value dilution. Many organisations in India have introduced 'Employee Stock Option Plan' for their officers, popularly known as ESOP.

7. This write-up is based on the inputs from (i) CII Code of Corporate Governance 1998 (ii) Birla Committee report on Corp. Governance appointed by SEBI (iii) Chandra Committee report submitted to Deptt. of Company Affairs.

Problems in Corporate Governance

In many countries, there is an increasing concern for improving the corporate governance and performance of the Board. This is an important issue. The problem of good 'Corporate Governance' arises in all categories of Indian companies. First—the public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%). Second—the multi national companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder. Third—the domestic business groups where the promoters (together with their friends and relatives) are the dominant shareholders, government owned institutions hold a comparable stake, and the balance is held by the general public.

(i) Public Sector Units (PSUs)

Looking at the way PSUs were governed in the past, it can be said that they were merely an extended arm of the state. Therefore, the structure allowed the administration of the respective ministry to exercise total control. We can take the example of the selection of the CEO. In comparison to the US and the European systems where CEO has been sought to strengthen the board, the board has very little say in India. The government takes decisions through the concerned ministry with the help of the Public Enterprises Selection Board. The Board of governors can neither fire the CEO nor can it alter the compensation package. Even in the audit, the dominant role is that of the Controller and Auditor General (CAG). In many PSUs, the Board may still be powerful on paper because the delegation of financial and operating powers to the CEO is very limited. Most of the operating issues have to be brought to the Board for decision making. Another interesting issue that has not received much attention so far is the potential that exists for conflict between the dominant shareholders and the minority shareholders.

(ii) Multinational Corporations

Due to the government regulations, many MNCs in India operate through subsidiaries which are not 100% owned by the parent. In the 1970s, the government had enacted a law limiting foreign ownership to 40% in most industries while allowing 51% in a few high technology areas. This law was liberalised in the 1990s and now 51% is permitted in most industries, while 74% or even 100% ownership is allowed in some cases. These rules have created severe corporate governance problems in several areas. In the 1970s, MNCs were forced to issue shares to the Indian public to comply with the law. The controls that then existed on pricing of public issues meant that these issues were at substantial discounts to the market price. In the 90s when the law permitted higher foreign ownership, these MNCs raised the foreign stake by issuing shares at very deep discounts to the market price. This obviously meant a large loss to the minority shareholders. When the government introduced regulations to prevent such preferential issues, the MNCs protested against what they called an assault on "shareholder democracy".

Another corporate governance problem arises where the foreign parent has two subsidiaries in India of which it holds a higher stake (say 100%) in one and a smaller stake (say 51%) in the other one. The manner in which MNC structures its business in India between these two subsidiaries is again a potential source of problem as far as the minority shareholder is concerned. There have been allegations in some cases that the most profitable brands and businesses have been transferred from the long established 51% subsidiary to the newly formed 100% subsidiary at very low prices compared to the market prices prevailing at that time. This implies a large loss to the minority shareholders of the

51% subsidiary who had contributed to the investments that were made in the past to build up these businesses.

(iii) Domestic Private Firms

The state of affairs in private firm is more complex than in the Public Sector Enterprises and Multinational Companies where there are clearly defined dominant shareholders. In the private business groups, the concept of dominant shareholders is obscure for two reasons. First, the promoters' shareholding is spread across several friends and relatives as well as corporate entities. It is sometimes difficult to establish the total effective holding of this group. Second, the aggregate holding of all these entities taken together could be well below a majority stake. In many cases, the promoter may not even be the largest single shareholder. However, the promoters play the role of the dominant shareholder in these groups. In such listed companies, state-owned institutions might own a good share, but play a very passive role. In such cases, the promoters are effectively dominant shareholders and would be able to get general body approval for all their actions. This allows the promoters to play all the games—structuring of businesses and transfer of assets between group companies, preferential allotment of shares to the dominant shareholder and so on. Two important issues in this context are (i) Black money (ii) Mergers and restructuring in same group.

Black Money A large parallel black economy exists in India where transactions are carried out in cash and are not recorded in the books of accounts. Though there have been several honourable exceptions, many Indian business groups have succumbed to black money. The literature on black money views it primarily as a means of cheating the government of its legitimate dues. The fact that it is not accounted for in the company's books means that the promoters are also cheating the minority shareholders.

Mergers and Restructuring in the Same Group Another important corporate governance issue is that of mergers and restructuring of companies in the same group. The valuation of two group companies for the purpose of merger could be biased in favour of one of the companies. It has been alleged that in many of these cases, the promoters had secretly built up large positions in the acquiring company and exchange for shares of the merged company by fixing higher swap ratio.

SECTION 4: CASES*

Case 1: Infosys and Corporate Governance

Infosys has been a pioneer in benchmarking its corporate governance practices with the best in South Asia.

Board Composition

The current policy of Infosys is to have an appropriate mix of executive and independent directors to have independence of the board and to separate board functions of governance and management. Currently, there is a fifteen-member board with 7 executives or full-time directors and eight independent directors. There is a clear definition of responsibilities of the Chairman, CEO (Chief Executive Officer)

*Case studies in this section have been coauthored by Dr. Justin Paul and Parmod Potti.

and COO (Chief Operating Officer) as the members of board and they have to make periodic presentations in front of the board on their responsibilities, performances and targets.

Independent Directors Infosys follows not only the clause 49 (50% independent directors) of the listing agreement of Indian stock exchange but also the more stricter NASDAQ listing rules and Sarbanes-Oxley Act, US while selecting its independent directors on its board.

Board Member Selection Procedure The board is responsible for the selection of new director and it delegates the selection of the new members and the nomination committee. The nomination committee further makes recommendation to the board regarding induction of any new member. The board also regularly works with the Chairman, CEO and the COO to determine the plans of internal succession of these posts in case of any emergency.

Board Functions

The board meets to review the quarterly results, discuss issues related to the company's financial performance and the shareholders' interest. The independent directors are always kept up to date with the information regarding the company by the board through separate meetings arranged at regular intervals. The board currently has 6 committees namely, compensation committee, audit committee, nomination committee, investment committee, share transfer committee and investor's grievance committee.

The compensation committee carries out formal evaluation of the employees. The COO and the CEO handle interaction of the board with the clients, employees, institutional investors, the government and the press. The risk management is handled by the board overall with the help of directions from the audit committee.

Question

How does independent directors on the board help Infosys to formulate best business policies?

Case 2: Reliance Industries and Corporate Governance

Reliance is one of the pioneers in the country in implementing the best international practices of Corporate Governance.

The board of Directors at Reliance periodically reviews its composition for ensuring a strong element of independence and commitment. The Directors are elected by the shareholders. However the board plays an important role in the selection of candidates for shareholders' approval.

Roles and Responsibilities of Board and Management

The board's roles and responsibilities include establishing an effective mechanism for overseeing the affairs, keeping in view the company's size, complexity, geographical operations and corporate tradition and culture. The Reliance's framework is designed to:

- Enable the Board to provide strategic guidance for the management;

- Define the respective roles and responsibilities of senior executives to ensure accountability; and
- Ensure a balance of authority such that no single individual has unfettered powers.

To ensure the truthful and factual presentation of it's financial position, the Company has put in place a strong internal audit process. The board has also constituted an audit committee, which is responsible to the external reporting, performance and objectivity of the internal audit function and independence of the external auditors.

To ensure long-term shareholder value creation and to promote shareholder participation in corporate affairs, Reliance has established and maintained communication strategies, including a policy for clarity in notices of meetings. Reliance also maintains its corporate website for convenient access by the shareholders to all the information about the company.

The company has adopted a remuneration policy that attracts and maintains talented and motivated executives so as to encourage enhanced performance of the company. The remuneration policy envisages a clear relationship between performance and remuneration, including the link between remuneration paid and the overall corporate performance.

Question

Discuss the link between Board of Directors and Corporate Governance practices in Reliance.

Chapter Summary

Nowadays, Corporate Governance has become an important subject. It is common that the minority investors rarely attend the meetings where it is pretty clear as to who has the power to implement changes. In capital markets, large investment banks particularly, Foreign Institutional Investors perform the function of making a judgment about the company and its management. There is a strong incentive for corporate managements themselves to adopt transparent processes and good governance practices. They have sought to cultivate an image of being honest with their investors and of being concerned about shareholder value maximisation. The situation is changing in India and the more progressive companies are voluntarily accepting tougher accounting standards and more independent directors than are mandated by law. They are also adopting more healthy governance practices.

Review Questions

1. Distinguish between the terms 'Corporate Social Responsibility' and 'Corporate Governance'.
2. What are the key dimensions of 'Corporate Social Responsibility'?
3. 'Corporate Governance' has become an important 'buzzword.' Discuss the reasons.
4. Explain the role of Board of Directors in an organisation.

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PART Nine

Global Economy and Business Environment

The McGraw-Hill Companies

Chapter 23

Economic and Business Environment in Europe

Learning Objectives

- to learn about the economic environment and policies in Europe
- to understand the potential and prospects of doing business in 'Euro' countries
- to assess the impact of recent developments in those countries

Chapter Structure

Section 1: Austria
Section 2: Belgium
Section 3: Finland
Section 4: France
Section 5: Germany
Section 6: Greece
Section 7: Ireland
Section 8: Italy
Section 9: Luxembourg
Section 10: The Netherlands
Section 11: Portugal
Section 12: Spain

Introduction*

Some countries in Western Europe began moving towards a common union in the 1950s. This initiative took off with agreements on reducing coals and steel tariffs, and the greatest success so far has been in the realm of free trade. The multinational organisation, called the European Union since 1993, established with 6 countries in the heart of Europe, has been expanded to 25.

The European Union is a vital movement counteracting Europe's political fragmentation. The Union is envisioned as a federation with common foreign policy and military force. Most member states have now adopted euro, the EU currency. Growing cross border connectivity characterises the European Union, especially in investments, business mergers and labour mobility. Clearly, the economic impetus is toward increased unity, a trend now underway for four decades, though progress politically has come more slowly. Within the zone called the Schengen Group which consists of 27 countries—Germany, France, Italy, Spain, Portugal, the Netherlands, Belgium, Luxembourg etc. all passport checks at border crossings have been eliminated. However, not all member countries are moving towards EU integration at the same rate. Scandinavia and the United Kingdom, in particular, are often seen out of step.

In other words, the economic environment in EU countries is different in various regions. In the past, various integration efforts have been blocked by regional politics and referendums. Still some countries have not adopted the common currency—the euro. In the beginning, 12 member countries participated in the common currency. They are—Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. Let's discuss economic environment in these 12 countries and see what are the different parameters and factors that affect these countries and their economy as a whole.

SECTION 1: AUSTRIA

Austria

Year of entry into EU: 1995
Political system: Republic
Capital city: Vienna
Total area: 83 858 km^2
Population: 8.1 million
Literacy rate: 98%
Life Expectancy: 78 years

Austria has established a reputation as a well performing economy. Among the European countries, Austria belongs to the group of five with the highest GDP per capita since the end of the 1980s. Unemployment in Austria has been consistently at the lower end within the EU and the OECD. Yet in recent years, the Austrian growth performance has weakened compared to the other high income countries. The unemployment, while still being relatively low, has increased. However, Austria's growth performance is largely reflected in higher productivity growth.

*This chapter was co-authored by Dr. Justin Paul, N. Arun, Dhananjay B. Aradhye and Pankaj Maderna.

Economic Challenges

Austria is facing challenges, some of which gives rise to the need to renovate its hitherto successful institutional framework, characterised by a large government sector. Since, this institutional set-up has subsequently come under stress associated with globalisation and accelerating technological change.

Attempts were made to keep unemployment low by taking older workers out of the labour force; and enterprises producing for the domestic market were sheltered by some sophisticated entry barriers, even after the EU accession in 1995. In recent years, these problems have been addressed along these lines to create a prospering economy. Also, while Austria has benefited from the opening of the eastern European Markets, reaping the full benefits of further integration requires that institutions and production processes are able to adjust rapidly.

Role of Government

In Austria, the target of balancing the general government budget was reached in 2001. This was achieved mainly via revenue increases, without much spending restraint. In 2002, a small deficit re-emerged, totalling 0.2 per cent of GDP on account of slower growth and the deficit rose in 2003. However, the deficit has been reduced to a minimum level later. Public sector reform, including further reform of the social security system, continues to rank high on the government's policy agenda.

The new government, which came into office in March 2003, has widened priorities to include substantial income tax reductions from 2004 onwards. Austria's tax to GDP ratio is high by international comparison. While this reinforces the case for tax reductions, policies to take into consideration the trade off between the beneficial effects of lower taxes on one hand and maintaining the momentum of fiscal consolidation on the other hand. However, future spending pressure is looming notably on account of the rapidly ageing population. Hence, cuts in government expenditure would become necessary to create room for the planned tax reductions.

SECTION 2: BELGIUM

Belgium

Year of entry into EU: Founding Member
Political system: Constitutional Monarchy
Capital city: Brussels
Total area: 30,158 km^2
Population: 10.2 million
Literacy rate: 98%
Life Expectancy: 78.13 years

The main public policy priority in Belgium continues to be the implementation of structural reforms to increase potential growth. This is being carried with the goal of reducing the large public debt. Debt reduction is necessary to respect the Maastricht Treaty[1], which calls for reduction of gross public debt

[1]The common currency 'Euro' and the eligibility criteria for a member country to join Euro were conceptualised in a treaty known as Maastricht Treaty.

to less than 60 per cent of GDP, but more importantly to prepare for the future budget costs of population ageing.

Tax Structure and Human Welfare

Tax rate on labour income is high in Belgium compared to many other countries. The employment record of older workers is poor, with Belgium having one of the lowest employment ratios for workers aged 55-64 in the OECD. The government's strategy for dealing with these challenges is to maintain fiscal policy settings that drive down public debt and to cut taxes, especially on low skilled labour. Belgian government has made progress on all these fronts despite a weakening international economy.

The Economy

The Belgian economy is traditionally synchronised with the European cycle and has recovered from a downturn in the recent past. Exports and private consumption expenditures turned around during 2003–05.

Economic growth had remained weak until early 2003 but picked up subsequently as the international economy recovered, reaching 2¾ per cent by 2004. Employment growth remained weak until mid-2003, unwinding the labour hoarding during the downturn and holding the unemployment rate at around 7 per cent in 2003, but subsequently recovered strongly. The future risk will be less if sustainability of fiscal policies is strengthened by achieving budget balance according to the plans.

SECTION 3: FINLAND

Finland

Year of entry into EU: 1995
Political system: Republic
Capital city: Helsinki
Total area: 338, 000 km^2
Population: 5.1 million
Literacy rate: 100%
Life Expectancy: 77.75 years

The transformation of the Finnish economy over the last decade represents one of the few examples of the "new economy" taking hold in Europe. Output and productivity growth over the second half of the 1990s was among the highest in the OECD and the recovery from the global downturn has been much stronger than for the euro area as a whole. However, population ageing threatens to expose weaknesses in the labour market.

Demographic developments, which over past decades have been broadly neutral, could reduce the growth rate of GDP per capita by ¼ of a percentage point per annum over the remainder of this decade and by almost 1 percentage point over the next decade. The strength of the economy can be linked to the likelihood of productivity gains in the information and communication technology (ICT) sector.

Reforms for Growth

Growth needs to be enhanced and broadened by boosting competition and labour market flexibility. Priority is given to reducing state ownership, and further reforms in utilities, transport and the retail sectors, as well as further strengthening of the competition framework.

In Finland, reductions in taxes on labour is also important and focus has been at the lower end of the wage distribution. Public finances need to be improved and room for labour tax cuts created by tight spending control. Further, pension reform could help the government in improving finances. As a minimum requirement, central government and municipalities are trying to avoid fiscal deficits, while the pension funds continue to accumulate assets. Maintaining these balances, while reducing the high taxation of labour, will require more efficient service provision, better fiscal coordination with municipalities and meeting some of the future growth in service demand. A broad package of measures along these lines, which would facilitate the attempts to achieve the employment target and boost productivity growth, could double the expected increase in GDP per capita between now and the end of the next decade.

Economic Policy—Monetary and Fiscal

The economic activity has slowed down in the recent past, following several years of strong employment and output growth in Finland. Although GDP increased by only 1.2 to 2.0 per cent during 2002–05, the labour market has resisted remarkably well. Employment has continued to rise and unemployment has edged up only marginally. Accommodative monetary and fiscal policies have reduced the extent of the slowdown. However, the budgetary easing caused the general government deficit to reach 3.1 per cent of GDP.

SECTION 4: FRANCE

France

Year of entry into EU: Founding Member
Political system: Republic
Capital city: Paris
Total area: 550,000 km^2
Population: 60.4 million
Literacy rate: 99%
Life Expectancy: 79.05 years

The share of France in world exports and imports has been in the range of 4.7 to 4.9% and 4.6 to 4.8% respectively during 2002-04. While countries like Greece, Spain and Portugal have trade deficit, France has been on the side with trade surplus (trade balance of 11.2 billion $ in 2004) in the recent years (see Fig. 23.6). Although France's economy has performed well in the past, the country faces a daunting task in meeting the fiscal challenge posed by the ratio of people retired to those employed doubling by 2030. This has obvious implications for the sustainability of the country's pension scheme.

Notwithstanding continued improvements in the productivity and income levels, the operational deficit of the health and pension systems would increase by some 5 per cent of the GDP by 2030 in the absence of far-reaching policy changes. Allowing such deficits to accumulate over time is not a realistic option because the resulting build-up of debt would be unsustainable. [OECD Annual Report, 2004]. While the ageing challenge is a long-run one, actions to deal with it are nonetheless urgent, both because deep reforms can only yield results over time and because reform options become fewer. Addressing the ageing challenge will require substantial efforts on a number of fronts.

Human Welfare and Tax Structure

The income tax burden in France is already high in international comparison. Raising it further could force both capital and skilled labour to go elsewhere, and, in so doing, threaten both the tax base and longer-term growth prospects. On the other hand, there seems to be considerable scope for structural reforms that could generate savings while respecting societal priorities. Proposals to reform the health-care system by making both its administrators and users more responsible for the overall costs are important initiatives that could have significant medium-term impacts.

As concerns pensions, plans to align the mandatory contribution period of public servants to those of the private sector, currently 40 years, are sensible. Such steps should help reduce the substantial inequalities between the private and public systems. However, notwithstanding the real difficulties that such measures may imply, more changes along similar lines are required. It is worth noting that the authorities have taken similar steps to improve the way public expenditure is managed and programmes evaluated.

SECTION 5: GERMANY

Germany

Year of entry into EU: Founding Member
Political system: Federal Republic
Capital city: Berlin
Total area: 356,854 km^2
Population: 82 million
Literacy rate: 99%
Life Expectancy: 77.78 years

The share of Germany in world exports and imports has been 9.4% and 8.2% respectively in 2004, which shows that the country is an important player in the international arena. Germany has also maintained remarkable trade balance [surplus of 135 billion $ in 2004 (see Figs 23.6, 23.7 and 23.8)]. A strong and competitive export industry is helping the German economy these days. Domestic demand has been declining over the last couple of years because of the poor labour market performance. Productivity growth is not high enough to the international standards in some industries in Germany.

Economic Policy

Fiscal targets have been missed on account of both cyclical and structural factors. The government has launched a major reform initiative to increase economic growth. These reforms are aimed at reducing government debt and removing fiscal distortions. Furthermore, there is considerable scope to foster the creation of new enterprises and widen product market competition, thereby also maintaining the strong innovative capacity of the economy. The major challenges are to link fiscal consolidation to public sector reform and to increase the capacity of the economy for employment growth. The reforms reflect a coherent vision about the reorientation of economic policy—combining a growth and stability-oriented macroeconomic policy with structural reforms—are implemented according to a transparent roadmap. After phased income tax reductions that contributed to the rise in the structural deficit, priority has now been given to balancing the budget within a limited number of years.

Reforms for Economic and Human Welfare

Important steps have been taken to reform health care and pensions, marking progress in re-establishing fiscal sustainability. However, more could be done to reduce the power in the hands of special interest groups and increase the efficiency of public sector.

Major reform steps to make the German labour market more conducive to employment creation have been legislated and are being taken. Employment protection legislation (EPL) has recently been eased.

The scope for individual agreements on wage and non-wage aspects of a labour contract has also been increased. Opening tertiary education to more competition and widening the autonomy of educational institutions with respect to achieving targets contribute to more effective human capital accumulation these days.

Competition in product markets has been encouraged by removing entry barriers.

The Future

Key indicators show Germany belongs to the countries in the OECD with strong innovation activity, even though some weakening in Germany's position relative to other OECD countries had occurred in 1990s. Measures to improve the framework conditions for innovation include providing capital to new firms and raising the efficiency of the higher education sector. Furthermore, making labour markets more flexible and increasing the scope for overall competition would improve the capacity of the German economy to innovate and contribute to higher potential growth.

SECTION 6: GREECE

Greece

Year of entry into EU: 1981
Political system: Republic
Capital city: Athens
Total area: 131,957 km^2
Population: 10.5 million
Literacy rate: 97%
Life Expectancy: 78.74 years

The continuous period of disinflation in the 1990s, with rates coming down from double-digit levels in 1994 to 2 per cent in 1999, seems to have ended. Since then, consumer price inflation has once again edged up, reaching 3¾ per cent by 2001, and raising further during 2002–05. Its differential with the EU average has widened to 1¼ points. The increase in inflation since 1999 in large part reflects the waning impact of earlier indirect tax cuts and agreements between the government and businesses in order to help meet the Maastricht low inflation criterion.

Economic Environment

Somewhat higher inflation than in economically more advanced countries is acceptable in the process of economic convergence in Greece. But this argument does not apply to all prices: it is essential for Greece to align price and cost inflation in tradeable sectors with the Euro area average.

The strong recovery of business investment since the mid-1990s had raised the growth of the business sector capital stock and thus helped to raise potential output growth estimates, from 2 per cent in the middle of the 1990s to around 3 per cent by 2000s. Other factors, which raised the growth potential of the economy, were a pick-up in the potential labour force, owing mainly to the inflow of migrants from neighbouring countries and higher female labour participation, as well as improved total factor productivity from microeconomic reforms. Rising potential output growth has opened room for faster non-inflationary economic growth in the future.

Household consumption remains the main pillar of domestic demand. The new tax/benefit package included in the budgets and continuing low nominal and real interest rates, can boost household spending and business investment. Private sector indebtedness is still low by international comparison, leaving ample scope for further borrowing. As domestic demand accelerates, imports are expected to pick up and the increase in world demand should also boost exports.

Political Scenario and its Effect on the Economy

The year 2004 was a turbulent one in Greek politics. The general election saw a landslide victory for the centre-right New Democracy party, thus ending a prolonged period of rule by the Panhellenic Socialist Movement (Pasok), which had been in power for many years. In the elections for the European Parliament in June, the conservatives increased their lead over the socialists to a record nine percentage points. The magnitude of the victories suggested that perhaps a new era of conservative rule was at hand.

The one thing that the government did was to undertake a thorough process of fiscal 'housekeeping' which added some four percentage points to the government deficit (to bring it to 5.3% of GDP). The fiscal review put Greece in breach of the Economic and Monetary Union's Stability and Growth Pact and revealed that Greece had never met the convergence targets for membership of the Eurozone. The European Commission has said that there is no question of Greece being asked to leave the inner circle of the European Monetary Union but it has taken infringement proceedings against the country for breaches of reporting regulations. Eurozone finance ministers (the so-called Ecofin Council) were, however, more lenient. They did not just blame Greece outright but were equally critical of the Commission's statistical agency Eurostat for the quality of its monitoring.

SECTION 7: IRELAND

Ireland

Year of entry into EU: 1973
Political system: Republic
Capital city: Dublin
Total area: 70,000 km²
Population: 3.7 million
Literacy rate: 98%
Life Expectancy: 77.17 years

The extraordinary growth in the second half of the 1990s had given way to a more normal, still rapid pace of expansion, which resulted in more jobs in the labour market. Unemployment rate has been relatively low in Ireland, among the other 'Euro' members. The economy has not been able to gather momentum since 2002 with slowdown in exports and weakening in business confidence. Some slackening in growth was in any case inevitable given the economy, manifest in high inflation, rapidly rising house prices and so on. While the slowdown can be linked to the burst of the IT bubble, it also reflects a deterioration in the Irish cost competitiveness ever since Ireland joined the European Monetary Union.

The future trend growth over the medium term is now widely believed to be between 4 and 5 per cent for real GDP. The policy challenge facing the Irish economy in the immediate future is to ensure that both income expectations and public finances adjust to a growth environment. The former is necessary to guard against deterioration in international competitiveness, while the latter is required to ensure fiscal sustainability and the maintenance of a growth-supportive tax structure.

Over a longer term, the broad aim of the authorities is to ensure that the economy will continue to grow at a reasonably high rate and that policies will be more clearly oriented towards protecting interests of consumers and producers.

At 6 per cent, real GDP growth was relatively well maintained in the recent past, but in terms of real GNP, a measure of national economic activity, growth has been much weaker at well below 2 per cent. The wide gap between GDP and GNP that is accounted for by net factor income payments has been a consistent feature of the Irish economy, but a growth gap of over 4 per cent is unprecedented and attributable to a strong performance of the biomedical and pharmaceutical sectors where margins are exceptionally high and accrue largely to foreign owners.

SECTION 8: ITALY

Italy

Year of entry into EU: Founding Member
Political system: Republic
Capital city: Rome
Total area: 301,263 km²
Population: 57.6 million
Literacy rate: 98%
Life Expectancy: 79.25 years

The Italian economy was not resilient to the global slowdown during 2001–2003. The programme of structural reforms over the past decade allowed Italy to join the Euro and improve macroeconomic fundamentals. The discretionary fiscal support and low real interest rates have temporarily revived both consumer and business spending. But, it is unlikely that activity will pick up in Italy in advance of that of its trading partners.

A bright spot in the downturn has been a strong employment performance, which can be attributed to the greater flexibility of the labour market following the reforms of the 1990s. However, both inflation rates and unit labour costs are rising faster than the euro-area average, while Italian exporters appear to have lost competitiveness, and certainly have lost market shares.

Economy: Challenges and Reforms

Looking ahead, Italy's key challenges are to raise the potential rate of growth and increase resilience to future shocks, to address the issue of competitiveness by keeping the inflation low consistent with the euro-area and to safeguard the sustainability of public finances while continuing to provide appropriate fiscal policy support to the growth process. Greater competition, reduced red tape and more efficient public spending are critical elements of such a policy mix.

The reforms themselves are likely to generate faster growth and thus eventually higher tax revenues, but the experience of other countries suggests that this will not come about in short term. Hence, an optimal policy would be early and permanent cuts in primary spending in those areas which do not directly improve competitiveness and growth performance, including tax cuts. In this context, it is encouraging that the Italian authorities have refrained from attaching a specific timetable to their tax reform plans. For the medium term, the adoption of a strategic multi-year framework, such as those implemented in some other OECD countries, could strengthen the implementation of fiscal policy, conducted in accordance with the Stability Programme.

The Future

Italy's public debt has fallen substantially in the past decade. The net worth position of the public sector is believed to be more comfortable, as there is a large amount of public assets, mainly real estate earning low returns. If there is no reason to keep them in public hands, the private sector can make more effective use of them in the long-run. While such real estate asset sales would allow the levels of the deficit and debt to fall, it is important that they not be used to substitute for structural spending reforms.

SECTION 9: LUXEMBOURG

Luxembourg

Year of entry into EU: Founding Member
Political system: Constitutional Monarchy
Capital city: Luxembourg
Total area: 2,586 km^2
Population: 429,200
Literacy rate: 100%
Life Expectancy: 77.48 years

Unemployment rate in Luxembourg has been relatively low for a long time, compared to other European countries. (See Fig. 23.4). Luxembourg has overcome the slowdown in economic activity that the country faced since 2000. The exceptionally buoyant international equity market conditions contributes towards economic growth. The growth is high enough. The important issues are related to education, transport and housing policy. The authorities have the challenge of implementing policies that facilitate adjustment to growth.

Economy

Economic growth had fallen down in the last few years. The severity of this slowdown was attributable to the financial sector, which accounts for some one-third of the GDP. With the stabilised equity prices and financial market volatility returning to more normal levels, a recovery in the financial sector have got underway. This, together with the revival of growth in the euro area, should lift growth to 4 per cent. Underlying inflation is likely to come down broadly in line with that in the euro area.

In these circumstances, factor supply adjusts to variations in demand for the goods and services produced in the Luxembourg economy.

SECTION 10: THE NETHERLANDS

The Netherlands

Year of entry into EU: Founding Member
Political system: Constitutional Monarchy
Capital city: Amsterdam
Total area: 41,864 km^2
Population: 15.8 million
Literacy rate: 99%
Life Expectancy: 78.58 years

The economic downturn in The Netherlands, like the boom that preceded it, can be seen as a phenomenon of business cycle. This is partly attributable to greater exposure to international trade, and to greater sensitivity to international stock price movements.

Furthermore, there has been a marked deterioration in public finances. In view of these developments, the main challenges are to reform those policies that have reduced efficiency and increased volatility, put public finances on a sustainable path, and, most importantly, increase growth by boosting both employment and productivity. The sharp increases in pension fund contributions depress economic activity and raise the costs of these contributions.

Economy

There has been decline in the general government budget balance in recent years. The government's determination to put public finances on a sustainable path is welcome as this world minimises the efficiency costs of taxation over time and treats future generations fairly.

Tax incentives for early retirement schemes as announced could facilitate the growth process. Regulations that unnecessarily inflate childcare costs and a high tax burden on labour should be reduced.

Competition in product markets, vital for raising productivity growth, has been strengthened through the Competition, Deregulation and Legislative Quality project (MDW) and the creation of a competition authority.

Tertiary education policies could contribute more to productivity growth by greater reliance on private funding and by making public funding more dependent on performance. Strengthening the corporate governance framework will also increase productivity.

SECTION 11: PORTUGAL

Portugal

Year of entry into EU: 1986
Political system: Republic
Capital city: Lisbon
Total area: 92,072 km^2
Population: 10.8 million
Literacy rate: 87.40%
Life Expectancy: 76.14 years

Convergence of the Portuguese economy towards the more advanced OECD economies seems to have halted in recent years, leaving a significant gap in per capita income. The proximate cause is low labour productivity as wage rates are substantially higher than the EU average. As regards the capital productivity, equipments in the business sector are not always efficiently used and new technologies are not readily adopted.

Further, the Portuguese labour force—even its younger members—have had less formal education than workers in other EU countries, including among the new entrants from Central and Eastern Europe. Workers in Portugal also have less access to training than in many other countries. Traditional Portuguese low value-added and highly labour-intensive products now face increasing competition from developing countries and the new EU entrants.

Economy

The key medium-term challenge is thus to step up growth through policies that raise human capital and encourage the mobility of the labour force. Competition needs to be stiffer, especially in the privatised utility sectors, where incumbents still exercise dominant market power. And the environment for doing business and investing can be further improved so as to encourage firm start-ups and expansion and allow greater innovation. The authorities have identified the weaknesses in the economy and have legislated for a notably wide range of measures to improve performance.

Reforms

An important example is recent reforms, which have translated into substantial reallocation of resources across all areas of government.

Effective implementation of reforms to contain the growth of public spending is important for several reasons. The excessive growth in public expenditure in the closing years of the 20th century had led to the need to slash spending in the face of the subsequent international downturn in order to limit the growing budget deficit.

This would help solve the chronic problem of structurally weak public finances and permit Portugal to ride out its cyclical experiences without having to cut or postpone fundamentally important programmes. In the longer term, fiscal consolidation would be required as an ageing population will make increasing demands on the public purse to finance pensions and health care.

Reforms to health care have recently been put in place, along the lines recommended in the earlier economic surveys. They are intended to improve the quality of delivery without raising costs. The reforms create better managerial and incentive structures for hospitals and general practitioners, reduce waiting lists and reduce the costs of pharmaceuticals. An important aspect of the reforms is the setting up of an independent regulatory agency with responsibilities and powers to ensure that citizens have equitable access to health care and that the suppliers are delivering high-quality services.

SECTION 12: SPAIN

Spain

Year of entry into EU: 1986
Political system: Constitutional Monarchy
Capital city: Madrid
Total area: 504,782 km^2
Population: 39.4 million
Literacy rate: 97%
Life Expectancy: 79.08 years

Spain's performance has remained remarkably strong primarily because of the structural reforms implemented since the mid-1990s and the sound macroeconomic policy framework. Employment has expanded strongly, enabling the economy to grow more rapidly than the euro area average, even during the recent slowdown. However, the persistent inflation differential with the euro area is worrying as it erodes competitiveness progressively and could lead to a period of slower growth. This inflation differential, which is partly the consequence of exceptional factors, highlights the need for strengthening competition in certain sectors. Additional reforms in these areas would also help in bringing down unemployment, which is mainly structural. Last, reforms are needed to prepare against the consequences of ageing. They should be phased in now to ensure the sustainability of the public finances, which will be under threat from sharply rising spending on pensions, medical and social services.

Economy

Spain did not escape the recent economic slowdown that hit the OECD, but did perform better than most countries. Job creation has been buoyant, increasing by nearly 1½ per cent, but productivity gains have remained small. Unemployment had risen for the first time since 1994, reaching 11½ per cent in 2002. Despite the easing of labour market pressures and a slightly negative output gap, inflation has not slowed—partly for exceptional reasons such as the euro changeover—and the differential with the euro area has not shrunk. This differential, which has been about 1 to 1½ percentage points since 1999, tends to weaken international competitiveness.

Domestic liquidity conditions have become easier in recent years because the European Central Bank (ECB) has relaxed monetary policy. The expansionary effect has been limited, however, by fiscal tightening since 2000. Policy has, quite rightly, been more prudent than in most other European countries. Fiscal consolidation that began in the mid-1990s has led to the elimination of the general government deficit in 2001, despite the economic slowdown. The government once again aims at a balanced budget in future.

The Future

According to the OECD, gross domestic product (GDP) growth has been in the range of 2 to 3 per cent since 2003. Even though the inflation differential may decline, a permanent improvement in inflation performance requires tackling nominal wage and price rigidities rather than a tighter fiscal stance.

Chapter Summary

"A day will come when all the nations of this continent, without losing their distinct qualities or their glorious individuality, will fuse together in a higher unity and form the European brotherhood. A day will come when there will be no other battlefields than those of the mind—open marketplaces for ideas. A day will come when bullets and bombs will be replaced by votes".

Victor Hugo spoke those words in 1849. It took more than a century for his predictions to start coming true. During that time, two World Wars and countless other conflicts on European soil caused millions of deaths. There were times when all hope seemed lost. Today, the dawning of the 21st century offers brighter prospects and renewed hope. But it also brings Europe new difficulties and challenges.

Enlargement of the Union to 25 member states has taken place in 2004. *"Europe has finally managed to reconcile its history with its geography".* The period 2007 to 2015 could see further enlargements of the European Union. In the meantime, its leaders—listening carefully to public opinion—will have to decide where, ultimately, to draw the Union's geographical, political and economic frontiers.

The EU has proved their worth, but they must be adapted to cope with the growing number of tasks to be carried out by a growing Union. The more member states the EU has, the greater become the forces that threaten to tear it apart. Short-term views of national interests can all too easily derail the long-term priorities of the Union as a whole. The kind of system that will work is a political and legal set-up based on majority voting, and with checks and balances built-in.

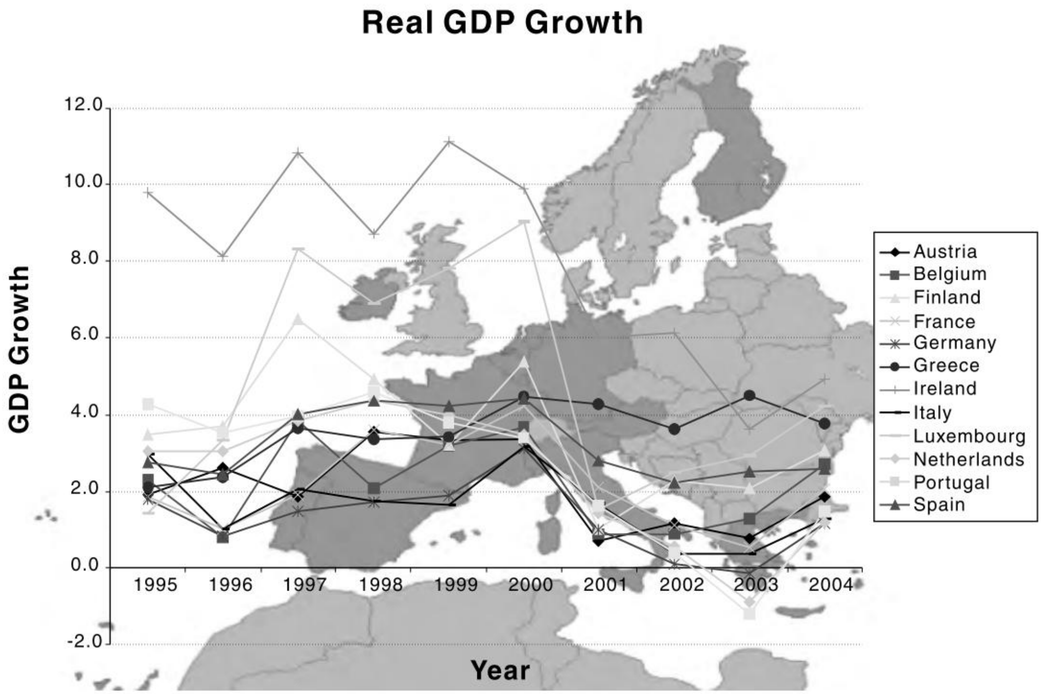


Fig. 23.1

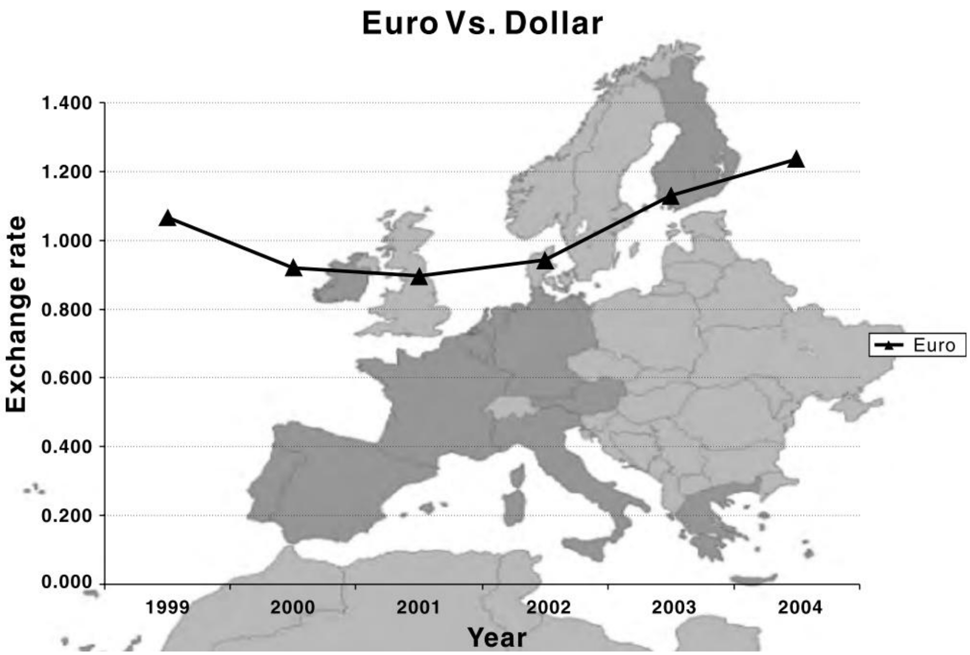


Fig. 23.2

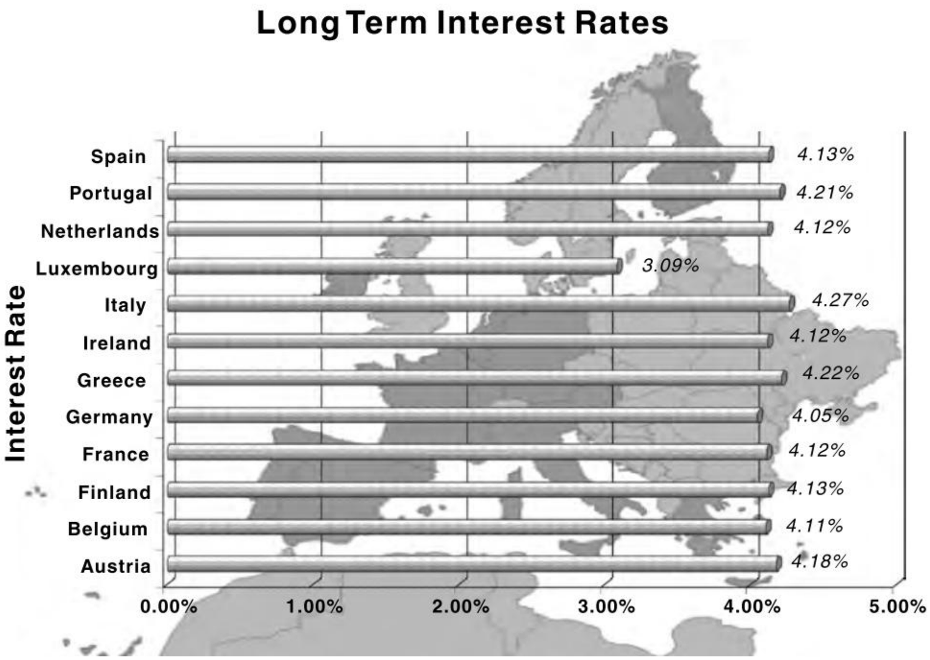
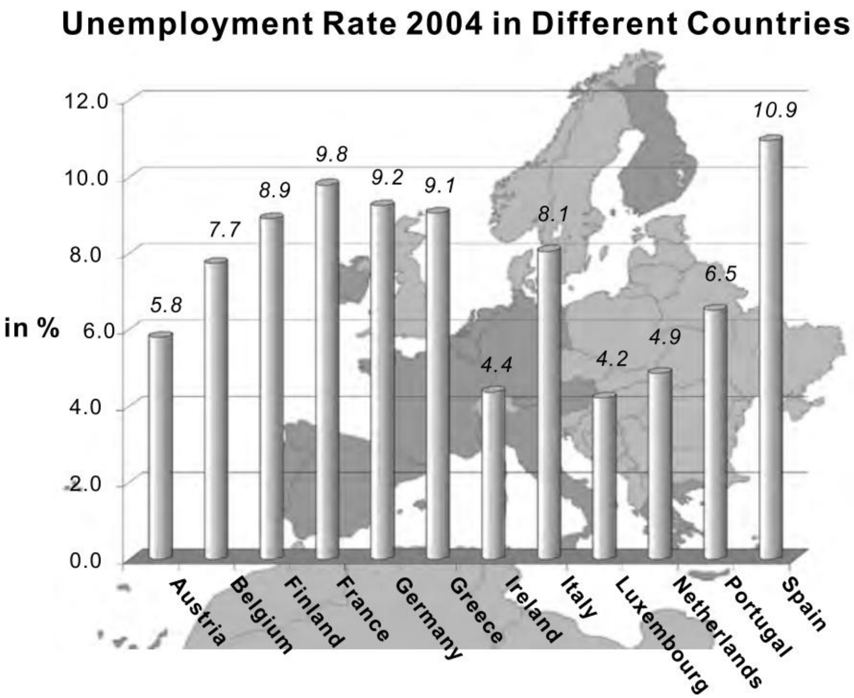


Fig. 23.3



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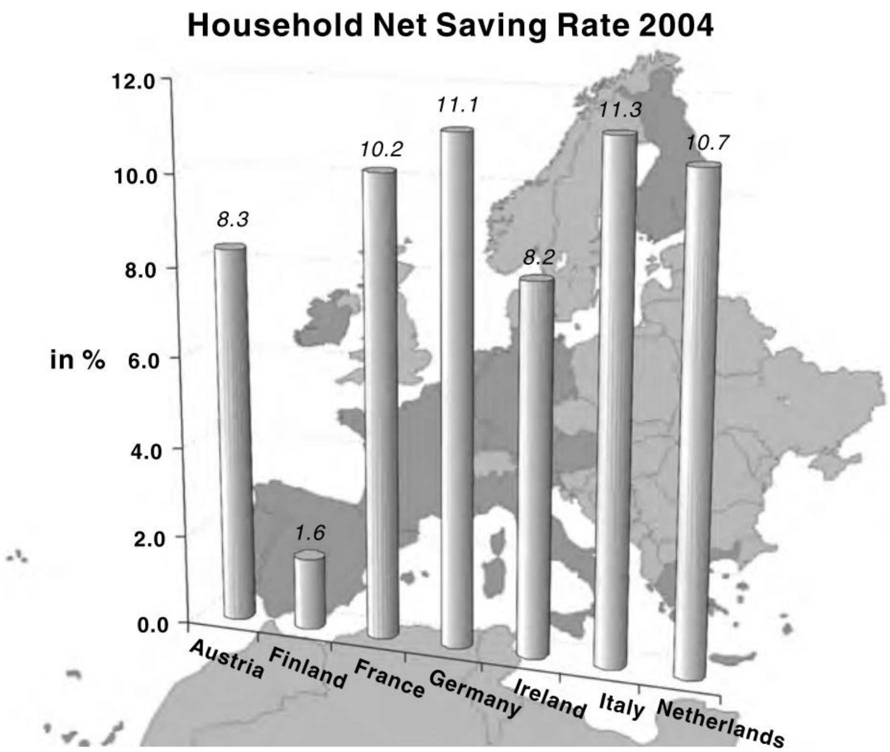

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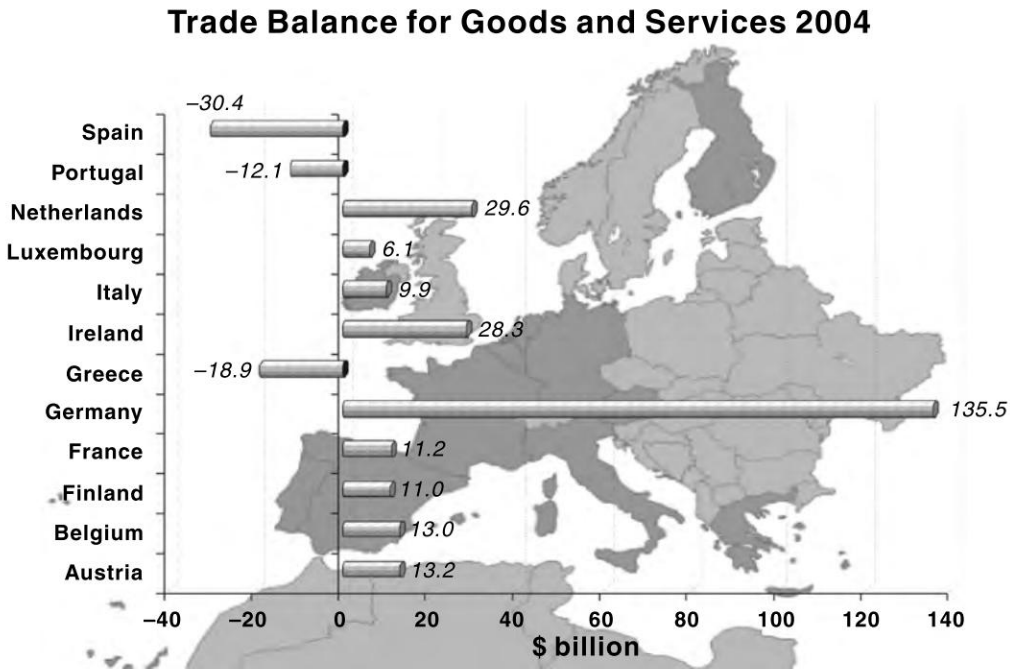

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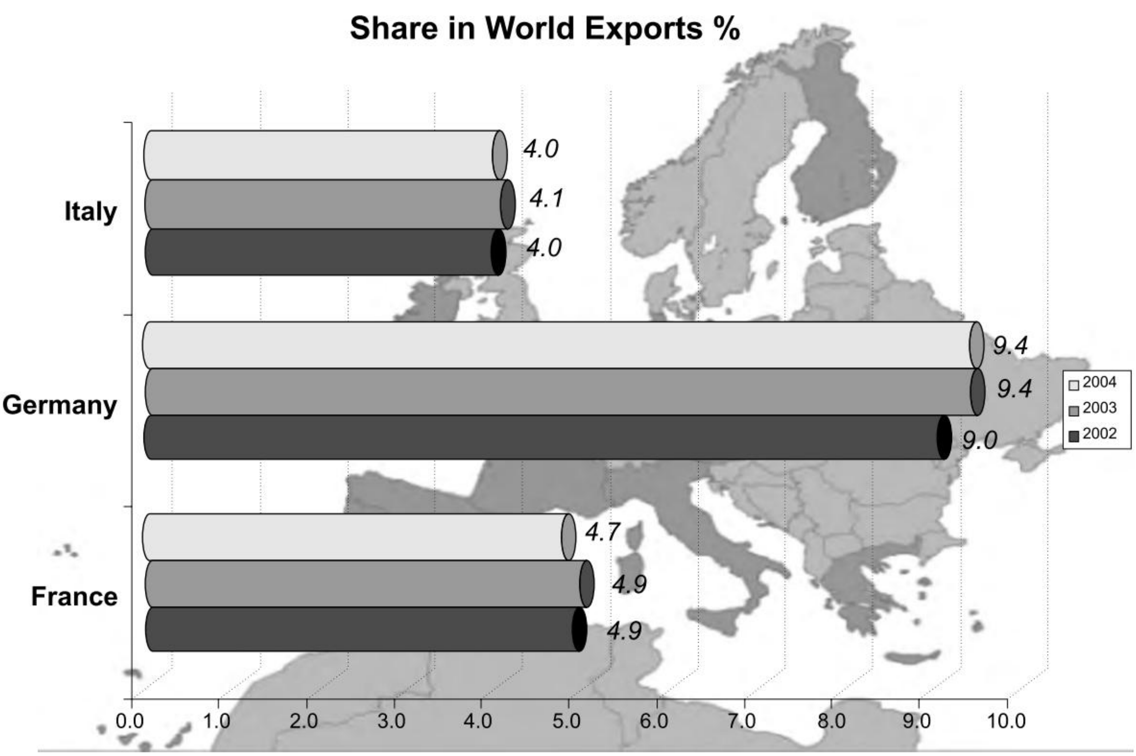

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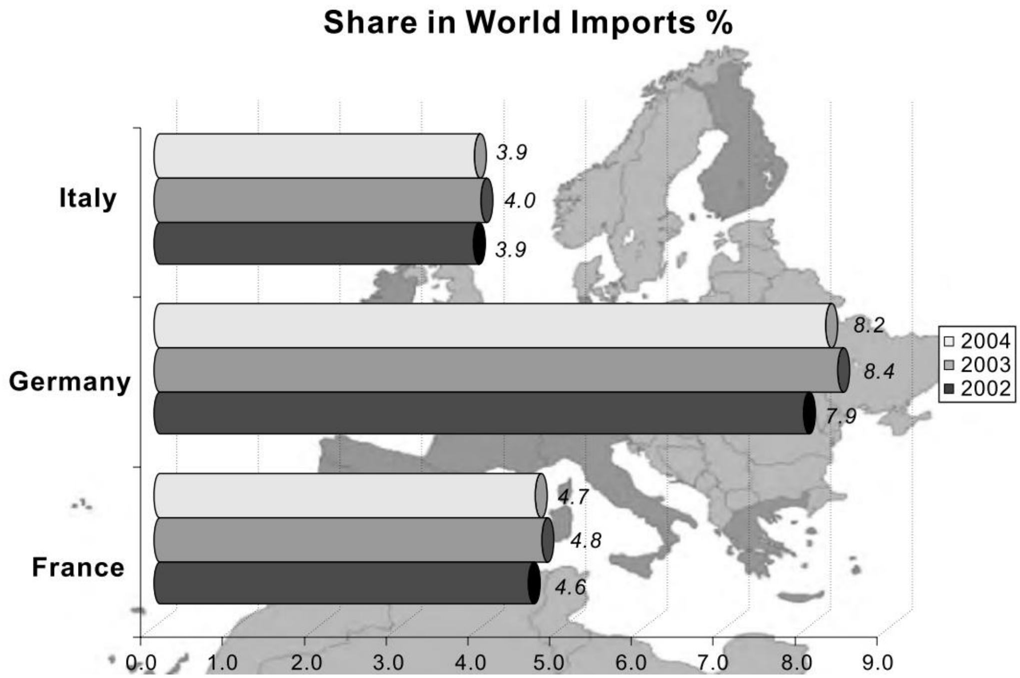

Fig. 23.8

Review Questions

1. Discuss the 'Business Environment' in Austria and Belgium.
2. Critically examine the implications of policy changes on the economy of France and Finland.
3. Discuss the challenges and opportunities for business in Italy and Ireland.
4. Draw the anatomy of Netherlands and Spanish economy.

Class/Field Exercise

1. Visit the website of European Union-EU (www.europa.eu.int) and European Central Bank respectively. Discuss the implications of European Union enlargement. Find out the reasons why all members of EU are not members of common currency EURO.
2. Visit the site www.forecasts.org and examine the forecasted value of EURO.

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2. European Union publications
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Chapter 24

Economic and Business Environment in SAARC Countries

Learning Objectives

- to understand the structure of economies in SAARC region
- to analyse the economic environment of business in major countries in the region
- to gauge perspective about the problems and prospects in these countries

Chapter Structure

This chapter* attempts to examine the macroeconomic structure of important SAARC countries—Bangladesh, India, Nepal, Pakistan and Sri Lanka—individually with a view that it would help the policy makers and business firms to analyse the impacts of different policy options and costs and benefits of increased economic integration in the SAARC regions. The chapter looks at if there are cross-country differences in production and consumption patterns and investment behavior in the SAARC countries.

Data used for drawing charts are given in the Appendices.

SECTION 1: SAARC–OBJECTIVES AND STRUCTURE

Seven South Asian Nations, viz., Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, formally launched the South Asian Association for Regional Co-operation (SAARC) on December 8, 1985 with an underlying objective to accelerate the economic development of the region.

SAARC is a manifestation of the determination of the people of South Asia to work together towards finding solutions to their common problems in a spirit of friendship, trust and understanding and to create an order based on mutual respect, equity and shared benefits.

Objectives

The following are the main objectives of SAARC:

1. To promote the welfare of the peoples of South Asia and to improve their quality of life
2. To promote and strengthen collective self-reliance among the countries of South Asia

SAPTA and Trade Liberalisation

The agreement on SAARC Preferential Trading Arrangement (SAPTA) was signed in 1993 and four rounds of trade negotiations have been concluded. With the objective of moving towards a South Asian Economic Union (SAEU), the Agreement on South Asian Free Trade Area (SAFTA) was signed during the Twelfth Summit in Islamabad in 2004. Beyond official linkages, SAARC also encourages and facilitates cooperation in private sector through the SAARC Chamber of Commerce and Industry (SCCI), which is a SAARC Apex Body.

Numerous business opportunities exist for trade and commerce among SAARC countries owing to their geographic closeness and high population. Though the full potential of SAARC business cooperation has not been achieved till now due to several political differences and economic imbalances between member countries, future business opportunities are bright and promising.

SAPTA was envisaged primarily as the first step towards the transition to a South Asian Free Trade Area (SAFTA) leading subsequently towards a Customs Union, Common Market and Economic Union. The Agreement on South Asian Free Trade Area (SAFTA) was signed on January 6, 2004 during the Twelth SAARC Summit in Islamabad. The Agreement came into force on January 1, 2006. Currently, the Sensitive Lists of products, Rules of Origin, Technical Assistance as well as a Mechanism for Compensation of Revenue Loss for Least Developed Member States are under negotiation.

*This chapter was co-authored by Dr. Justin Paul with Dejo George, Sudhir Panigrahi, Ajinkya Prasad, Unnikrishnan R and Phullpreet Singh who were the participants of PGP and Executive PGP at IIM Indore.

Under the Trade Liberalisation Program scheduled for completion in ten years by 2016, the customs duties on products from the region will be progressively reduced. However, under an early harvest programme for the Least Developed Member States, India, Pakistan and Sri Lanka are to bring down their customs duties to 0-5 % by January 1, 2009 for the products from such member states. The Least Developed Member States are expected to benefit from additional measures under the special and differential treatment accorded to them under the Agreement.

Structure of Economies

SAARC economies are basically rural in nature. Agriculture plays a vital role in SAARC region. Except for India, Pakistan and Sri Lanka, where service sector plays major role than agriculture, in all the other countries, the contribution of agriculture to GDP is the highest. However, over the last few decades, it can also be observed that there has been a fall in the relative importance of agricultural contribution to GDP in SAARC members, except in the case of Nepal where agriculture's role has not changed significantly.

SAARC partners have adopted various strategies for the expansion of their industrial sectors, or the diversification of their economies, from production of primary products to that of manufactured goods. As far as Bangladesh, Bhutan and India are concerned, industrial sector and services sector have gained at the loss of agriculture. The prominent trading and commerce activities in Sri Lanka have made the service sector vital than the agricultural and industrial sectors of its economy.

The relevant economic question for these nations is whether agricultural development or industrial development is the appropriate strategy for accelerating their economic development. SAARC nations tend to focus more towards industrial development than agricultural development because of the belief that rich countries are rich because they are industrialised; and poor countries are believed to be poor because they are primary-producing. Thus, SAARC nations are keen in expanding and developing the industrial sectors of their economies.

Agricultural Productivity

Agriculture continues to be dominant in all the member countries though the secondary and territory sectors show a rising trend. Productivity of cultivable land is reflected in the form of yield of crop per unit area. India's productivity with respect to wheat, vegetables and pulses is higher compared to other SAARC counties. Productivity of tobacco is highest in Pakistan; paddy highest in Sri Lanka and in the case of millets, Nepal ranks first.

Political Environment

One point of view with respect to economic co-operation is that unless the political matters are settled first, there is little scope for fostering regional economic co-operation. Thus, political factors do play a vital role which has a bearing on economic and other matters. Say for example, the war like situation between India and Pakistan definitely has a high level of correlation on other matters too.

Similarly, the unsettled issues of Indian origin Tamils in Sri Lanka have a say in the Indo-Sri Lankan co-operation.

Foreign Trade

Manufactured goods play a major role in both the exports as well as the import structure of the member countries of SAARC. However, most of the SAARC countries have been dependent on the production and export of a few agricultural commodities for the expansion of their economies. A major share of their international trade is also based on the export of these primary products, and the import of raw materials and other capital goods required for various sectors of the economy.

As far as trade statistics is concerned, India's export and import values are the highest among SAARC members. Trade within SAARC: Major portion of exports of Bangladesh is to Pakistan; India is to Bangladesh; Pakistan is to Bangladesh; and Sri Lanka is to Pakistan. On the other hand, major portion of imports of Bangladesh is from India; Pakistan is from Bangladesh; and Sri Lanka is from India. It has to be noted that the proportion of trade flows within the SAARC region are small and there exists low trade growth rate within region.

SECTION 2: BANGLADESH

Bangladesh is located in the broad, fertile delta of the Ganges and Brahmaputra rivers. Ninety per cent of the land is less than 10 m above sea level. A combination of cyclones and floods, internal political problems and poor infrastructure affects the people's struggle to rise to the high income group (refer to the economic profile for Bangladesh given in Exhibit 24.1).

Country Analysis and Business Opportunities

Bangladesh is one of the world's most densely populated countries with about 120 million people of mixed races. Muslims represent about 85% of the total population. Bangla is the official language of the country. English is the second language and widely used in education, business and commerce. The literacy rate is around 42.6% but the trend towards higher education in the urban society is noticeable.

Dhaka, the capital of Bangladesh, is situated almost in the middle of the country on the bank of the river Buriganga. There are two sea ports: Chittagong and Khulna. The main centers of commercial activities are the capital city of Dhaka and the port city of Chittagong.

Though Bangladesh has a number of natural resources, the country does not have enough capital and the right level of technical know-how. The government is keen on securing participation of foreign investment for accelerating production and economic growth. To that end, the government has announced a number of incentives including tax holidays and repatriation of profits from the country. The government has recently undertaken the work of updating the Companies Act, Patent Laws, Trade Mark Laws and the Customs Act to complement its new industrial and investment policies.

The major items of exports are ready-made garments and clothing, jute goods, shrimps and frozen foods, raw jute and jute products, leather, newsprint, fertilizer and so on. The major items of imports are machineries, crude petroleum and petroleum products, raw cotton yarn, fabrics, cement, edible oils, foodgrains, etc.

The country exports its apparel products worth nearly 5 billion US$ per year to the USA, EU, Canada and other countries of the world. At present, the country is the 6th largest apparel supplier to the US and EU countries. The major products are Knit and Woven Shirts and Blouses, Trousers, Skirts, Shorts, Jackets, Sweaters, Sportswear and many more casual and fashion apparels.

Extensive programs of incentives, to expedite investment (FDI), are now in place in the country. Some of them are listed below.

- No ceiling for investment in most of the sectors
- Tax holiday of up to 10 years
- Tax-exemption and duty-free importation of capital machinery and spare parts for 100% export-oriented industries
- Residency permits for foreign nationals including citizenship
- Easy capital profit and divided repatriation facilities
- Double taxation avoidance
- Tax-exemption on the interest payable on foreign loans
- No limitation pertaining to equity participation, i.e. up to 100 per cent foreign private investment allowed.
- 15 year's tax holiday for private power generation companies
- Exemption of tax on interest on foreign loan
- Tax exemption on royalties, technical know-how and technical assistance fees
- Avoidance of double taxation on the basis of bilateral agreement
- Six months multiple entry visa for the investors
- TAKA, the nation's currency, is convertible for international payments in the current account
- Working capital loan, as well as term loan, from local commercial banks allowed to the industries set up with foreign capital
- Citizenship by investing a minimum of US$ 5,00,000 or by transferring US$ 10,00,000 to any recognised financial institution (non repatriable)

Except five reserve sectors, all industries are open for private investment. Industries earmarked for public sector investment are included in the reserve sector namely: (i) arms, ammunition and other defense equipment and machinery (ii) production of nuclear energy (iii) forest plantation and mechanised extraction within the bounds of reserved forests (iv) security printing (currency notes) and minting, and (v) railways and air transportation (except certain domestic routes and air cargo)

While import tariffs have been reduced in recent years, the use of fixed tariff values have in many cases resulted in an effective tariff rate far beyond the actual rate. Thus, custom duty is paid on a fixed tariff value of the imported goods rather than on the actual price. The fixed tariff value system has recently been supplemented through the acceptance of pre-shipment inspection certificates from four international inspection companies. An additional import permit fee of 2.5% is paid on most imported items and a trade-neutral value-added tax (VAT) of 15% is added to the price of all traded goods. A supplementary duty is levied on luxury items such as cars with an engine capacity greater than 1,000 cc, some electronic devices such as computers and "undesirable" items such as cigarettes.

There is no limit to the amount of foreign exchange that may be brought to Bangladesh, but all foreign currency exceeding the amount of US $5,000 must be declared upon entry, and visitors should be prepared to account for it on departure.

Estimate shows that about 80 per cent of the exported garment accessories like cartons, threads, buttons, labels, poly bags, gum tapes, shirt boards and neck boards are now being produced in the country, contributing to the national GDP. But, the textile (Spinning, Weaving, Finishing etc.) industry is just budding.

Presently, the total fabric requirement in Bangladesh is for about 3 billion yards, of which about 85-90 per cent is imported from countries like China, India, Hong Kong, Singapore, Thailand, Korea, Indonesia and Taiwan. Fabric requirement is increasing at the rate of about 20 per cent per annum. This offers a tremendous opportunity for exporters from other countries.

Prospects for a huge textile industry capable to supply over 3 billion yards of fabrics a year to the export-oriented garment industry is bright.

Other areas of investment that has bright prospects are:

Infrastructure

Energy, telecommunication, oil and gas, ports, highways and bridges.

Agro-based Industry

Dairy of poultry, processing of fruits and vegetables, shrimp, fish culture and processing, shrimp feed plants etc.

Labour-intensive Industries

Electronics, data processing and software development, electrical goods and accessories, light engineering goods, toys, and jewellery.

The current fiscal deficit hovers at around 4.2% of the GDP. This is possibly due to the restraints imposed on current expenditures to keep inflation under control. As a share of GDP, revenues remained at a low rate of 10.6%. Domestic resources funded 43% of the deficit with foreign financing the rest.

The per capita GDP has been gradually improving with the current per capita income nearing US $1900 (Purchasing Power Parity Adjusted) and US$ 400 (actual) respectively. On the contrary, the income inequality at the national level has increased from 25.9 per cent in 1991–92 to 32.6 per cent in 2004 with the urban inequality rising at a faster pace than rural inequality.

Growth Sectors

GDP in Bangladesh is driven by industrial production, services and agriculture. The percentage contribution of the different sectors to the overall GDP has been almost constant in the past two decades. However, over the years trend shows marginal decrease in contribution of agriculture and increase in industry contribution whereas services has been constantly growing (Refer Fig. 24.1).

External Sector

The exports from Bangladesh have been growing steadily over the past decade with figures touching US$ 7603.0 million. The current trend reflects increased exports for the items like apparels, frozen food and leather. Similar trend has been observed in export earnings as per cent of GDP with the percentage contribution of exports to GDP close to 12–14 percent now. Imports has also increased over the years touching US$ 10,903 million. Imports in Bangladesh were induced by higher input demand of the import-dependent apparels sector, stronger growth in intermediate goods (chemical, fertilizer) and increased demand for certain consumer goods (e.g. edible oil, sugar etc).

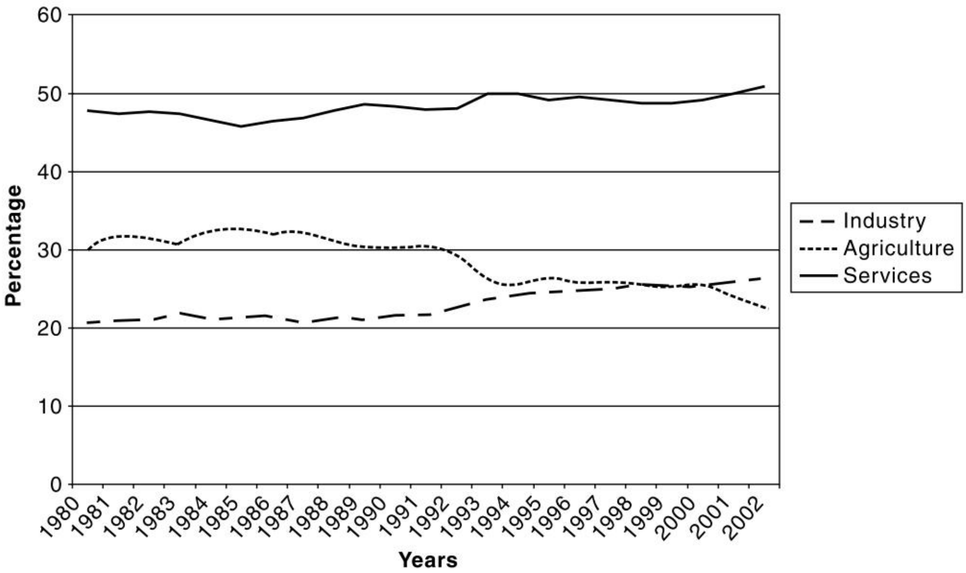

Fig. 24.1 Sectoral Contributions to GDP for Bangladesh

Balance of Payment

The gross official foreign exchange reserves of the Bangladesh's Central Bank continued to grow against the backdrop of steadily increasing export earnings, and stood at US$ 2,705 million. The following Graph depicts the values for exports, imports and thus the overall BoP for the last 24 years which has been an increasing trend for exports and imports and an inconsistent one for BoP which has been on negative side (Refer Fig. 24.2).

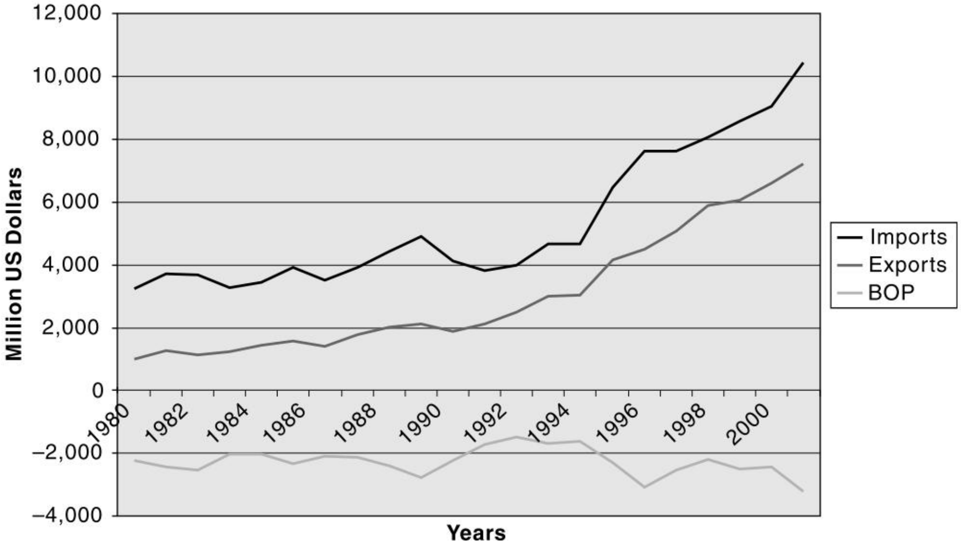

Fig. 24.2 Imports, Exports and BoP for Bangladesh

Exchange Rate

The exchange rate of Bangladesh Taka has been made a free-floating one effective from May 31, 2003 to make the currency more competitive. The exchange rate of Bangladesh Taka against all major currencies remained broadly stable lately.

Social Structure

Bangladesh has made major progress in improving the standard of living of its people over the past two decades. It has successfully reduced the fertility rate from 7 to 3.56 births per woman; infant mortality rates have fallen to 54 per thousand live births and life expectancy is now 60.8 years. The population growth rate fell from over 3% in the 1970s to 2.09% in 2000. Primary education enrolments have doubled in less than 20 years. The adult illiteracy rate has fallen to 48.6%. Progress is still very much required as the UNDP Human Development Index places Bangladesh in 145th position out of 162 countries.

SECTION 3: SRI LANKA

Sri Lanka, in 1977, had abandoned its import substitution trade policy for market-oriented policies and export-oriented trade. Sri Lanka's most dynamic sectors now are food processing, textiles and apparel, food and beverages, telecom, and insurance and banking (refer to the economic profile of Sri Lanka given in Exhibit 24.5).

Country Analysis and Business Opportunities

Sri Lanka, an island in the Indian Ocean and located south of the Indian subcontinent, is also known as the Island of Serendipity. Sri Lanka has a population of 18.5 million of whom the majority is Sinhalese. Other ethnic groups include Sri Lankan Tamils, Indian Tamils, Moors, Malays, Burghers (of Portuguese & Dutch descent) and others.

Sinhalese and Tamil are the official languages in Sri Lanka. English is widely spoken and understood. Mainly an agricultural country, the chief crop of Sri Lanka is rice with which the country is almost self sufficient. Tea, rubber and coconut are also important agricultural crops, with tea being a major foreign exchange earner. Other crops of importance are cocoa and spices. Sri Lanka is also a major exporter of precious and semi-precious stones. In the last three decades, tourism has emerged as an important industry.

Let us discuss the business environment and opportunities in different industries in Sri Lanka.

Apparel Fabrics

The textile industry exports accounts for over 50 per cent of the total exports. The country relies heavily on fabric imports to meet the demand of garment manufacturers. Sri Lanka imports over $1 billion worth of fabric annually. Hong Kong, South Korea, Taiwan and India are the other major exporters of textile fabric to Sri Lanka.

Diversified Electrical Manufacturers

The electrical home appliance market is also growing steadily and there has been a visible expansion in this sector over the last few years. The growth in the construction sector will also have an impact on the electronics and electronic machinery industry since more scope will be available to supply the construction industry. Competitive pricing will help the exporters to carve a fair share of the local market. US, Japanese, Taiwan and Korean products now enjoy major market share in Sri Lanka.

Power Transmission Equipment

Sri Lanka, by its own estimates, needs to add an additional 1500 MW of generating capacity by 2010. Since the country's hydro power potential is nearly exhausted and is highly vulnerable to poor rainfall, the government has to develop alternative power plants like thermal power plants. Opportunities exist for foreign firms to supply transmission equipment.

Industrial Machinery

Total machinery and equipment imports to Sri Lanka were $680 to $900 million during the last 5 years. Special incentives have also been offered to sectors identified as 'thrust' industries in order to diversify and expand industrial and export bases. These industries include electronics and electronic components, ceramics and glassware, rubber and rubber-based industries, light and heavy engineering, cutting and polishing of gems, diamonds and manufacture of jewellery. Industries in these sectors are eligible to import machinery and equipment duty-free. The main suppliers for machinery and mechanical appliances are India, Taiwan, Japan and the European Union.

Paper

Local production of paper and pulp is limited. Almost the entire requirement of paper and pulp is imported with around 15 per cent produced domestically.

Investment Opportunities

The government's industrialisation strategy calls for the expansion, diversification and upgrading of its industrial base, as well as promotion of foreign investment in virtually all sectors of the economy.

Infrastructure

Private investors are active in telecommunications services such as cellular telephone services, wireless local loop systems and pay telephone networks. Investments in the power sector, ranging from mini-hydro systems to large-scale generation plants, and the port sector are also being implemented.

Other opportunities in infrastructure investments include housing & property development, hospitals, voice and data communication systems, public transport and environment. Foreign ownership of up to 100 per cent is allowed in these ventures.

Electronics

Sri Lanka has all the required attributes for successful investment in the electronics industry. For example, the status of Sri Lankan workers as among the best educated and most trainable in South Asia is especially relevant.

Many industries manufacturing for export are already located here. Products manufactured include head-stacks for computer disk drives, magnetic heads for audio and video equipment, ferrite core transformers and household appliances.

Rubber

The island is the world's fifth largest exporter of natural rubber, generating over 100,000 tonnes annually. More than 60 per cent is exported in an unprocessed form. On the manufacturing front, Sri Lanka is the world's leading supplier of solid rubber tires for off-road vehicles.

Agriculture

Sri Lanka's tropical climate is ideal for large-scale export-oriented investments in areas such as foliage, cut flowers and exotic fruits and vegetables.

Mining and Processing

Sri Lanka is well-endowed with minerals and these form an important export category. The local graphite is of premium quality and offers many processing opportunities in graphite lubricants, flake graphite, carbon brushes, refractory bricks and midget electrodes. Other minerals include heavy metal mineral sands, clays, dolomite and appetite. The mineral sands contain around 75 per cent titanium dioxide—the opaque white pigment used in paints. Traditionally, these have been exported in unprocessed form.

Gems and Jewellery

For centuries, the island has been famous for its precious gems. The availability of these precious stones and of superior manufacturing skills highlight Sri Lanka's potential as an international centre for jewellery.

Tourism, Recreation and Leisure Projects

Sri Lanka hosts around 400,000 tourists each year with the potential to increase this figure substantially. Growing acceptance of Sri Lanka as a major tourist destination offers excellent opportunities for strategic investments in the leisure industry.

Economic Growth and Indicators

During the past decade, the economy grew at an average rate of 5% which is further strengthened during the early years of 2000. This growth reflects continuation of the growth momentum in the recent past with respect to industry and services, though the prolonged drought is affecting agricultural performance, and the rise in oil prices also has negative impact on the industry and services sectors. GDP growth trend has been inconsistent showing substantial dips at various occasions (Refer Fig. 24.3). This behavior can be attributed to the continuing struggle between the government and the LTTE.

The fiscal deficit for the year recently stands at 6.5% of the GDP. Over the years, fiscal deficit hovered around the figure of 8-8.5% of GDP. The government has initiated various measures for reducing this figure, especially in the areas of revenue and public investment.

The per capita income hovers around $947. The following chart depicts the yearly data for the last 24 years. This shows an increasing trend over the years (Refer Fig. 24.4).

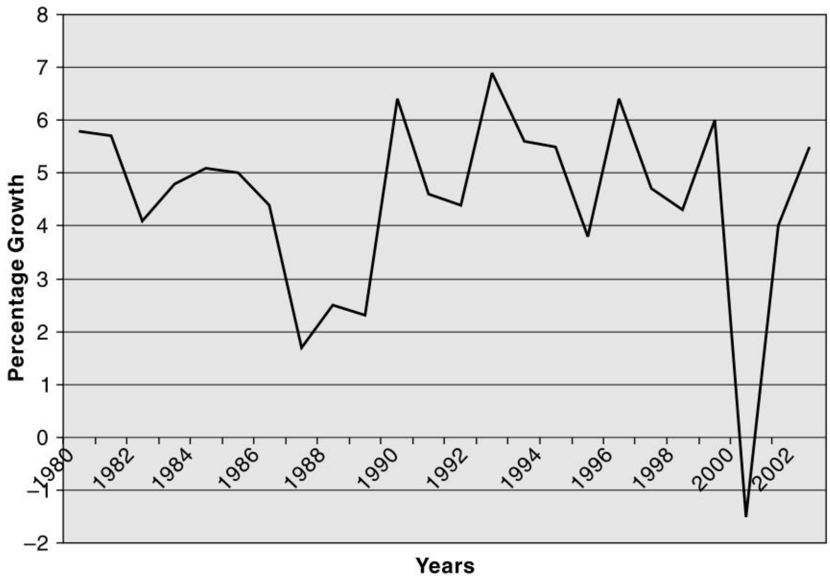

Fig. 24.3 Sri Lanka

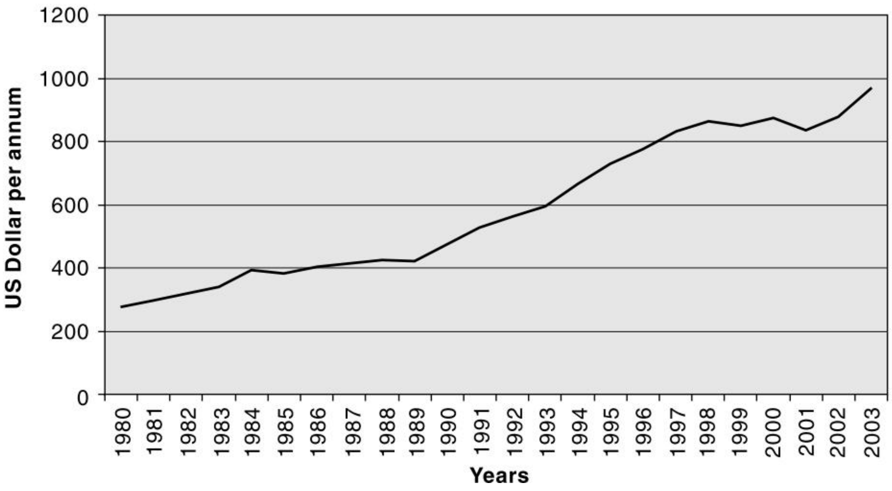

Fig. 24.4 Per Capita Income

Growth Sectors

Currently, for the year 2004 GDP, services sector contributed 55%, agriculture contributed 18% and rest of the industries' contribution stands at 27%. The overall trends for last 34 years depicts that services has been contributing almost 50% of the GDP and has been increasing consistently, while contribution from agriculture has been shrinking (Refer Fig. 24.5).

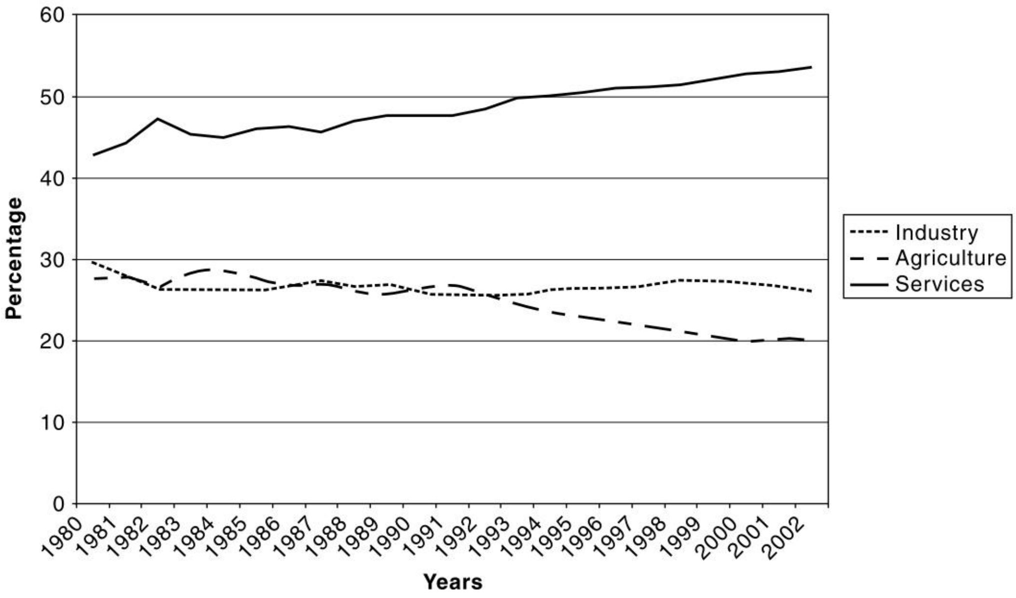

Fig. 24.5 Sectoral Contributions to GDP for Sri Lanka

External Sector

Sri Lankan exports include apparel, rubber-based products, diamonds, machinery, tea, rubber, coconut and gems and jewels and imports include investment and intermediate goods such as petroleum, wheat, sugar and milk products. Over the last two decades, the exports and imports have been increasing in a similar trend.

Balance of Payment

Currently, the services and current transfer accounts registered surpluses, while income account deficit has widened. Reflecting these developments, the current account deficit stands at US dollars 407 million. Recently, inflows to the capital and financial accounts were not sufficient to finance the widening current account deficit and this resulted in a significant BoP deficit, thereby exerting pressure on both exchange rate and external reserves of the country.

Exchange Rate

Under the prevailing independently floating exchange rate regime, the exchange rate is determined by the demand and supply of foreign currencies. Recently, the rupee depreciated by about 7.0 per cent mainly due to widening trade and current account deficits and slowdown in the inflows of programme loans to the government. Current value of Sri Lankan currency stands at 104.45 against American dollar. The chart for 24 years shows depreciating Sri Lankan Rupee and somewhat consolidating in the years 2001-04 due to weakening of the US Dollar (Refer Fig. 24.6).

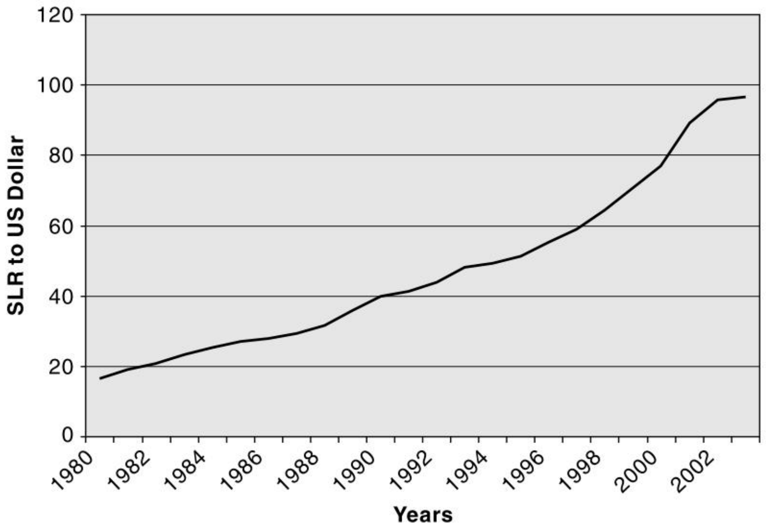

Fig. 24.6 Sri Lanka

Stock Exchange

The stock exchange movements for the last five years are shown in the chart. Increasing index denotes booming economic and industrial conditions (Refer Fig. 24.7).

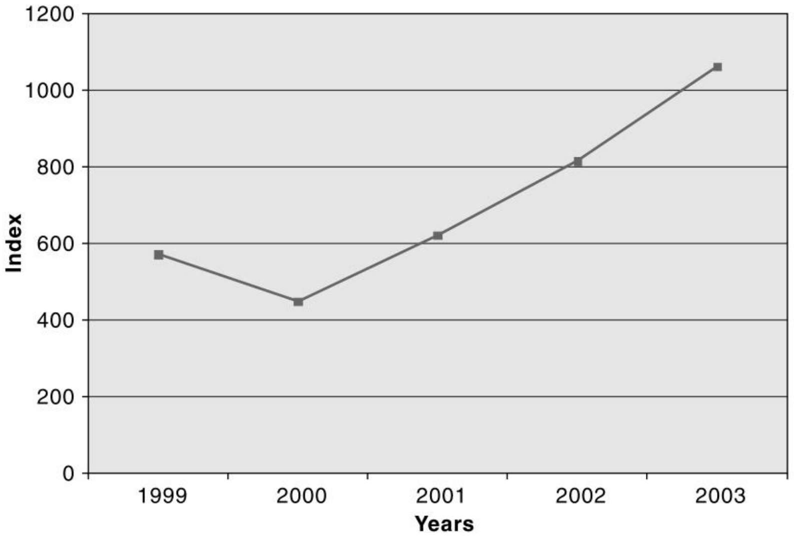

Fig. 24.7 Colombo Stock Price Index

Social Structure

In terms of key indicators of Human Resources Development, Sri Lanka stands close to the standards of developed nations with a literacy rate of 90 per cent and 73 years of life expectancy. In terms of Human Development Index (HDI), Sri Lanka stands at 96th position among 177 countries.

SECTION 4: NEPAL

Nepal is among the least developed countries in the world with 42% of its population living below the poverty line. Agriculture is the mainstay of the economy, providing a livelihood for over 80% of the population and accounting for 40% of the GDP. Industrial activity mainly involves the processing of agricultural produce including jute, sugarcane, tobacco, and grain. Security concerns in the wake of the Maoist conflict and the September 11 terrorist attacks in the US have led to a decrease in tourism, a key source of foreign exchange (refer to the economic profile for Nepal given in Exhibit 24.3).

Country Analysis and Business Opportunities

Nepal is situated in the lap of the Himalayas, between the two most populous countries in the world, India in the East, South, and West, and China in the North. Nepal is a land locked country and home place of natural beauty with a per capita income of only $279, Nepal is one of the world's poorest countries.

Agriculture accounts for approximately 39 per cent of Gross Domestic Product (GDP) and 76 per cent of the employment. In the last five years, real GDP growth has averaged less than five per cent per annum.

Nepal traditionally runs large trade and current account deficits, which are offset by equally large service, transfer and capital account surpluses. This is a result of the increase in official capital due to large inflows of remittances from Nepalese workers employed abroad.

In FY 2003–04, Nepal's exports totalled US$ 740.46 million and imports stood at US$ 1.89 billion. Carpets and garments constitute the vast majority of Nepal's officially recorded exports and are mostly exported to Germany and the United States respectively.

Nepal is a land-locked state, which makes market access a challenge. Surface transport into and out of Nepal is severely constrained. There is only one reliable road route from India to the Kathmandu Valley. The only practical seaport for entry of goods bound for Nepal is Kolkata in India, about 650 miles from the border.

Nepal's overall potential as a market for exports is modest. Best prospect sectors for product sales include telecommunications equipment, computers and peripheral equipment, water resources equipment and aircraft parts. Best prospect sectors for investment are hydropower and civil aviation infrastructure building.

Economic Growth and Indicators

Main contributors to Nepal GDP are agriculture, industries and services. On the expenditure side, gross fixed capital formation as a share of GDP continues its slide. Recently the figure stood at 18.7%—well below the average of 20.8% of GDP for the last decade. The trend shows an inconsistent GDP growth for the last two decades. This denotes an unstable economy with the GDP growth hovering around an average of 3 per cent (Refer Fig. 24.8).

Currently, the budget deficit after grants amounts to 1.5% of GDP for the second year in running. The government targets of spending on infrastructure have not been met due to insurgency whereas education target expenditure could be achieved.

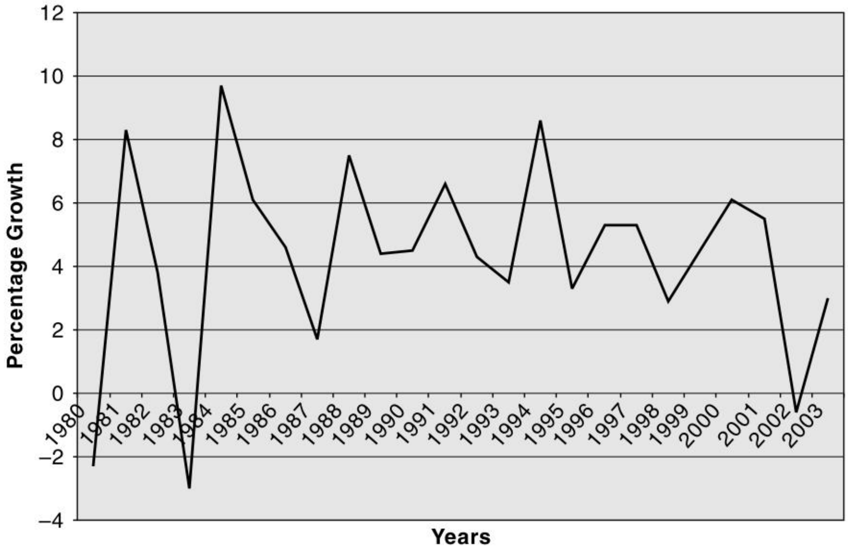

Fig. 24.8 Nepal

Growth Sectors

Recently, industry sector underperformed expanding by only at an average of 2% owing to the security situation. However, performance of agriculture and services have been strengthening over the years due to the strengthening in tourism and strong performance of transport and communications. Overall trends show converging contributions from different sectors towards the total GDP (Refer Fig. 24.9).

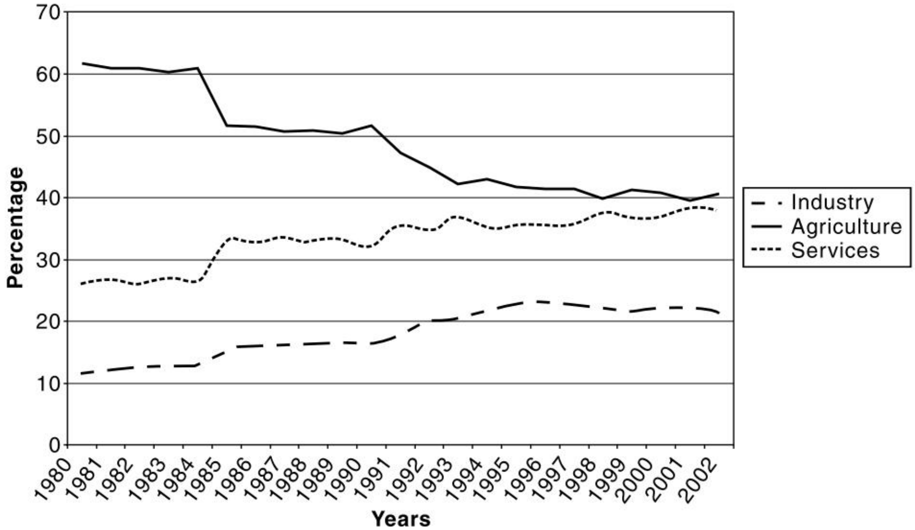

Fig. 24.9 Sectoral Contributions to GDP for Nepal

External Sector

Exports increased recently reflecting increased demand for items like apparels, frozen food and leather. Increased imports were induced by higher input demand of the import-dependent apparels sector, stronger growth in intermediate goods (chemical, Petroleum, fertilizer) and increased demand for certain consumer goods (e.g. edible oil, sugar etc.). Import has been showing a constant growth over the years reflecting bad situation for BoP, exception being the last year. The current figures for imports as a per cent of GDP is 19.3 per cent and FDI flow stand at US$ 385.0 million.

Balance of Payments

Because of the forgoing developments in current, capital and financial accounts of the external sector of the economy, reserve assets increased by Rs 20.6 billion for the current year. Consequently, in the review year, the overall BoP remained in surplus by Rs 16.0 billion.

Social Structure

- Unemployment—47%.
- Population below poverty line is 42%
- Literacy rate is 45%
- Nepal ranked 144 out of 174 countries

SECTION 5: PAKISTAN

Pakistan, a developing country, has suffered for decades of internal political disputes, low levels of foreign investment, and a costly confrontation with India. However, IMF-approved government policies, assisted by generous foreign assistance and renewed access to global markets since late 2001, have generated solid macroeconomic recovery in the last few years (refer to the economic profile for Pakistan given in Exhibit 24.4).

Country Analysis and Business Opportunities

The Islamic republic of Pakistan emerged on the map of the world as an independent sovereign state on 14th August, 1947 as a result of the division of the former British India. It is bounded by Iran in the west, Afghanistan in the north-west, India in the east and southeast and Arabian Sea in the south. There is a common border with China in the north. The total area of the country is 796,095 sq.km with a population of 150.0 million.

The country has an agricultural economy with a network of canals irrigating a major part of its cultivated land. Wheat, cotton, rice, millet and sugarcane are the major crops. Among fruits—mangoes, oranges, bananas and apples are grown in abundance in different parts of the country. The main natural resources are natural gas, coal, salt and iron. The country has an expanding industry. Cotton, textiles, sugar, cement, and chemicals play an important role in its economy. It is fed by vast hydroelectric power.

Urdu is the national language and is used as a medium of understanding throughout the country. Pakistan is culturally divided into four bilingual provinces. Punjabi is spoken in Punjab, Sindhi in Sindh, Pashto in NWFP and Balochi in Balochistan.

Pakistan has two major operating ports serving 803,943 square kilometres of hinterland, besides offering services for land-locked Afghanistan. The Karachi Port has 28 general cargo berths with draft of 10 to 11.3 m and three oil jetties. The other major port, Port Qasim, is located approximately 50 km south-east of Karachi and became fully operational in 1983. The Port of Karachi and Port Qasim are well served by the road and rail system, linked directly with the National Highways and rail services.

Pakistan is linked to almost all the countries of the world through five international airports; Karachi, Islamabad, Lahore, Peshawar and Quetta.

Pakistan follows a liberal investment policy. The features are:

- Equal treatment to local and foreign investors
- All economic sectors open for FDI
- 100% foreign equity allowed in many sectors
- No government sanction required
- Attractive incentive packages
- Remittance of Royalty, Technical & Franchise Fee; capital, profits, dividends allowed
- Foreign investment fully protected under:
    - Foreign Private Investment (Promotion & Protection) Act, 1976
    - Protection of Economic Reforms Act, 1992
    - Foreign Currency Accounts (Protection) Ordinance, 2001
- Bilateral Agreements:
    - Investment Protection: 43 Countries
    - Avoidance of Double Taxation: 51 Countries

Investment Opportunities

To limit the risks inherent in all business activities, medium sized investors are advised to:

- Select a reliable partner, with an obvious long-term interest in a partnership to help understand the local environment;
- Target a sector where Pakistan has a specific advantage and plan for a long-term investment.

It is worth noting that at present finance is not an area where Pakistani businessmen are looking for help or support from overseas partners. As discussed above, further to an improved macroeconomic situation, the country is liquid and many business groups are flushed with funds, eagerly looking for business opportunities and know-how.

Economic Growth and Indicators

The GDP growth rate of Pakistan had shown a decreasing trend over the past two decades with brief periods of fluctuations in between. Of late, the GDP growth rate has been increasing and the current GDP growth rate is in the range of 6 to 7.5%, with the industry sector contributing almost half of the expansion. Manufacturing, the major sub sector, expanded due to the availability of excess capacity in most industries at the start of the year. Higher cash incomes of farmers, continuing strong levels of worker remittances are few other factors fuelling the economic growth. The historical growth rate of GDP in Pakistan is shown in the figure (Refer Fig. 24.10).

The per capita income standing as of now is purchasing power parity—$2,100. The per capita income over the past two decades has only shown a meager fifty per cent increase (Refer Fig. 24.11).

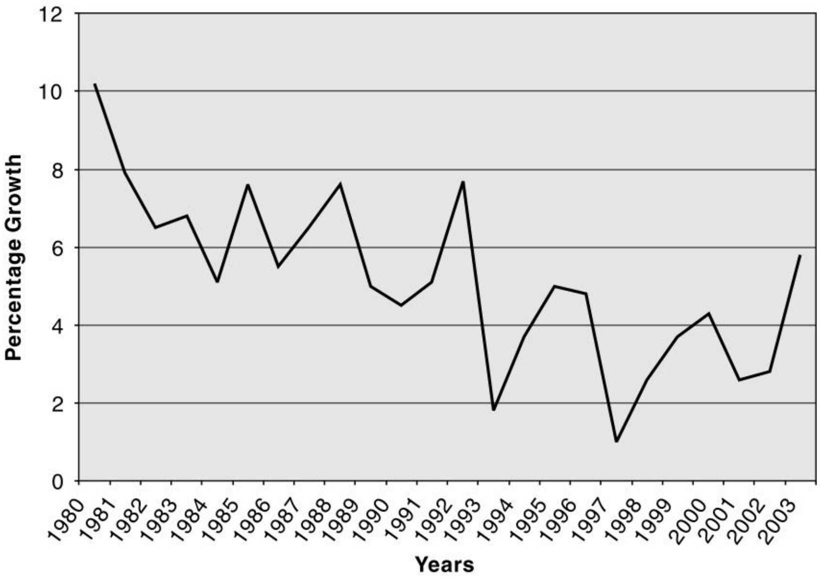

Fig. 24.10 Pakistan

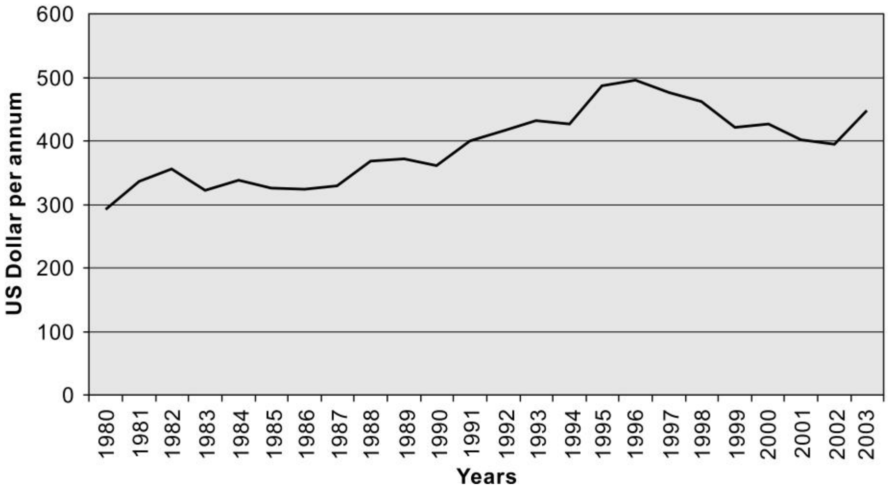

Fig. 24.11 Per Capita Income

Growth Sectors

GDP in Pakistan is driven by industrial production, services and agriculture with services being the dominant contributor. Yearly trends show consistent and overall constant contribution to the overall GDP. Currently, the figures stand at 55%, 24%, 21% for services, agriculture and industry respectively (Refer Fig. 24.12).

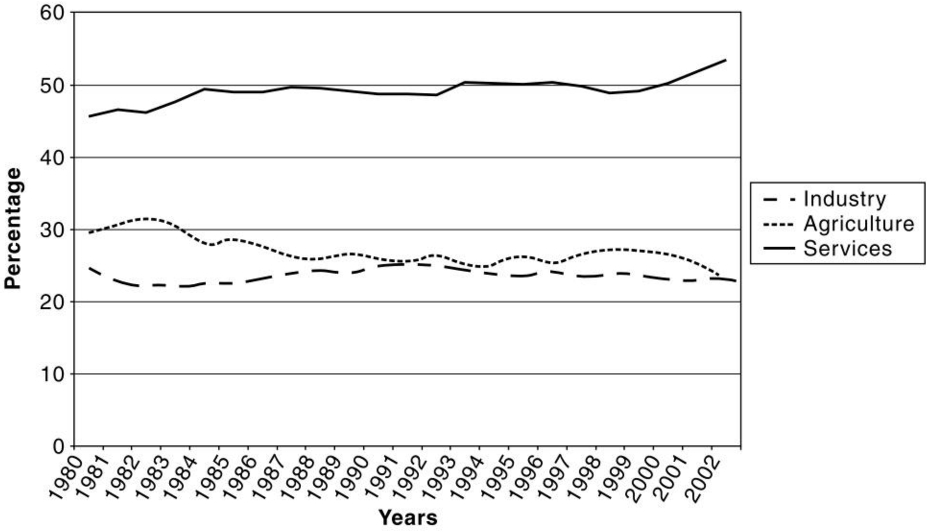

Fig. 24.12 Sectoral Contributions to GDP for Pakistan

External Sector

Recently, due to the recovering global economy, exports saw a strong growth; imports too surged up as the domestic economy strengthened. Over the last two decades, though the exports have been increasing favourably, the imports have been affecting the BoP unfavourably.

Balance of Payment

The current account of the balance of payments has remained in surplus for the last four years, though the size of the surplus is falling significantly. Local textile industry, in particular, geared up for a more competitive export market (Refer Fig. 24.13).

Social Structure

Population policy 2002 is designed to achieve social and economic revival by curbing the rapid population growth. Unemployment rate stands at around 8 per cent. Population below poverty line is 35% with the overall literacy level lying around 54%. Pakistan is placed at 142nd position out of 177 countries with respect to human development index (HDI) by the United Nations.

SECTION 6: INDIA

India's economy encompasses traditional village farming, modern agriculture, handicrafts, a wide range of modern industries, and a multitude of support services. Government controls have been reduced on foreign trade and investment, and privatisation of domestic output has proceeded slowly. The economy has posted an excellent average growth rate of 6% since 1990, reducing poverty by about 10 percentage points. India has been capitalising on its large numbers of well-educated people skilled in the English language to become a major exporter of software services and software workers. Despite strong growth,

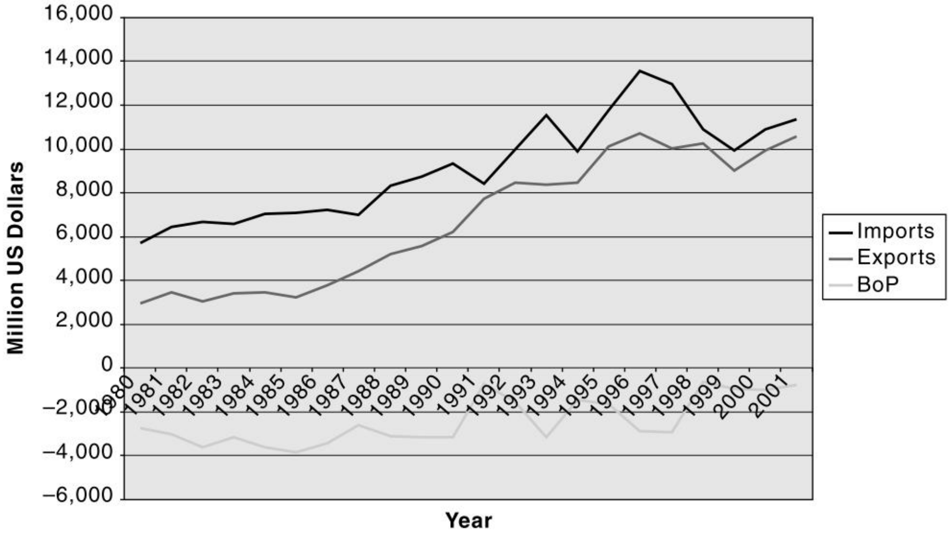

Fig. 24.13 Imports, Exports and BoP for Pakistan

the World Bank and others worry about the continuing public-sector budget deficit, running at approximately 10% of GDP (refer to the economic profile for India given in Exhibit 24.2).

Economic Growth and Indicators

India recorded one of the highest growth rates in the world in the past two years, second only to China among the emerging market economies. According to the World Development Indicators 2004, India became the fourth largest economy in terms of purchasing power parity, after the US, China and Japan. Domestic developments—largely immune to the global business cycle—powered a surge in real GDP growth to 8.2 per cent—the highest in 15 years. This is the growth trend India was looking for becoming on par with China and developed nations. The trend shows, after 1991 reforms, the growth has been consistently good.

The tables reveal some interesting facts: it took three decades for India to surmount the 'Hindu Growth Rate' syndrome of an average 3.5 per cent per annum; it took the country 40 years to double its per-capita income; the economic reforms introduced in the 1980s and 1990s placed the economy on the higher growth. This is reflected in the graph of per capita income for the last 24 years which depicts a greater slope for years after 1992 (Refer Fig. 24.14).

Growth Sectors

The main contributing factors for India's GDP are services, agriculture and industrial output. Currently, services sector dominates with a contribution of 57.5% to the overall GDP. Agriculture and industry sectors contribute 20.5 and 22% respectively. Year wise trend of percentage contribution by each sector shows that service and industry sectors are increasingly contributing to the GDP while the percentage relevance of agriculture is coming down in spite of the fact that 65% of the Indian population is employed in Agriculture (Refer Fig. 24.15).

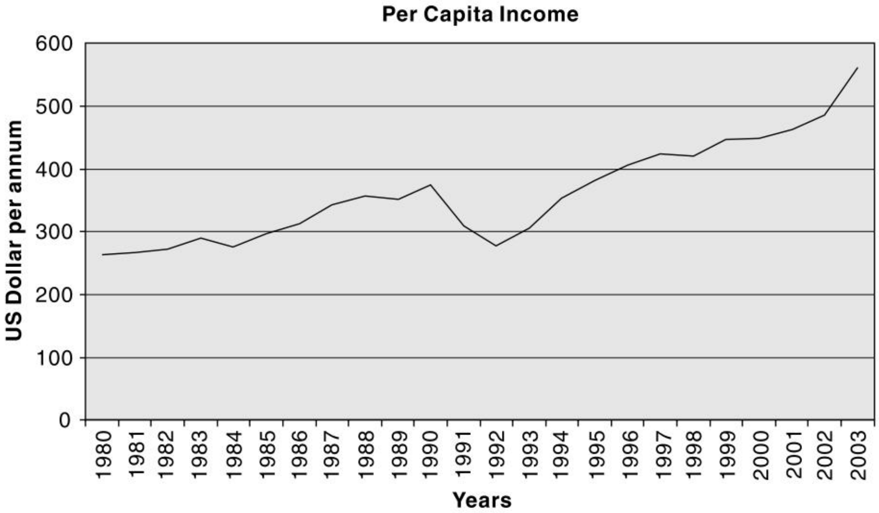

Fig. 24.14 Per Capita Income

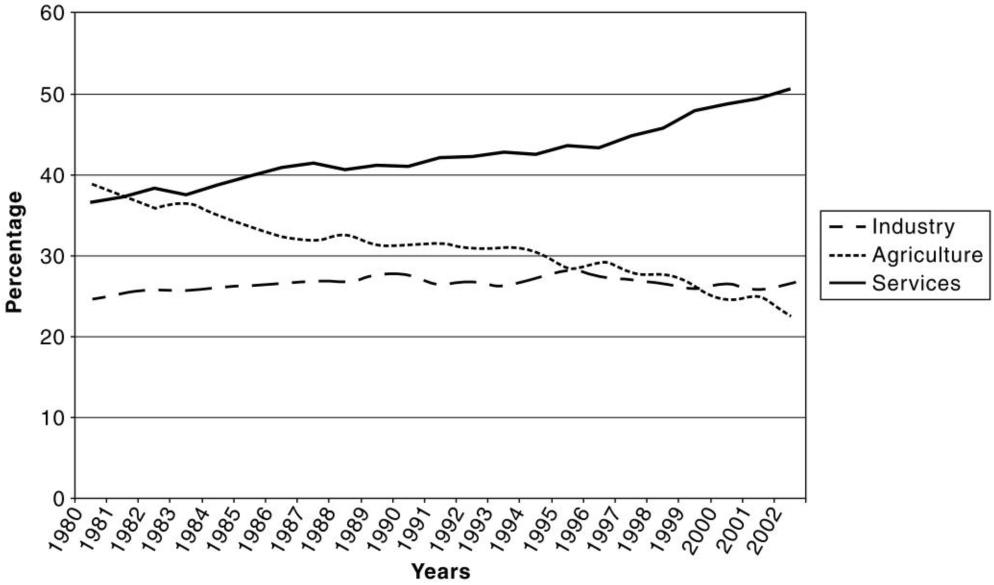

Fig. 24.15 Sectoral Contributions to GDP for India

External Sector

Buoyant software exports and record workers' remittances led to a current account surplus during the past few years even as the merchandise trade deficit expanded due to the strong industrial recovery underway. The sustained buoyancy in merchandise exports was led by manufactures, reflecting structural changes and the growing competitiveness of the industrial sector. The exports now stand at $57.24 billion and imports at $74.15 billion.

Balance of Payments

The overall strengthening of the balance of payments was reflected in an unprecedented accretion to India's foreign exchange reserves, which by March 2004, touched US $113 billion, the sixth highest in the world. The figure depicts exports and imports for the last 24 years. The balance of payment has been showing a less negative trend over the recent years due to reduction in imports relative to exports (see Fig. 24.16).

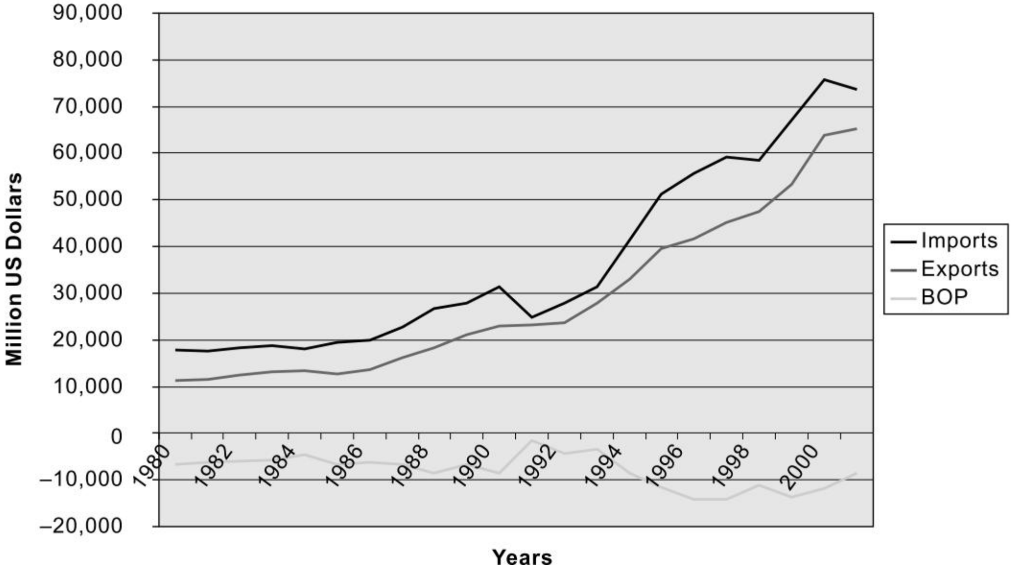

Fig. 24.16 Imports, Exports and BoP for India

Exchange Rate

Over the past two decades, rupee has dropped consistently viz a viz the dollar but during the past few years, rupee has strengthened due to consolidating Indian economy and global weakening of US dollar. The expected deregulation of the Chinese currency in the coming years would further strengthen the rupee. The chart depicts the year on year rupee dollar exchange rates trend since 1980 (Refer Fig. 24.17).

Social Structure

Though the economy has been doing well over the past decade, the percentage population below poverty line still remains at a high 25% and the unemployment rate is at a high 9.5%. The growing concern for India is the large population and a still growing population rate of 1.44%. India is stated to overtake China as the country with the largest population by 2010. The illiteracy percentage remains at a high 40.5% with the male and female percentage illiteracy at 29.8 and 51.7 respectively.

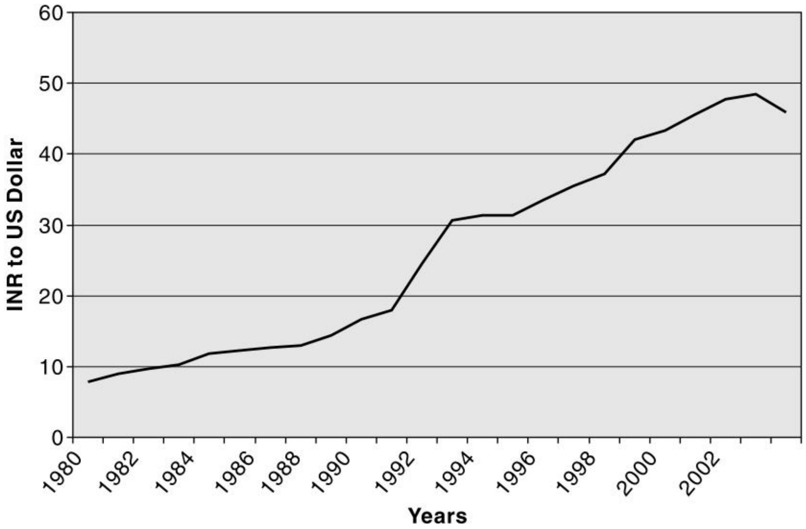

Fig. 24.17 India

SECTION 7: PROBLEMS AND PROSPECTS

Though there exists certain differences among SAARC member states, such as, geographical and population imbalances, they have many factors in common—rural economies, low income, population pressure, unemployment, geographically neighbour states and dependence on external debt, to name a few.

Even though diversification was mooted as a remedy for low level growth of exports, some SAARC nations' depend on exports of manufactured goods. Similarly, high nominal tariffs on a variety of non-tariff barriers such as quantitative restrictions, fiscal charges and discriminatory practices and outright ban on imports has to be avoided among SAARC members. Also, SAARC can deal with the world's major trading blocks as a composite unit in order to maximise the gains of trade for both sides.

An efficient and better communication net work, among SAARC partners, which can give information of export potentials, import needs, domestic economic policies, tariff and non-tariff barriers, infrastructural facilities, demand and supply situation and investment opportunities, will help for a better economic co-operation and regional development.

This is where South Asia Free Trade Agreement (SAFTA) comes into picture. It replaces the earlier South Asia Preferential Trade Agreement (SAPTA) and may lead to a full-fledged South Asia Economic Union. SAFTA has become operational on 1st January, 2006, the date on which all seven SAARC countries eased foreign trade among them.

SAFTA affirms the existing rights and obligations under Marrakech Agreement, establishing the WTO and other treaties and agreements to which SAARC members are signatories. It provides for free movement of goods in the region through elimination of tariffs, para-tariffs that include border charges and fees, and non-tariff restrictions on movement of goods and any other equivalent measures.

Review Questions

1. Discuss the similarities and disparities between SAARC nations based on the macroeconomic variables discussed in the chapter.
2. Critically examine the economic environment in Bangladesh, Nepal and Sri Lanka.

Class/Field Exercise

Visit the website of SAARC and examine the progress on SAFTA (South Asian Free Trade Agreement).

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Annexure

Exhibit 24.1 Economic Profile of Bangladesh[1]

Bangladesh	
GDP	Purchasing power parity - $258.8 billion (2004 est.)
GDP–real growth rate	5.3% (2004 est.)
GDP–per capita	Purchasing power parity - $1,900 (2004 est.)
GDP–composition by sector	Agriculture: 21.7% industry: 26.6% services: 51.7% (2004 est.)
Population below poverty line	35.6% (2004 est.)
Inflation rate consumer prices	5.6% (2004 est.)
Unemployment rate	40% (includes underemployment) (1)
Public debt	43.3% of GDP (2004 est.)
Agriculture products	rice, jute, tea, wheat, sugarcane, potato, tobacco, pulses, oilseeds, spices, fruit, beef, milk, poultry
Industries	cotton textiles, jute, garments, tea processing, paper newsprint, cement, chemical fertilizer, light engineering, sugar
Industrial production growth rate	1.9% (2004 est.)
Current account balance	$393 million (2004 est.)
Exports	$6.713 billion (2004 est.)
Exports commodities	garments, jute and jute goods, leather, frozen fish and seafood (2001)
Imports	$9.459 billion (2003 est.)
Imports commodities	machinery and equipment, chemicals, iron and steel, textiles, foodstuffs, petroleum products, cement (2000)
Reserves of foreign exchange gold	$2.624 billion (2004 est.)
Debt external	$18.06 billion (2004 est.)
Currency	taka (BDT)
Exchange rates	taka per US dollar–58.15 (2003)

Exhibit 24.2 Economic Profile of India[2]

India	
GDP	Purchasing power parity–$3.033 trillion (2004 est.)
GDP-real growth rate	8.3% (2004 est.)
GDP-per capita	Purchasing power parity–$2,900 (2004 est.)
GDP-composition by sector	Agriculture: 23.6% industry: 28.4% services: 48% (2002 est.)

(*Contd.*)

[1]*Source:* Applied Language (http://www.appliedlanguage.com)
[2]*Source:* Compiled from www.indiastats.com and from the website of RBI.

(*Contd.*)

Population below poverty line	25% (2002 est.)
Unemployment rate	9.5% (2004 est.)
Public debt	59.7% of GDP (2004 est.)
Agriculture products	rice, wheat, oilseed, cotton, jute, tea, sugarcane, potatoes; cattle, water buffalo, sheep, goats, poultry; fish
Industries	textiles, chemicals, food processing, steel, transportation equipment, cement, mining, petroleum, machinery, software
Industrial production growth rate	6.5% (2004 est.)
Current account balance	$3.41 billion (2004 est.)
Exports	$57.24 billion f.o.b. (2004 est.)
Exports commodities	Textile goods, gems and jewellery, engineering goods, chemicals, leather manufactures
Imports	$74.15 billion f.o.b. (2003 est.)
Imports commodities	crude oil, machinery, gems, fertilizer, chemicals
Imports partners	US 6.4%, Belgium 5.6%, UK 4.8%, China 4.3%, Singapore 4% (2003)
Reserves of foreign exchange gold	$102.3 billion (2004 est.)
Debt external	$101.7 billion (2004 est.)
Currency	Indian rupee (INR)
Exchange rates	Indian rupees per US dollar–46.5806 (2003)

Exhibit 24.3 Economic Profile of Nepal[3]

Nepal	
GDP	Purchasing power parity–$38.29 billion (2004 est.)
GDP - real growth rate	3% (2004 est.)
GDP - per capita	Purchasing power parity–$1,400 (2004 est.)
GDP - composition by sector	Agriculture: 40% industry: 20% services: 40% (2002 est.)
Inflation rate consumer prices	2.9% (2002 est.)
Unemployment rate	47% (2001 est.)
Agriculture products	rice, corn, wheat, sugarcane, root crops; milk, water buffalo meat
Industries	tourism, carpet, textile; small rice, jute, sugar, and oilseed mills; cigarette; cement and brick production
Exports	$568 million f.o.b., but does not include unrecorded border trade with India (2002 est.)
Exports commodities	carpets, clothing, leather goods, jute goods, grain
Imports	$1.419 billion f.o.b. (2002 est.)
Imports commodities	gold, machinery and equipment, petroleum products, fertilizer
Debt external	$2.7 billion (2001)
Currency	Nepalese rupee (NPR)
Exchange rates	Nepalese rupees per US dollar–76.1414 (2003)

[3]*Source:* Applied Language (http://www.appliedlanguage.com)

Exhibit 24.4 Economic profile of Pakistan[4]

Pakistan	
GDP	Purchasing power parity–$318 billion (2004 est.)
GDP–real growth rate	5.5% (2004 est.)
GDP–per capita	Purchasing power parity–$2,100 (2004 est.)
GDP–composition by sector	Agriculture: 23.3% industry: 23.5% services: 53.2% (2004 est.)
Population below poverty line	35% (2004 est.)
Inflation rate consumer prices	2.9% (2004 est.)
Unemployment rate	7.7% plus substantial underemployment (2004 est.)
Public debt	72.7% of GDP (2004 est.)
Agriculture products	cotton, wheat, rice, sugarcane, fruits, vegetables; milk, beef, mutton, eggs
Industries	textiles and apparel, food processing, pharmaceuticals, construction materials, paper products, fertilizer, shrimp
Industrial production growth rate	7.6% (2004 est.)
Current account balance	$3.358 billion (2004 est.)
Exports	$11.7 billion f.o.b. (2004 est.)
Exports commodities	textiles (garments, bed linen, cotton cloth, and yarn), rice, leather goods, sports goods, chemicals, manufactures, carpets and rugs
Imports	$12.51 billion f.o.b. (2003 est.)
Imports commodities	petroleum, petroleum products, machinery, plastics, transportation equipment, edible oils, paper and paperboard, iron and steel, tea
Reserves of foreign exchange gold	$11.67 billion (2004 est.)
Debt external	$33.54 billion (2004 est.)
Currency	Pakistani rupee (PKR)
Exchange rates	Pakistani rupees per US dollar - 57.752 (2003)

Exhibit 24.5 Economic profile of Sri Lanka[5]

Sri Lanka	
GDP	Purchasing power parity–$73.7 billion (2004 est.)
GDP–real growth rate	5.5% (2004 est.)
GDP–per capita	Purchasing power parity–$3,700 (2004 est.)
GDP–composition by sector	Agriculture: 19.9% industry: 26.3% services: 53.8% (2004 est.)
Household income or consumption by percentage share	lowest 10%: 3.5% highest 10%: 28% (1995)
Distribution of family income - Gini index	34.4 (1995)
Inflation rate consumer prices	6.3% (2004 est.)
Unemployment rate	8.4% (2004 est.)

(*Contd.*)

[4]*Source:* Applied Language (http://www.appliedlanguage.com)
[5]*Source:* Applied Language (http://www.appliedlanguage.com)

(*Contd.*)

Agriculture products	rice, sugarcane, grains, pulses, oilseed, spices, tea, rubber, coconuts; milk, eggs, hides, beef
Industries	rubber processing, tea, coconuts, and other agricultural commodities; clothing, cement, petroleum refining, textiles, tobacco
Industrial production growth rate	5.8% (2004 est.)
Current account balance	$278 million (2004 est.)
Exports	$5.269 billion f.o.b. (2004 est.)
Exports commodities	textiles and apparel, tea, diamonds, coconut products, petroleum products
Imports	$6.626 billion f.o.b. (2003 est.)
Imports commodities	textiles, mineral products, petroleum, foodstuffs, machinery and equipment
Reserves of foreign exchange gold	$2.273 billion (2004 est.)
Debt external	$10.52 billion (2004 est.)
Currency	Sri Lankan rupee (LKR)
Exchange rates	Sri Lankan rupees per US dollar–96.521 (2003), 95.6621 (2002), 89.383 (2001), 77.0051 (2000), 70.6354 (1999)

Appendices

Bangladesh

Bangladesh GDP Growth

Year	GDP Growth	Year	GDP Growth
1980	1.5	1992	5
1981	3.8	1993	4.6
1982	2.4	1994	4.1
1983	4	1995	4.9
1984	5.2	1996	4.6
1985	3.2	1997	5.4
1986	4.2	1998	5.2
1987	3.7	1999	4.9
1988	2.2	2000	5.9
1989	2.6	2001	5.3
1990	5.9	2002	4.4
1991	3.3	2003	5.3

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Sectoral Growth contribution to GDP for Bangladesh

Currency Rate Bangladesh

Year	Currency Rate	Year	Currency Rate
1980	15.5	1992	37.0
1981	16.3	1993	37.0
1982	20.0	1994	40.0
1983	23.8	1995	40.0
1984	24.9	1996	40.0
1985	26.0	1997	42.0
1986	29.9	1998	45.0
1987	30.6	1999	47.0
1988	31.2	2000	50.2
1989	33.2	2001	53.9
1990	33.3	2002	57.4
1991	35.7	2003	57.5

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

India

GDP Growth for India

Year	GDP Growth	Year	GDP Growth
1980	6.7	1992	5.3
1981	6.4	1993	4.9
1982	3.7	1994	7.5
1983	7.1	1995	7.6
1984	4.1	1996	7.4
1985	5.6	1997	4.5
1986	4.8	1998	6.0
1987	4.3	1999	7.1
1988	9.9	2000	3.9
1989	6.4	2001	5.2
1990	5.8	2002	4.6
1991	0.9	2003	8.0

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

India Per Capita Income

Year	Per Capita Income	Year	Per Capita Income
1980	264.2	1992	277.2
1981	267.3	1993	305.4
1982	271.6	1994	353.3
1983	289.2	1995	381.2
1984	276.5	1996	405.9
1985	297.0	1997	424.5
1986	312.7	1998	421.1
1987	342.7	1999	446.9
1988	357.9	2000	449.4
1989	352.0	2001	463.5
1990	374.5	2002	485.9
1991	309.3	2003	562.2

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

India: Sectoral Growth Contribution to GDP

Year	Industry	Agriculture	Services	Year	Industry	Agriculture	Services
1980	24.5	38.9	36.6	1992	26.7	30.9	42.3
1981	25.3	37.4	37.3	1993	26.3	31	42.8
1982	25.8	35.9	38.3	1994	27.1	30.4	42.5
1983	25.8	36.6	37.6	1995	28.1	28.2	43.6

(*Contd*)

(*Contd*)

1984	26.2	35.2	38.7	1996	27.4	29.2	43.4
1985	26.4	33.7	39.9	1997	27.2	27.8	44.9
1986	26.6	32.5	40.9	1998	26.5	27.7	45.8
1987	26.7	31.9	41.4	1999	25.9	26.2	47.9
1988	26.6	32.7	40.7	2000	26.6	24.6	48.8
1989	27.6	31.3	41.2	2001	25.7	25	49.4
1990	27.6	31.3	41.1	2002	26.6	22.7	50.7
1991	26.4	31.5	42.1				

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Rupee/US Dollar Currency Rate India

Year	Currency Rate	Year	Currency Rate
1980	7.91	1992	30.65
1981	8.97	1993	31.37
1982	9.67	1994	31.4
1983	10.34	1995	33.45
1984	11.89	1996	35.5
1985	12.24	1997	37.17
1986	12.78	1998	42.07
1987	12.97	1999	43.33
1988	14.48	2000	45.68
1989	16.65	2001	47.69
1990	17.94	2002	48.41
1991	24.47	2003	45.95

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Nepal

GDP Growth for Nepal

Year	GDP Growth	Year	GDP Growth
1980	–2.3	1992	4.3
1981	8.3	1993	3.5
1982	3.8	1994	8.6
1983	–3.0	1995	3.3
1984	9.7	1996	5.3
1985	6.1	1997	5.3
1986	4.6	1998	2.9
1987	1.7	1999	4.5
1988	7.5	2000	6.1
1989	4.4	2001	5.5
1990	4.5	2002	–0.6
1991	6.6	2003	3.0

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Nepal Per Capita Income

Year	Per Capita Income $	Year	Per Capita Income $
1980	131	1992	174.2
1981	150	1993	183.2
1982	154.5	1994	199
1983	154.4	1995	210.1
1984	159	1996	210.9
1985	157.9	1997	224.2
1986	168	1998	216.4
1987	170.5	1999	218.9
1988	196.4	2000	233.4
1989	194	2001	231.1
1990	194.9	2002	223.1
1991	205.6	2003	231.7

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Pakistan

GDP Growth for Pakistan

Year	GDP Growth	Year	GDP Growth
1980	10.2	1992	7.7
1981	7.9	1993	1.8
1982	6.5	1994	3.7
1983	6.8	1995	5
1984	5.1	1996	4.8
1985	7.6	1997	1
1986	5.5	1998	2.6
1987	6.5	1999	3.7
1988	7.6	2000	4.3
1989	5	2001	2.6
1990	4.5	2002	2.8
1991	5.1	2003	5.8

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Pakistan Per Capita Income (in US $)

Year	Per Capita Income	Year	Per Capita Income
1980	293.4	1992	417.0
1981	337.0	1993	431.8

(*Contd*)

(*Contd*)

1982	356.4	1994	426.7
1983	322.2	1995	486.7
1984	338.8	1996	495.5
1985	326.8	1997	475.7
1986	324.5	1998	461.7
1987	329.0	1999	421.5
1988	367.6	2000	426.9
1989	372.7	2001	402.0
1990	360.7	2002	394.9
1991	399.9	2003	448.0

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Currency Rate Pakistan

Year	Currency Rate	Year	Currency Rate
1980	9.9	1992	24.78
1981	9.9	1993	25.9
1982	10.55	1994	29.94
1983	12.7	1995	30.63
1984	13.48	1996	33.33
1985	15.16	1997	38.71
1986	16.13	1998	42.85
1987	17.17	1999	50.14
1988	17.56	2000	51.65
1989	19.16	2001	58.25
1990	21.39	2002	61.26
1991	22.37	2003	58.39

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Sri Lanka

GDP Growth for Sri Lanka

Year	GDP Growth	Year	GDP Growth
1980	5.8	1992	4.4
1981	5.7	1993	6.9
1982	4.1	1994	5.6
1983	4.8	1995	5.5
1984	5.1	1996	3.8
1985	5.0	1997	6.4
1986	4.4	1998	4.7
1987	1.7	1999	4.3

(*Contd*)

(*Contd*)

1988	2.5	2000	6.0
1989	2.3	2001	–1.5
1990	6.4	2002	4.0
1991	4.6	2003	5.5

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Sri Lanka Per Capita Income

Year	Per Capita Income	Year	Per Capita Income
1980	276.4	1992	562.6
1981	299.6	1993	596.7
1982	318.9	1994	664.5
1983	340.9	1995	731.1
1984	392.6	1996	774.3
1985	383.0	1997	833.5
1986	404.4	1998	864.5
1987	414.9	1999	851.5
1988	426.8	2000	876.6
1989	421.1	2001	837.2
1990	477.1	2002	877.8
1991	528.0	2003	970.4

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Currency Rate Sri Lanka

Year	Currency Rate	Year	Currency Rate
1980	16.53	1992	43.83
1981	19.25	1993	48.25
1982	20.81	1994	49.42
1983	23.53	1995	51.25
1984	25.44	1996	55.27
1985	27.16	1997	59.00
1986	28.02	1998	64.45
1987	29.45	1999	70.64
1988	31.81	2000	77.01
1989	36.05	2001	89.38
1990	40.06	2002	95.66
1991	41.37	2003	96.52

Source: EarthTrends: The Information Portal (http://www.earthtrends.wri.org).

Chapter 25

Economic and Business Environment in East and South-East Asian Countries

Learning Objectives

- to learn about the economic and business environment in countries such as China, Japan, Singapore, Thailand, Malaysia etc.
- to gather market information about these Asian countries

Chapter Structure

Section 1: **Japan**

Section 2: **China**

Section 3: **Malaysia**

Section 4: **Singapore**

Section 5: **Thailand**

Section 6: **Brunei**

SECTION 1: JAPAN

Economic Overview

Population: 127 million; **Location/Size:** Eastern Asia–Island chain between the North Pacific Ocean and the Sea of Japan/145,882 square miles
Major cities: Tokyo (Capital), Osaka (Kansai), Nagoya, Fukuoka/Kitakyushu, Sapporo
Languages: Japanese
Ethnic Groups: Japanese (99%)
Religion: Shinto and Buddhist (84%), others (16%). But Japanese people are not religious
Income Tax: 20% middle income group professionals
Currency: Yen
Exchange rate: US$1 = 100 to 105 Yen (April 2008), US$1 =86 Yen (2008 Nov), US$1=92 Yen (Jan 2010)
Major trading partners: United States, Germany, China, OPEC
Total merchandise exports: Exceeds Total Merchandise Imports
Major export products: Machinery and transport equipment, chemical and other manufactured goods
Major import products: Chemical and other manufactured goods, mineral fuels, foodstuffs, crude material

Japan is known worldwide for quality, speed and productivity. Japan is also home for many successful multinational firms such as Toyota, Sony, Honda, Canon, Sharp, Sanyo, Panasonic, Suzuki, Mitsubishi, Hitachi etc. There are many things we need to learn and implement based on the business practices and management philosophy of Japanese enterprises. How to achieve greater success in business like Japanese firms? Can we link Japan's success to the unique Japanese culture or focus given to the quality and standard? What are the secrets for the success of Japanese firms in the global markets? Should we attribute their global success to the unique Japanese culture based on collectivism, harmony and politeness and the management strategy based on continuous improvement in quality and innovation? In 1950s and 1960s, Japan was destroyed during the Second World War and there were bomb attacks in all the Japanese cities. Japan was a poor country and was an American colony for more than 10 years after 1945. Today, the country is party of rich group of G-8 countries and they have third rank in the world in terms of gross national income. How did Japan and Japanese companies achieve rousing gains, success and respectful position among the consumers in global markets? What are the factors that motivate customers in many countries to prefer 'Made in Japan' compared to products made in other countries?

Japan has taken important steps towards economic deregulation and restructuring. Government–industry cooperation, a strong work ethic, mastery of high technology and a comparatively small defence allocation (1% of GDP) helped Japan advance with extraordinary rapidity to the rank of second most technologically-powerful economy in the world after the US and third-largest economy after the US and China, measured on a purchasing power parity (PPP) basis. (Using market exchange rates rather than PPP rates, Japan's economy is larger than China's). One notable characteristic of the economy is the teamwork of manufacturers, suppliers and distributors in closely-knit groups called keiretsu. A second basic feature has been the guarantee of lifetime employment for a substantial portion of the urban labour force. Both features are now eroding. Industry, the most important sector of the economy, is heavily dependent on imported raw materials and fuels. The tiny agricultural sector is highly subsidised and protected, with crop yields among the highest in the world. Usually self sufficient in rice, Japan import about 50% of its requirements of other grain and fodder crops. Japan maintains one of the world's largest fishing fleets and accounts for nearly 15% of the global catch.

For three decades overall real economic growth had been spectacular: a 10% average in the 1960s, a 5% average in the 1970s and a 4% average in the 1980s. Growth slowed markedly in the 1990s, largely because of the after-effects of overinvestment in real estate, shares and the resultant bubble during the late 1980s. Robotics constitutes a key long-term economic strength with Japan possessing 410,000 of the world's 720,000 'working robots'.

SECTION 2: CHINA

Economy Overview

Population (July 2005E): 1.3 billion
Location/size: Eastern Asia/3.7 million square miles (9.6 million square kilometres, slightly smaller than the United States)
Major cities: Beijing (Capital), Shanghai, Tianjin, Guangzhou, Shenyang, Wuhan, Chengdu, Hong Kong
Languages: Mandarin (official), many local dialects
Ethnic groups: Han Chinese (92%); Zhuang, Uygur, Hui, Yi, Tibetan, Miao, Manchu, Mongol, Buyi, Korean, others (8%)
Religion: Officially atheist; Daoist (Taoist), Buddhist, Muslim (1-2%), Christian (3-4%)
Currency: Yuan
Exchange Rate (2007): US$1 = 6.5 to 7.5 Yuan/Renminbi
Real GDP growth rate: Between 8% and 12% (last 7 years)
Inflation rate: 3 to 5%
Current account surplus (2005F): $81.6 billion
Major trading partners: Japan, United States, European Union, South Korea, Taiwan
Merchandise exports: Exceeds Merchandise Imports
Major export products: Light industrial and textile products, mineral fuels, heavy manufactures, agricultural goods
Major import products: Machinery, steel, chemicals, industrial materials, grain
(Statistical note: All data reported here exclude Hong Kong, a former British colony which reverted to China on July 1, 1997.)

The People's Republic of China (China) is the world's most populous country and the second largest energy consumer (after the United States). China has emerged as the fastest growing economy in the world since opening its doors in the late 1970s. With economic growth averaging 8 to 9 percent annually, China has quadrupled the size of its economy since the 1980s. It has vastly outperformed India in terms of economic development and forced many of its neighbouring countries to re-evaluate their positions in today's global economy. China is transforming itself from a rural society to an urban society, from an agricultural economy to a manufacturing economy, and from a centrally planned economy to a state-managed market economy 'with Chinese characteristics'.

China's accession to the World Trade Organisation (WTO) in the year 2001, combined with its enormous growth potential, provides tremendous business opportunities for many companies. However, the volatility of the U.S.–China relationship, issues surrounding the general business environment and cultural differences between East and West all have an important impact on doing business with China. There have been legal, economic, political and social changes taking place within China. All of these issues contribute to the many opportunities and challenges for companies interested in starting or expanding business in China. It is worth noting that there are more than three reputed organisations have forecasted that China would emerge as the largest economy in the world in early 2040 surpassing the status of USA.

A research paper titled 'Dynamic Competition: A Look at Firms in the Fortune Global 500' by Prof. Sally Sledge, Norfolk State University presented at the American Society for Competitiveness Conference in the US in October 2009 showed that there are many Chinese firms in the fortune 500 list, as per the 2008 ranking, while there were hardly any Chinese firms in 1995 in the fortune 500 list. The total number of Japanese firms have shown substantial decline over this period in the fortune 500 list. What could be the possible reasons and economics that determine these changes?

SECTION 3: MALAYSIA

Map of Malaysia

Economic Overview

Population: – 2009 estimate 28,310,000; 2000 census 24,821,286
Density: 85.8/km^2 222.3/sq mi
GDP (PPP): 2008 estimate Total \$384.388 billion (30th); Per capita \$14,081
GDP (nominal): 2008 estimate Total \$221.606 billion, Per capita \$8,118
Source: http://en.wikipedia.org/wiki/Malaysia

Country Analysis

Malaysia is a medium-sized, export-oriented economy. It has developed rapidly over the past 20 years from an agricultural-based economy to one dominated by intermediate manufacturing. The Malaysian Government has played an active role as an economic planner and regulator, as well as a business player in its own right. However, it has progressively divested itself of direct investments in industry in recent years. Malaysia's key feature of economic policy has been sustainable growth, with particular sectoral focus on transport, energy and telecommunications infrastructure.

Malaysian government emphasises on technical and vocational skills training, and investment in domestic research and development capabilities with a view to reducing the dependence of the industrial sector on foreign investment and technology. In view of the current economic downturn, the government has stepped up development in the new growth sectors such as the knowledge-based industries, in particular the high-technology manufacturing and high value-added services.

The Government of Malaysia has been highly proactive in response to the Global economic downturn and has adopted measures to protect and stimulate its economy.

Business Opportunities

There are business opportunities in:

- Healthcare and pharmaceutical products
- Education and training services
- Food and beverages
- Environmental technology
- Information and communication technology
- Biotechnology
- Franchising industry

Malaysia is a multi-racial nation consisting of Malays, Chinese and Indians. Majority of Malays belong to Islam religion. English is widely spoken and is used in business.

Investment opportunities exist in the following sectors in Malaysia:

Manufacturing sector including food processing, chemical, textile, electronics and other high-tech industries

- Agriculture sector
- Information and communication technology sector
- Research and development sector

In Malaysia's Industrial Master Plan, the focus is on further development of the manufacturing sector with the back-up of R&D and design capabilities, the development of supporting industries, packaging, distribution and marketing. This integration of manufacturing and other operations aims to strengthen industrial linkages and increase the productivity and competitiveness of industries in the country.

Within the industries, there are opportunities for joint venture partnerships. Malaysian companies have the experience of regional and international marketing and foreign companies seeking joint venture partners in Malaysia will have a wide range of companies to select from, in order to match their needs. Malaysian government agency provides assistance in identifying suitable partners.

SECTION 4: SINGAPORE

Map of Singapore

Economy Overview

Population: 2009 estimate 4,987,600; 2000 census 4,117,700
Density: 6,814/km^2 17,275.7/sq mi
GDP (PPP): 2008 estimate Total \$239.146 billion; Per capita \$56,226 (4th)
GDP (nominal): 2008 estimate Total \$181.939 billion; Per capita \$38,972
Source: http://en.wikipedia.org/wiki/Singapore

Country Analysis of Singapore

Singapore is the most economically successful and prosperous country of South East Asia. The key factor in Singapore's outstanding economic performance has been the free trade stance of the Government, which resulted in a competitive economy fully integrated with the global economy. Singapore has pursued, with great success, a strategy of export-oriented industrialisation. The Government has introduced policies, backed by its substantial capital resources that ensure modern and advanced infrastructure. Multinational corporations represent a key pillar of the Singapore economy. Singapore is the major regional trade and trans-shipment centre, as well as a growing telecommunications hub.

Singapore remains as an attractive destination for multinationals seeking to establish regional headquarters in Asia. Furthermore, as the island state's future is closely linked with that of its neighbours, the government agencies promote the economic integration of the Association of South-East Asian Nations (ASEAN) countries. In addition to the Free Trade Agreement (FTA) with the US, Singapore has also got bilateral Free Trade Agreements with Australia, Japan, Jordan, India, New Zealand, South Korea etc.

Singapore's major industries include petroleum refining, electronics, oil drilling equipment, rubber products, processed food and beverages, ship repair, entrepot trade, financial services and biotechnology.

Business Opportunities

Singapore does not impose import tax on products except for alcohol, tobacco, automobile and petroleum products. Although it is also a multi-racial country, the population (4 million) is predominantly Chinese. Major religions include Buddhism, Taoism, Christianity, Islam and Hinduism. Singapore has little restrictions on trade and the way of doing business is similar to that of any sophisticated western country.

Food and Beverage

Singapore relies on imports for a large proportion of its food and beverage. There is no agriculture production and virtually all raw materials for food manufacturing are imported. Singapore also has a large food service industry with many hotels, restaurants, airline caterers and clubs. It is also a regional purchasing centre for hypermarket and food businesses. Opportunities include selling to hypermarkets, agents and distributors for products such as meat and meat preparations, dairy products and eggs, confectionery, seafood, vegetables and fruits, spices and food ingredients, wine and fruit juices.

Educational Services

Singapore parents are keen to send their children abroad for overseas exposure. Courses, which are popular include hard sciences, i.e., technical and engineering related courses as well as business management courses. Opportunities exist for training courses in production planning, procurement and logistics, management courses, automation and quality assurance.

Information Technology

Singapore aims to be the hub of knowledge-based industry. It has implemented the Singapore One concept, which connects the whole island through fibre-optic cables. Services within the IT industry, which are in demand, include Internet applications including electronic commerce, software development and applications, networking systems (LAN/WAN products) and IT training and education. The liberalised telecommunication sector in Singapore offers excellent opportunities for firms.

Environmental Services

These include equipment and services, which contribute to the building of a clean and garden city. Opportunities exist for water equipment and chemicals, air pollution control equipment, instruments and monitoring systems and waste management equipment as well as services in solid waste management, hazardous waste management, consulting and engineering, remediation, water treatment works and analytical services.

Franchising

Singapore has one of the highest per capital incomes in the world. Expatriate professionals form a significant number of foreigners, estimated at 34% of foreign population. Singapore attracts more than 7 million visitors annually. Its well-developed infrastructure is a main reason why it is successful as a distribution centre as well as showcase for imported products in the region. The market outlook for franchises is good and the island is home to many franchises from around the world.

SECTION 5: THAILAND

Thailand has a free enterprise economy and welcomes foreign investment. After enjoying the world's highest growth rate from 1985 to 1995—averaging almost 9% annually—increased speculative pressure on Thailand's currency in 1997 led to a crisis that uncovered financial sector weaknesses and forced the government to float the baht.

Economy Overview

Population: 2009 estimate 63,389,730; 2000 census 60,606,947
Density: 132.1/km^2 342/sq mi
GDP (PPP): 2008 estimate Total $547.060 billion (24th); Per capita $8,239
GDP (nominal): 2008 estimate Total $273.313 billion; Per capita $4,116
Source: http://en.wikipedia.org/wiki/Thailand - cite_note-imf2-2

After Thailand's economic crisis in 1997, the country has recovered much of its strong demand for raw materials and industrial inputs, providing investment opportunities for producers of these goods.

The chicken industry accounts for about 1% of GDP, and employs an estimated 2 million people**.** Thailand is a large industrial economy with great potential for international trade. Opportunities exist in:

- Food and beverages
- Information technology
- Telecommunications
- Building and construction (especially ports and railways)
- Marine industry
- Automobile industry (replacement equipment market)

Business Opportunities

Automotive Sector

Opportunities exist in diesel engine components, suspension and chassis parts, large injection moulds and moulded parts, press dies, jigs and fixtures, catalytic converters, industry plastic and rubber products, steel casting and forging, engineering plastic compounding, design and engineering services.

Food and Beverages

Increase in demand for international food and beverages is due to the growing number of tourists, foreigners living and working in Thailand and overseas-educated Thais. Consequently, there is growth in the food service sector. Natural and organic foods are in demand and imported fruit and vegetables are also popular. Opportunities exist in fresh fruit, wine processed foods, meat and dairy.

Cosmetics

Opportunities exist in the supply of general cosmetic items such as facial powder, eye shadow, lipstick, cosmetics made from natural extracts, and medicinal cosmetics that contain medicinal properties mainly for skin care.

Information and Communication Technologies

High priority needs/opportunities for Thailand's telecommunications sector include fixed-line prepaid card technology, Intelligent Network (IN), ISDN terminal equipment, SDH equipment, fibre-optics/cables and technologies, call/customer management systems, Internet/e-commerce convergence technology, Voice Over Internet Protocol (VOIP), software and Internet security, e-commerce training and consultancy in business-to-business, Mobile/Wireless Intelligent Network, wireless application protocol technology, digital mobile base stations and related equipment, paging transmitting and tracking systems, third generation convergence technology, transmission networks, data/network services and management, project management. Opportunities also exist in software applications, business intelligence solutions, professional training and networking and telecommunication software.

Doing Business with Thailand

Thailand is the only country in South East Asia never to have been a European colony. The name Thai means, 'free'. Thais will shake hands with foreigners but appreciate the traditional greeting, which is to press your hands together (as though in prayer), keeping arms and elbows close to your body.

When addressing a person use their first name and the prefix 'Khun'. Use appropriate titles where necessary, including Doctor or Professor. Always offer a business card at a meeting and take plenty with you. It is preferable to have cards printed with English on one side and Thai on the other.

It might be useful to start with small talk before introducing important issues and smile at social and business occasions. Do not frown, express anger, hold eye contact or pass anything over a person's head—all are inappropriate. The Thais are strong negotiators and appreciate flexibility and compromiser, which are perceived as strengths.

SECTION 6: BRUNEI

Map of Brunei

Economic Overview

Population: 2009 estimate 388,190; 2001 census 332,844
Density: 67.3/km^2 (134th) 174.4/sq mi
GDP (PPP): 2008 estimate Total $19.716 billion; Per capita $50,198
GDP (nominal): 2008 estimate Total $14.553 billion, Per capita $37,053
Source: http://en.wikipedia.org/wiki/Brunei on 4th January 2010

Country Analysis

Brunei's small, wealthy economy is based heavily upon proceeds from exports of crude oil and natural gas. Revenues from the hydrocarbons sector account for nearly half of gross domestic product (GDP), around 90 percent of merchandise exports and 80 percent of government revenues. Brunei consumes little energy domestically, and is a sizeable net exporter of oil and natural gas. However, the country's hydrocarbon reserves have declined over the last several decades.

Facts on Brunei Darussalam

Brunei Darussalam is a monarchy with a national ideology based on Islam. Brunei has a population of 350,000, of which 68% are Malays, 15% Chinese and the remaining 17% is made up of indigenous groups, Indians and foreign workers.

Trade

Although heavily reliant on imports, Brunei's small population has enabled the country to enjoy a strong trade surplus for many years. Japan remains Brunei's largest export market, accounting for over 40% of all exports, followed by ASEAN (20%), Australia (8.3%) and Korea (11.2%). ASEAN countries are the biggest import sources, providing 47.4% of total imports, with 20% from Malaysia and 20% from Singapore. Closely behind is the USA.

Business Opportunities

Oil and Gas

The oil and gas reserves that have fuelled Brunei's economic growth continue to be the country's main source of revenue and provide the second largest source of employment, after the civil service. It is currently estimated that Brunei's known reserves of oil and gas will last for 25 and 40 years respectively.

Manufacturing

The manufacturing sector currently plays a relatively minor role in Brunei's economy. Manufacturing has been identified by the government as an important area for economic diversification.

Review Questions

1. Discuss the business environment in China.
2. Compare the country and economic indicators of China and Japan.
3. Discuss the important areas for doing business in Singapore and Thailand.

Objective Type Questions

1. Name the currency of Japan.
2. Singapore & Malaysia are neighbouring countries. True/False

Class/Field Exercise

1. Japan External Trade Organization is the best source of information on Japanese Market. The website is http://jetro.go.ip. Using this site, analyse the trend and pattern of international trade in Japan.
2. The website of Association of South East Nations is http://www.aseansec.org/. Visit the website and also collect the information from other sources why India and China have announced bilateral Free Trade Agreement (FTA) with ASEAN. Watch the video given below:
http://video.in.msn.com/watch/video/india-to-sign-trade-pact-with -asean/fdo2u8ov

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Chapter 26

Economic and Business Environment in South America

Learning Objectives

- to gather insight and information about the business and economic environment of South America
- to trace ups and downs of South America in 21^{st} century
- to understand the paradigm similarities and differences of countries in South America

Chapter Structure

Section 1: **Overview of the Continent—South America**

Section 2: **Brazil**

Section 3: **Argentina**

Section 4: **Venezuela**

Section 5: **Chile**

Section 6: **Colombia**

Section 7: **Regional Trade Blocks and the Road Ahead**

Map of South America

SECTION 1: OVERVIEW OF THE CONTINENT—SOUTH AMERICA*

South America with its distinguishing physical features, vibrant culture, and developing economies provides the ideal platform for us to study the economic environment of different countries. It has been in the news for both the right and wrong reasons. There have been corrective actions regarding economy by countries like Argentina and Brazil. The continent is known for its abundant, yet largely untapped, natural resources. Let us first focus on the general aspects of the continent like topography, people, resources, economy and insights into its recent past. Then we will discuss in detail the profiles of the various nations and learn about the prominent economic and social indicators. Lastly, we will discuss the recent trends, government interventions and lessons from the economic catastrophes and the future of the South American economy in the era of globalisation.

South America is the fourth largest continent after Asia, Africa and North America. It spans a total area of 17.8 million square kilometres with an estimated population of 350 million. It is the southern of the two continents of the Western Hemisphere. It is divided politically into 12 independent countries—Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Suriname, Uruguay, and Venezuela—and the overseas department of French Guiana. On its west, lie the Andes Mountains, while in the north flows the River Amazon. The continent's great river systems empty into the Atlantic Ocean and the Caribbean Sea. Lake Titicaca on the Peru-Bolivia border is the largest of the continent's lakes. The inland waterways are well developed and provide the lifeline for trade and commerce of the region. South America embraces every climatic zone – tropical, rainy, desert and high alpine.

It is extremely important to know the lifestyle of the people, their origin and their preferences to understand the business environment. Native people constitute a significant portion of the continent's population, especially in Bolivia, Ecuador, Peru and Paraguay. Elsewhere in South America, the population is generally Mestizo (descendants of Spaniards and American Indians) although Chile, Argentina, Uruguay and S Brazil have primarily European populations. Immigration since 1800 has brought European, Middle Eastern and Asian (especially Japanese) people to the continent. With the exception of Brazil and Ecuador, the national capitals have the largest populations and are the economic, cultural, and political centres of the countries. Since World War II, the urban population has rapidly expanded. Sao Paulo in Brazil is the largest city of South America and one of the fastest growing cities in the world.

Economic History

In the 17th century, the exploitation of the continent's resources and the development of its industries began as a result of foreign investment and initiative especially that of Spain, the United Kingdom and the United States, but since World War II, the nations of South America have been enjoying greater economic independence. An increasing number of South American industrial centres have developed heavy industries to supplement the light industries on which they had previously concentrated. The major agricultural exports are coffee, bananas, sugarcane, tobacco and grains. Meat is also an important export item. In the interior, hunting and gathering of forest products are the main economic activities of the indigenous people. Fishing is also an important industry.

*Girish Madan, Dr Justin Paul, Kaushik Ray and Manish Gupta co-authored this chapter.

In the late 1970s, Latin America had underwent a phase of unsustainable economic activity because of heavy overseas borrowings and excessive government intervention in the economy. During the 1980s, Latin American countries saw prices of their exports plunge, interest rates reach to the peak, and access to international capital being cut back severely. Governments ran out of foreign exchange reserves, inflation soared in some cases to as much as triple digit levels. Under these circumstances, job creation during the 1980s was slow and direct foreign investment was weak. Trade flows during the period were relatively small compared with what one might expect from economies of their size.

After a frightening period of high inflation, high unemployment rates and economic upheaval, situation took a turn for the better. The inflation was brought under control. Finally, Latin America has become an active participant in the flow of foreign direct investment and other forms of capital.

Let us analyse the top five economies of South America (in terms of GDP).

SECTION 2: BRAZIL

Brazil is the fifth largest country in the world and the largest in the southern hemisphere, with 8.514 million square kilometres area. Brazil shares borders with most of the South American countries, except Chile and Ecuador. It has over 15.7 thousand kilometres of landlocked borders and approximately 7.3 thousand kilometres of coastline (Atlantic Ocean).*

The Federative Republic of Brazil consists of the Union, 26 states, the Federal District and over 5,500 municipalities. The country is divided into five territorial macro-regions—north, northeast, southeast, south and central-west—which group states with similar physical, human, economic and social characteristics.

Brazil's current population is estimated at 181 million spread irregularly throughout the national territory. Some regions are densely populated—such as the southeast—while others are almost uninhabited. The Brazilian population is predominantly urban, with approximately 81% of people living in cities and towns. Brazil is the biggest market in the region.

In 2004, the Brazilian Gross Domestic Product (GDP) reached approximately US$ 514 billion. The economically active population of the country is estimated at 76 million. The rate of open unemployment as calculated for the metropolitan regions of Brazil's six major capitals was 7.0%.

The overall view of the Brazilian economy is marked by regional imbalances requiring that the state plays an effective role as the redistributor's agent. The heterogeneous profile of the demographic distribution of the Brazilian population presents the south and southeast regions as the main consuming centres in the country. At the other end, the north region presents the lowest demographic density rate. From an economic perspective, the data presented in Table 26.1 is relevant for discussion.

Another feature of the Brazilian economy is its unequal income distribution, with the poorest 50% of the population holding only 12.3% of the national income whereas the richest 20% holding 62.4%. This partially explains the fact that for estimated Economically Active Population (76 million workers), only around 14 million individuals filed income-tax returns in 2004.

It is worth nothing that Indian pharmaceutical and IT companies have established their manufacturing facilities and made an impressive entry into Brazil. The enhancement of India's image by the achievements in these sectors have made the marketing job of other products easier.

In the rural area, it is also possible to find great land concentration, with more than 35% of the ownership of all existing rural land area belonging to only 1% of the proprietors. With regard to the

*All data (unless otherwise specified) are as per the statistion of the year 2003–04.

external sector, Brazil exported US$ 58.2 billion (FOB) and imported US$ 55.6 billion (FOB), resulting in a trade surplus of US$ 2.6 billion in 2004. The foreign trade flow (imports + exports) of US$ 113.8 billion accounted for about 28% of the GDP.

Table 26.1 Macro Economic Data on Brazil[1]

Population, total	181 million
Population density (people per sq km)	21.1
Population growth (annual %)	1.2
Urban population (% of total)	81 %
GDP (at purchasing power parity, current US$)	514.4 billion
GDP real growth (annual %)	1.8 %
Industry, value-added (% of GDP)	35.3%
Agriculture, value-added (% of GDP)	7.5 %
Services, etc., value-added (% of GDP)	56 %
Exports of goods and services (% of GDP)	15.7
Imports of goods and services (% of GDP)	13.5
Inflation	13.4 %
Unemployment rate	19.5 %
Life expectancy at birth	73.4

Until 1986, inflation was fought (mostly) with orthodox measures in Brazil. That year, yearly inflation was running at more than 100% for the second year in a row. In 1987, the government plan froze prices and salaries, besides cutting budgetary investments. In 1989, the Summer Plan again froze prices and proposed the privatisation of state companies and the dismissal of civil servants. In 1990, President Fernando Collor had taken office promising to kill the inflation with only one shot. The main measure of the government known as Collor Plan was to freeze all financial assets in bank accounts which exceeded a few thousand dollars (the money was to be gradually returned after eighteen months). Besides, as usual, prices and salaries were frozen, budget expenses cut and taxes were increased. The plan brought recession to Brazil and was not successful.

In January 1999, Brazil was hit harder, dragging down other Latin American economies with it. But Brazil's President Fernando Cardoso responded quickly with 'Real Plan'—a series of tightening measures that produced short-term misery but presumably long-term stability and growth. The Real Plan was founded on three key elements: (i) a fiscal strategy with the Constitutional Amendment creating the Social Emergency Fund; (ii) a monetary reform process with voluntary adoption of a new unit of account later to become the national currency; (iii) a big bang approach developed towards opening the economy with aggressive trade liberalisation and a new foreign exchange policy. The Real Plan proved to be the panacea Brazil needed and inflation was finally brought in control.

Country—in Brief

- Categorised as an emerging economy by Goldman Sachs under the title BRIC (Brazil, Russia, India and China)

[1]All data reported in Tables in this chapter (unless otherwise specified) are as per the statistics of the year 2003–04.

- One of highest economic aid recipient countries
- Third highest kilometres of highway

SECTION 3: ARGENTINA

Table 26.2 Macro Economic Data on Argentina

Population, total	39.5 million
Population density (people per sq km)	13.0
Population growth (annual %)	1.02
Urban population (% of total)	89.3
GDP (at purchasing power parity, current US$)	433.5 billion
GDP real growth (annual %)	8.7%
Industry, value-added (% of GDP)	34.3
Agriculture, value-added (% of GDP)	11.4
Services, etc., value-added (% of GDP)	56.9
Exports of goods and services (% of GDP)	9.8
Imports of goods and services (% of GDP)	11.5
Overall budget deficit, including grants (% of GDP)	–2.9
Inflation	13.4%
Unemployment rate	17.3%
Life expectancy at birth	76 years

Following independence from Spain in 1816, Argentina experienced periods of internal political conflict between conservatives and liberals and between civilian and military factions. After World War II, a long period of authoritarian rule and interference in subsequent governments was followed by a military rule that took power in 1976. Democracy returned in 1983, and numerous elections since then have underscored Argentina's progress in democratic consolidation. In 1989, after decades of economic decline and chronic inflation, Argentina began an unprecedented and profound economic restructuring based on macroeconomic stabilisation, trade liberalisation and privatisation.

For sound economy, the Currency Convertibility Law was established in 1991. It advocated a quasi currency board, which provided the pillar of price stability. The government privatised most state-controlled companies, opened the economy to foreign trade and investment and improved tax collection. Brazil contributes greatly to Argentina's exports then Chile and Mexico—fellow members of the Latin American Association of Integration, whose purpose is to gradually establish a Latin American common market.

Argentina experienced a boom in economic growth in the early 1990s. Real GDP growth averaged over 6% for the 1991–97 periods.

Till the mid 1990s, the Argentine economy was considered a model for the emerging economies of the world. By the late 1990s, however, the Argentina's economic growth had stopped. Unemployment was rampant. In December 2001, Argentina suffered its worst economic crisis ever, when the nation defaulted on its $155 billion foreign debt payments, the largest such default in history. In response, Argentina devalued its peso, which had been pegged to the dollar for a decade. The devaluation plunged the banking industry into crisis and wiped out much of the savings of the middle class. Banking and foreign exchange were suspended. Half of Argentina's 36 million had to live in poverty, unemployment rate reached 22%, and protests and strikes multiplied. The IMF refused to bail out Argentina initially, and insisted that the nation first reform its economic policies.

Dollarisation provided the first positive step. It was quickly followed with reforms to the financial system and taxes. Labour laws and health care system were both revamped. Tax net was diversified and strengthened. Remedial measures to arrest inflation finally started bearing fruit in mid-2002. As an outcome, Argentina has experienced steady economic growth since 2002. In addition, Argentina benefitted from continued economic growth in the Latin America and Caribbean region, which grew between 3.5 to 4.5 per cent in 2004 and 2005. Also trade organisations like Mercosur have aligned the Argentine economy with the rest of South America. Despite indications that the economy has stabilised, Argentina still has a long way to go to achieve higher growth and prospects.

Country—in Brief

- One of the highest debt recipient countries
- Large proportion of women in service sector
- Lowest proportion of male workers engaged in agriculture

SECTION 4: VENEZUELA

Table 26.3 Macro Economic Data on Venezuela

Population, total	25.5 million
Population density (people per sq km)	17
Population growth (annual %)	1.9
Urban population (% of total)	88
GDP (current US $) at purchasing power parity	94.2 billion
GDP real growth (annual %)	3.2%
Industry, value-added (% of GDP)	43 %
Agriculture, value-added (% of GDP)	2.3%
Services, etc., value-added (% of GDP)	56%
Inflation	22.3%
Unemployment rate	19.5%
Life expectancy at birth	72.3 years

A country rich in natural resources, with one of the largest petroleum and mineral reserves in Latin America and the Caribbean, Venezuela has a great potential to achieve sustainable economic and social development. Nevertheless, the country had suffered a prolonged economic and political crisis and social ills such as inequality and poverty.

The percentage of Venezuelans living in poverty (household income of less than $2 a day) has increased from 32.2 per cent in 1991 to 48.5 per cent in 2003. Likewise, the proportion of those living in extreme poverty—below $1 a day—has also shown increase. This increased poverty is accompanied by a widening inequality gap. Currently, the richest 20 per cent of the Venezuelans receives 53 per cent of all the income, while the poorest 20 per cent accounts for only a three per cent share of the country's total income.

The economy of Venezuela is built upon the valuable petroleum and mineral resources. Until 1970, the nation was the world's largest petroleum exporter. While resource extraction has contributed in developing an industrial economy, the nation is vulnerable to fluctuations in world markets. High petroleum prices in the early 1980s gave the nation the highest annual per capita income in South America, but in the early 1990s a weak global oil market, coupled with political instability and a crisis in the banking system. The petroleum area dominates the economy, accounting for around 80% of the export earnings, and more than half of the government operating revenues. A strong rebound in international oil prices fuelled the recovery in 1999. Their currency Bolivar is widely believed to be overvalued by as much as 50%.

Venezuela continues to be highly dependent on the petroleum sector, which accounts for roughly one-third of the GDP. The domestic political instability and a two-month national oil strike from December 2002 to February 2003 had temporarily halted economic activity. But the economy is on the positive path to growth at present.

Country—in Brief

- Large environmentally protected area
- Dependent on Petroleum sector
- Low Gasoline prices

SECTION 5: CHILE

Table 26.4 Macro Economic Data on Chile

Population, total	16.1 million
Population density (people per sq km)	17.4
Population growth (annual %)	1.3%
Urban population (% of total)	83
GDP (current US $)at purchasing power parity	72.2 billion
GDP real growth (annual %)	3.3
Industry, value added (% of GDP)	34.5
Agriculture, value added (% of GDP)	8.8
Services, etc., value added (% of GDP)	56.9
Exports of goods and services (as % of GDP)	34.5%
Imports of goods and services (as % of GDP)	31.3%
Inflation	3.3%
Unemployment rate	12.3%
Life expectancy at birth	76.3 years

Typical of other Latin American economies, Chile also had a dependent past in its history. In the sixteenth century, foreigners, particularly Spanish settlers, were attracted to central Chile because of the pleasant climate and fertile soil. After a long and bloody struggle for freedom, Independence was finally declared in 1810.

It is interesting to look at the political structure based on 'past and present' aspects. A three-year-old Marxist government was overthrown in 1973 by a dictatorial military regime led by Augusto Pinochet, who ruled until a freely elected president was installed in 1990. Sound economic policies, first implemented by the Pinochet dictatorship, led to unprecedented growth in 1991–97 and have helped secure the country's commitment to democratic and representative government.

At present, Chile has a market-oriented economy characterised by a high level of foreign trade. During the early 1990s, Chile's reputation as a role model for economic reform was strengthened when the democratic government of Patricio Aylwin - which took over from the military in 1990—deepened the economic reform initiated by the military government. Growth in real GDP averaged 8% during 1991–97, but fell to half that level in 1998 because of tight monetary policies implemented to keep the current account deficit in check and because of lower export earnings. Because of a severe drought and the recession in 1999, reducing crop yields, hydroelectric shortfalls and electricity rationing, Chile experienced negative economic growth for the first time in more than 15 years. Despite the effects of the recession, Chile maintained its reputation for strong financial institutions and sound policy that has given it the strongest sovereign bond rating in South America. By 2000, exports and economic activity had begun to recover, and growth had rebounded to 4.4%. Growth fell back to 2.8% in 2001 and 1.8% in 2002, largely due to lackluster global growth and the devaluation of the Argentine peso. One bright spot was the signing of a free trade agreement with the US, which came into effect on January 1, 2004. The Chilean economy, on the back of regional trade agreements, increase in net exports, tighter fiscal and monetary policies and growing world economy, has rebounded strongly on the way to growth.

Recently, Chile has been ranked first in investment grading in Latin America.

Country—in Brief

- Large in number of pupils completing primary education
- Lowest nuclear waste generated
- Third last in proportion of population living on less than $1 per day in South America

SECTION 6: COLOMBIA

Table 26.5 Macro Economic Data on Colombia

Population, total	46.16 million
Population density (people per sq km)	18.4
Population growth (annual %)	1.5
Urban population (% of total)	76
GDP (current US $)at purchasing power parity	77.6 billion
GDP real growth (annual %)	3.7
Industry, value-added (% of GDP)	30
Agriculture, value-added (% of GDP)	14.3
Services, etc., value-added (% of GDP)	55.2
Exports of goods and services (as % of GDP)	23.2
Imports of goods and services (as % of GDP)	24.7
Inflation	7.3 %
Unemployment rate	16.8 %
Life expectancy at birth	71.8 years

Colombia has a track record of sound democratic political system and years of sustained economic growth.

There is a notable quotation "If Colombia had achieved peace 20 years ago, the income of the average Colombian would now be 50% higher than the present one."

Nevertheless, the country has managed to sustain GDP growth despite unfavorable international and regional trends as well as violence at home. Economic growth had demonstrated that Colombia's economic foundation remains strong.

While other Latin American and Caribbean countries struggle with either inequality or poverty or violence, Colombia has to confront all the three issues simultaneously. Colombians in the top 20 per cent of the resource scale receive 60 per cent of the national income, which is in sharp contrast with Sweden, where the top 20 per cent of the population receive 34 per cent of the national income. One of Colombia's most notable characteristics—and a factor that led to armed violence—is inequality which persisted even during periods when substantial economic growth brought more income.

On the economic front, unemployment rate is about 17 per cent in the urban areas where three-quarter of the population lives. In addition, economic problems are hitting Venezuela, Colombia's biggest market for non-traditional exports. In short, Colombia faces a test to get its economy back on rails; and for that, peace and stability are of paramount importance.

SECTION 7: REGIONAL TRADE BLOCKS AND THE ROAD AHEAD

Association of American Chambers of Commerce in Latin America (AACCLA)

AACCLA is a leading advocate of increased trade and investment between the United States and Latin America and represents 23 American Chambers of Commerce in 21 Latin American and Caribbean countries. AACCLA aims to promote free trade, free markets and free enterprise and generate support among government officials and business for trade liberalisation initiatives such as the Free Trade Area of the Americas (FTAA).

Mercosur

Brazil, along with Argentina, Uruguay and Paraguay (with Chile and Bolivia as special, instead of full members), makes up the Mercosur—the Southern Common Market. The Mercosur came in effect on January 1, 1995, with the main purpose of promoting the social and economic progress of its member countries. The Mercosur is an economic bloc characterised by free trade between its members and by the use of a common external tariff (for products from outside the bloc), forming a customs union. It provided an important pillar of strength when countries like Argentina and Brazil were hit hard by extremely high inflation which led to currency crisis.

South American Community of Nations (SACN)

On December 8, 2004 in Cuzco, Peru, the heads of states and governments of South America approved the creation of the South American Community of Nations (SACN). The new regional organisation underscored the need to foster a greater convergence between the existing South American blocs, Mercosur, the Andean Community (Colombia, Ecuador, Peru, Venezuela) and with Guyana and Suriname

(South American countries which are members of Caricom) in order to establish and perfect a free trade area and for the fusion of both regional groupings into the new one.

One of the main objectives of SACN is to have stronger negotiating power with the USA, Europe, China, Japan and the Association of South East Asian Nations (ASEAN), and also with the United Nations.

Another important objective is to lessen and terminate as soon as possible the territorial disputes existing between Chile and Bolivia, Venezuela and Guyana, and Suriname and Guyana.

The Road Ahead

We have come to know that the continent South America, despite occasional setbacks, is on a gradual road to progress. Argentina, Brazil, Chile, Colombia, Ecuador and Venezuela are showing significant upward indicators of growth.

Let us put forth some of the reasons and recent trends.

- There has been a significant acceleration in world trade, which helps countries whose exports are a significant percentage of GDP. That is true for Chile, Ecuador, Uruguay, Venezuela and Bolivia.
- Commodity prices (oil and metals) have increased in the global market. Incomes rise and the terms of trade improve for countries whose export prices raise in general relative to other goods and services. While increase in oil prices help Colombia, Venezuela and Ecuador, metals prices are significant for Chile and Bolivia.
- Global capital funds have become active in the region. Foreign savings are a major source of investment capital for these countries. Greater exchange rate stability for a number of countries would help to attract foreign investors, so would economic recovery, low inflation and political stability.
- Brazil is South America's flagship country and holds the key to the region's future. Its economy is larger than all of the others combined. When it catches a slow wind or a lull, all of the others tend to struggle. Recent reports indicate that hopefully, the worst is over for the Brazilian economy.
- The economic prosperity is directly linked to political stability. This holds true for South America as well. For long lasting economic stability, politics will have to take a backseat and economics would have to come to the driver's seat.

Table 26.6 Exchange Rates in Major South American Nations (Indicative)

Country	Brazil	Argentina	Venezuela	Chile	Colombia
Exchange rate	2.46 Real per US $	3.06 Argentine pesos per US $	1160 Bolivares per US $	688.95 Chilean pesos per US $	2504 Colombian pesos per US $

Chapter Summary

In the true spirit of the course, let us analyse the changes taken place in developing countries in South America during the last decade one by one.

1. Many of the economies of Latin America have adopted more prudent and open policies that foster competition and participation in global markets. They have embraced globalisation with open arms.
2. A prudent fiscal policy is crucial to economic stability and several of the economies of the region have made significant strides in this direction.
3. There has been a substantial dismantling of the controls imposed by government over private sector prices and wages. It is now widely understood that excessive budget deficits and money creation are the root cause of inflation and controls over private prices have been generally abolished. Finally, exchange rates in many Latin American countries have become more flexible.
4. The role of the government in other aspects of the economy has been substantially diminished, with an accordingly greater scope allowed for private activity and for competition from abroad. Internally, many Latin American countries have privatised major businesses.
5. Trade barriers have been removed in many countries, through participation in regional agreements and broader international arrangements. In consequence, the share of foreign trade in economic activity has increased substantially in many sectors.
6. Finally, in Latin America, areas where government oversight is important and necessary, progress has been made in improving supervision and regulation. In particular, effort has focused on strengthening and modernising the region's banking sectors.

Review Questions

1. Discuss the recent developments in Argentina's economy.
2. Analyse the strength, weakness, opportunity and threat (SWOT) aspects of economy of Chile and Brazil.
3. Compare and contrast the economic environment and policies in Venezuela and Colombia.

Class/Field Exercise

Use websites such as http://globaledge.msu.edu to complete the following task: You are working for a company which is considering investing in a foreign country. CEO of your firm has requested you to prepare a report regarding the attractiveness of Latin American countries. A friend mentioned about a useful tool called the 'FDI Confidence Index'. Your professor also fold you about Market Potential Index. Find these indices and choose the Best and Second Best attractive countries in Latin America based on these index values/ranks.

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Chapter 27

Economic and Business Environment in North America

Learning Objectives

- to analyse the country profiles of Canada and Mexico
- to survey of developments in different sectors like financial, social, infrastructural, agricultural, industrial, political and external in those economies

Chapter Structure

Introduction*

The study of business environment is one of the most exciting branches of broader disciplines of economics and management. Economics, in addition to the efficient allocation of scarce resources, also deals with the financial, political, social, and institutional mechanisms, both public and private, necessary to bring about rapid and large scale improvements in the standard of living.

It is very interesting to study and analyse Canada and Mexico, their economic structures, monetary and banking developments, securities market, inflation, external sector, i.e. Balance of payments position, capital account, Foreign exchange reserves, Industrial sector, Agricultural sector and social sector and so on. These two countries are also members of North American Free Trade Agreement (NAFTA) along with United States which has contributed to the recent growth in exports and imports. In this chapter, let us analyse the economic and business environment in two important countries i.e., Canada, which is a High income OECD, and Mexico, which is an UMC (Upper-middle income) country.

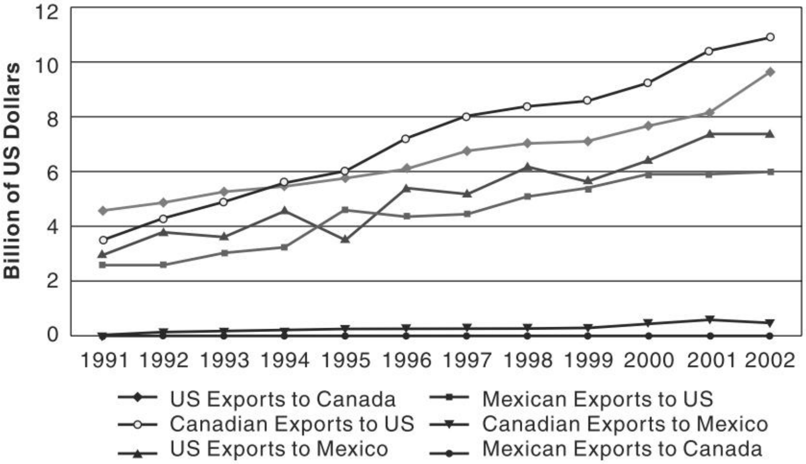

Fig. 27.1

SECTION 1: BUSINESS ENVIRONMENT IN CANADA

Brief Country Profile

Canada is the second largest country in the world after Russia. However, its population is only about one-fifth of Russia's. The relationship with its powerful neighbour USA is a major defining factor for Canada. The USA and Canada have the world's largest trading relationship with the rest of the world.

Facts and Figures

Population:	32,507,874
Population growth rate:	0.92%

*This chapter was co-authored by Dr. Justin Paul with Kriti Agarwal and Varsha Kujur, his students at IIM Indore.

Canada

*Map not to scale

Languages:	English 59.3% (official), French 23.2% (official), others 17.5%
Literacy:	97%
Capital:	Ottawa
Area:	9.9 million sq km (3.8 m sq miles)
GDP:	purchasing power parity—US$958.7 billion
GDP—real growth rate:	1.7%
GDP—per capita	purchasing power parity—US$29,800
Inflation rate (consumer prices)	2.5 to 3% (Last 3 years)
Agriculture—Main products:	Wheat, barley, oilseed, tobacco, fruits, vegetables; dairy products; forest products; fish
Major Industries:	Transportation equipment, chemicals, processed and unprocessed minerals, food products; wood and paper products; fish products, petroleum and natural gas

Exports:	US$279.3 billion f.o.b.
Exports-commodities:	Motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment; chemicals, plastics, fertilizers; wood pulp, crude petroleum, natural gas, aluminum etc.
Imports:	US$240.4 billion f.o.b.
Imports—commodities:	Machinery and equipment, crude oil, chemicals, electricity, durable consumer goods
Currency:	Canadian dollar (CAD) = 100 cents
Exchange rates:	Canadian dollars per US dollar - 1.2 to 1.3 (Last 3 years)

Source: Compiled from www.statcan.ca

Overview

The North American Free Trade Agreement, involving Canada, the US and Mexico, has brought a trade boom for Canada. NAFTA created the largest free trade area in the world, covering at the time some 360 million people and nearly C$500 billion in yearly trade and investment. NAFTA also maintains the tariff elimination schedule for the bilateral trade between the United States and Canada. Separate bilateral schedules were negotiated by both the countries with Mexico for the elimination of tariffs. The agreement had also set out rules in areas such as investment, services, intellectual property, government procurement, competition policy and temporary entry of business persons. However, Canada made no commitments to liberalise trade in social services or cultural industries. NAFTA has had some clear effects on Canada's economy. Canadian product exports to both Mexico and the United States roughly doubled between 1994 and 2000, from C$1 billion to C$2 billion to Mexico, and from C$183 billion to C$359 billion to the United States. NAFTA has made Canada more attractive to foreign and domestic investors. American moves, in the form of increased subsidies for US farmers, had created particular tension. However, after the September 11, 2001 attacks in the US, the challenge of protecting the 9,000 km Canada-US border from possible terrorist infiltration prompted both the countries to look at ways of sharing information.

Immigration has helped to make Canada one of the world's richest countries, and the country is largely free of racial tension. Many recent immigrants hail from Asia. Canada's indigenous peoples make up for less than two per cent of the population.

Government

Head of state: Queen Elizabeth II, represented by Governor-General Adrienne Clarkson
Prime Minister: Paul Martin

Liberal leader Mr Martin was returned to power in a minority government in general elections in June 2004. Paul Martin is regarded as a fiscal conservative. He was credited with clearing Canada's large budget deficit in the 1990s. He has promised to undertake a major restructuring of government and has committed to improving relations with the US.

The government sets out an agenda to improve the standard of living and quality of life of the Canadians. The major themes advanced are:

- Economy;
- Health of Canadians;

- Environment;
- Strength and safety of Canadian communities;
- Canada's role in the world.

Prudent fiscal planning and significant reduction in the federal debt have helped the Government of Canada to make major investments as per the priorities of its people. Both the Federal Budget and Fiscal and Economic Update focus on:

- Building a more productive and innovative economy;
- Learning, acquiring knowledge;
- Canada's relationship with the world; and
- A more accountable government.

Monetary and Banking Developments

The Bank of Canada (BoC) determines monetary policy for Canada. The Bank does not have periodic policy setting meetings. Instead, the council meets on a daily basis and changes in policy can be made at any point of time.

The Bank of Canada's focus is on maintaining the 'integrity and value of the currency'. This primarily involves ensuring price stability and this is maintained by adhering to an inflation target agreed upon with the Department of Finance. This inflation target is currently set at 1%–3%. The BoC controls inflation through short-term interest rates. Monetary conditions tighten when short-term rates increase or the Canadian dollar appreciates.

In order to change monetary policies, the Bank can change the Bank Rate that affects the interest directly, thereby also impacting the exchange rate. If the currency appreciates to undesirable levels, the BoC can decrease interest rates to offset the rise. If it depreciates, the BoC can raise rates. However, interest rate changes are not used for the purposes of manipulating the exchange rate but to control inflation.

The following are the most commonly used tools by the BoC to implement monetary policy:

Bank Rate

This is the main rate used to control inflation. This is the rate of interest that the Bank of Canada charges to commercial banks. Changes to this rate will affect other interest rates, including mortgage rates and prime rates charged by commercial banks. Therefore, changes to this rate will have impact on the overall economy.

Open Market Operations

The Large Value Transfer System (LVTS) is the framework for the BoC's implementation of monetary policy. It is through this framework that Canada's commercial banks borrow and lend overnight money to each other in order to fund their daily transactions. The LVTS is an electronic platform through which these financial institutions conduct large transactions. The interest rate charged on these overnight loans is called the overnight rate or bank rate. The BoC can make changes in the overnight rate by offering to lend at rates lower or higher than the current market rate if the overnight lending rate is trading above or below the target rate.

On a regular basis, the bank releases a number of publications that are useful for the public to monitor the data. This includes a biannual Monetary Policy Report that contains an assessment of the current economic environment and implications for inflation and a quarterly Bank of Canada Review that includes economic commentary, featured articles, speeches by members of the Governing Council and important announcements.

- *Commodity Linked Currency:* Canada's economy is highly dependent on commodities. The positive correlation between the Canadian dollar and commodity prices is close to 60%. Typically, as commodity prices increase, the CAD$ increases and when commodity prices decrease, the CAD$ declines.
- *Strong Correlation with the US:* The US imports 80 to 85% of Canada's exports. The Canadian economy is highly sensitive to changes in the US economy.
- *Mergers and Acquisitions:* Due to the proximity of the US and Canada, crossborder mergers and acquisitions are very common, as companies worldwide strive for globalisation. These mergers and acquisitions lead to money flow between the two countries, which ultimately impact the currencies.
- Bank of Canada monitor and publish *Interest rate differentials* between the rates of Canada and the short-term interest rate yields of other industrialised countries. Interest rate yield differentials provide traders with indications of potential currency movements, as investors are always on a lookout for assets with the highest yields.

Financial Institutions and Markets

Because of the improving investor confidence, Canadian capital market has regained buoyancy in the recent past. Although Canadian Venture Capital (VC) activity had declined in 2003, it has seen a modest uptake since then. The public equity markets rebounded in 2004 and 2005, both in Canada and globally, registering overall gains for the first time in four years. Nevertheless, initial public offering (IPO) activity was sluggish, particularly in the US during 2001–03. The major news in foreign exchange markets was the rise in the Canadian dollar, which had attained decade-high levels against US Dollar counterpart. This was generally attributed to US dollar weakness, although the Canadian dollar held its own against other major currencies as well.

Social Sectors

Canada routinely ranks among the top three countries in the world for overall living standards. The country has been consistently ranked among the top five in terms of Human Development Index by United Nations Development Programme (UNDP) and was ranked No.1 in 2001. There are more jobs in retail and wholesale trade.

Infrastructure

The Government of Canada has taken constructive steps to engage and consult with stakeholders; to continue to promote new partnerships between federal, provincial, territorial and municipal governments; and to provide, predictable, long-term funding for cities and communities in urban and rural areas. The combined efforts of organisations contribute to Canada's success. Over the last decade, the

Government of Canada has spent close to $12 billion in new funds for infrastructure projects across the country. These funds are expected to leverage $30 billion in total investments by all partners.

Latest Economic Trends

Real gross domestic product growth rate was 2.8% in 2004, an increase from the 2.0% growth in the previous year. Exports rebounded despite remarkable strength in the Canadian dollar.

The Canadian dollar strengthened vis-à-vis the US currency in 2004, appreciating 7.7% on top of a 12.1% gain in 2003. While exports increased 4.9%, imports picked up speed, growing much stronger at 8.2%, leading to a significant decline in Canada's trade balance during 2004–05.

Industrial production has increased in the range of 3 to 3.5% in the last three years. Wholesale and retail trade activity posted solid gains, and the finance and insurance services had a boom time in the recent past. Mining, oil and gas extraction output grew 2.7%, boosted by increased production of potash, diamonds, coal and certain metals. Oil and gas exploration continued to expand, triggered by high energy prices.

Despite strong growth in labour income, personal saving continued to plummet, as growth in spending outstripped income growth. The saving rate fell to the lowest level on record since the 1930s. With sustained robust growth in residential construction, personal sector net borrowing continued to climb. The combined surplus of all levels of government (on a national accounts basis) swelled to $17 billion in 2004, with the federal surplus accounting for the bulk of this amount.

Exports Rebound Despite Strength in the Dollar

Canadian exports climbed 4.9% during 2004–05 reversing the 2.4% drop in 2003. Exports of goods grew 5.2%, with automotive products, machinery and equipment and industrial goods and materials contributing most of the increase. Exports of services bounced back from a decline in 2003, growing 2.7%.[1]

Manufacturers Boost Production

Manufacturers' output rose by 3.9% after a flat 2003. Increases spanned virtually all categories, with strong gains in transportation equipment, chemical products and machinery production. The manufacturing of information and communication technologies (ICT) products rebounded (+12.0%) after three consecutive annual declines. Production of industrial chemicals was up sharply, while the pharmaceutical industry had years of moderate growth. Textiles, leather products and clothing were weak spots in manufacturing, as the reduction of trade barriers and fierce competition from Asian producers continued to dampen output.

Businesses Invest Heavily in Machinery and Equipment

Business capital spending in machinery and equipment surged 9.4% in 2004, the highest increase since 1999. Imports rose in tandem, as Canadian businesses took advantage of the increased purchasing power of the strong dollar to buy investment goods from outside the country.

1. Annual Report, Bank of Canada, 2004–05

National Saving Expands

The combined saving of all sectors of the economy expanded 12.3% in 2004, following 15.3% growth in the previous year. The national saving rate (national saving as a proportion of net national income) increased to 8.0%. While households reduced saving and increased borrowings in the face of low interest rates and improved asset values, the saving of corporations and governments swelled to more than offset this drop.

Government Surplus Continues to Rise

The combined surplus of the federal, provincial and municipal governments more than doubled in 2004 (on a national accounts basis) to $17 billion. The federal level accounted for the bulk of this amount, as growth in revenues outpaced spending. Direct taxes from all levels increased 8.3% with strong growth (+16.6%) in the portion coming from corporations and government business enterprises, parallel to the rising profits.

Summary

The Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks. Given the recent developments, the economy has expanded by around 3 per cent in 2004 and 3½ per cent in 2005. The key challenges before the country are as follows:

- Maintaining steady improvements in living standards, particularly healthcare of the senior citizens.
- Ensuring that public finances across all levels of government remain sustainable in the long term.

Competitive forces are, in general, strong in Canada in large part because most barriers to international trade have been dismantled. Administrative and economic regulations inhibiting competition are amongst the lowest in the OECD. Vibrant competition stimulate faster productivity growth.

SECTION 2: BUSINESS ENVIRONMENT IN MEXICO

Brief Country Profile

Capital: Mexico City
Currency: Mexican Peso
Area *Total:* 1,972,550 sq km
Land: 1,923,040 sq km
Water: 49,510 sq km
Population: 103.7 million
Population growth rate: 1.18%
GDP Total ($ at PPP): *935 billion*
GDP per head ($ at PPP): 9,200
GDP (% real change pa): 1.3

*Map not to scale

Recorded unemployment: 3.25%
Inflation rate (consumer prices): 4 to 5% (Last 3 years)
Literacy: (*definition:* age 15 and over can read and write)
Total population: 92.2%
Male: 94%
Female: 90.5% (2003 est.)
Human Development Index: 0.790 (medium) (1999).

Overview

In the mid-1970s, Mexico went from being a net importer of oil and petroleum products to a significant exporter. Oil and petrochemicals became the economy's most dynamic growth sector. By mid-1981, Mexico was beset by falling oil prices, higher world interest rates, rising inflation, a chronically overvalued peso, and a deteriorating balance of payments that spurred massive capital flight. This disequilibrium, along with the shortage of Mexico's foreign exchange reserves—by the end of 1982, they were insufficient to cover three weeks' imports—forced the government to devalue the peso thrice during 1982. The collapse of the new peso in December 1994 and the ensuing economic crisis had caused the economy to contract by an estimated 7 per cent during 1995. Even till 2003, its real GDP growth rate had been very less. In the year 2000, its growth rate was as high as 6.58% but it became negative in 2001. It has slowly recovered since then and rose to 0.73% in 2002 and 1.3% in 2003 and at a higher rate after that. However, its amount of public debt as a percentage of GDP has increased from 20.74% in 2000 to 24.40% in 2004. Mexico and the EU have agreed to phase out tariffs on 85 per cent of the agricultural products by 2010.[2]

Mexico and Foreign Trade

Mexico has emerged as Latin American giant in foreign trade (US $ 195 billion imports and $ 189 billion exports in 2004). Mexico's most competitive sectors have been in non-oil related manufactured goods. Manufacturing accounts for about 22% of the GDP and manufactured goods accounted for more than 85% of the total exports. Exports represent 30% of the GDP and contribute to half of Mexico's economic growth. More evidence of Mexico's economic growth is the fact that it has become one of the world's largest apparel exporters, and ranks as the world's 11th largest agriculture producer, 9th mining producer, and 6th natural gas producer. This economic dynamism has created momentum for direct foreign investment growth due to the attractive value of the peso; privatisation, modernisation of industry and further reductions in import duties for Mexican products under NAFTA.

Mexico's international trade performance has been remarkable in the recent past. However, its imports were also continuously increasing in the first half of 21st century. Mexico has also become a leading destination for India's exports with US $7 billion in 2004 (EXIM Bank Brief, January 2005, Bombay).

Mexico—Statistics

Major exports of 2003	**% of total**	**Major import of 2003**	**% of total**
Manufactures	86.1	Intermediate goods	75.8
Oil	11.3	Consumer goods	12.6
Agricultural products	2.3	Capital goods	11.9
		Leading suppliers 2003	**% of total**
		US	68.0
		China	6.1
		Japan	4.9
		Germany	4.0

Agricultural Sector

Approximately, one quarter of Mexico's 100 million people live in rural areas, and depend primarily on agriculture. Incomes in farming tend to be low, only about a third of the national average, and agriculture contributes only 5% of the national GDP. The irrigation is also rainfall dependent.

The creation of the North American Free Trade Area in 1994 has further pushed agricultural policy towards export production. 78% of Mexico's agricultural exports, predominantly fruit, vegetables, live cattle and coffee, now go to the US. Under its agricultural policy, called the Alliance for the Countryside,

[2]Finance and Development, IMF, March 2000 and www.wikipedia.org/wiki/mexico

the government has targeted various technical developments, including water distribution and irrigation systems, genetic enhancement of livestock, tractor purchase and repair programmes, and hybrid seed exchange for maize growers.

Despite the reforms, agriculture still appears to be a sector in decline. The opening of the country to foreign imports has had a devastating effect on prices. The credit for small farmers has been cut back at the time when they needed funds to help in the restructuring process. Addressing the issues of the subsistence farming economy remains of the highest national priority for the government.

The United States exported a record $7.9 billion worth agricultural products to Mexico in 2003. Mexico is the United States' third largest agricultural market. Under NAFTA, Mexico has eliminated nearly all import tariffs and tariff-rate quotas on agricultural products from the United States. As of January 1, 2003, the only US agricultural exports subject to tariffs or tariff-rate quotas are corn, sugar, dry beans, chicken leg quarters, and non-fat dry milk.

Intellectual Property Rights (IPR) Protection

Under NAFTA and the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), Mexico has implemented certain standards for the protection of intellectual property and procedures to address infringement such as piracy. Although Mexican legislation on IPR matters is quite comprehensive, the enforcement of these IPR laws is limited in many sectors.

Industrial Sector

Industrial production in Mexico has recovered after three years of recession during 2001–03, which is closely linked with the US economy. In the domestic market, consumption remains strong as the investment rises. Much of this is explained by the expansion in US industrial production, which has a significant impact on the Mexican industrial sector and exports. Additionally, over the last few years there has been vigorous recovery in investment which, coupled with healthy growth rates, makes it clear that the internal engines of the economy are back on track.

Political Structure

The political system is presidential, bicameral (Senate and Chamber of Deputies) and federal (32 states). The president is elected every six years. The 500 members of the Chamber of Deputies are elected every three years, 300 from single-member districts and 200 by proportional representation. Three-quarters of the 128 Senate members are elected directly for a six-year term, with the remaining one-quarter elected by proportional representation.

Financial System

Banking System

Mexico has a developed banking system, consisting of a central bank and six types of banking institutions: public development banks, public credit institutions, private commercial banks, private investment banks, savings and loan associations, and mortgage banks. The central bank, the Bank of Mexico (Banco de México), regulates the money supply and foreign exchange markets, sets reserve requirements for

Mexican banks, and enforces credit controls. It serves as the fiscal agent of the federal government, the issuing bank for the new peso, and a discount house for private deposit banks. It supervises the private banking sector through the National Banking Commission and provides funds for government development programs. To ensure continued control of inflation, the central bank was made autonomous in April 1994. Mexico has a number of other official banks for agriculture, foreign trade, cooperatives, public works, housing, transportation, and the sugar industry, among other specialised purposes.

The private banking sector consists of more than 200 banks which together have more than 2,500 branches. The proliferation of banking institutions resulted from regulations that prohibited any single bank from combining more than two banking functions. Mexico's two largest private banks are the *Bank of Commerce* comprising thirty-five affiliated banks with more than 500 branches, and the *National Bank of Mexico*.

Stock Exchange Mexico's stock market had a US$70 billion capitalisation in September 1996, according to Morgan Stanley Capital International indices. In 2004 and 2005, the stock market maintained a strong recovery due to better expectations of the economic performance in Mexico and the United States. Its stock index had went up to as high as 11880 at the end of the year 2004 from 8500 in 2003.

Inflation In Mexico, another important achievement in recent years has been the reduction in inflation. On the external side, non-oil exports have continued to show a positive trend.
In addition, the flexible exchange rate regime has helped Mexico absorb external shocks in an orderly manner and has shown less volatility than expected.

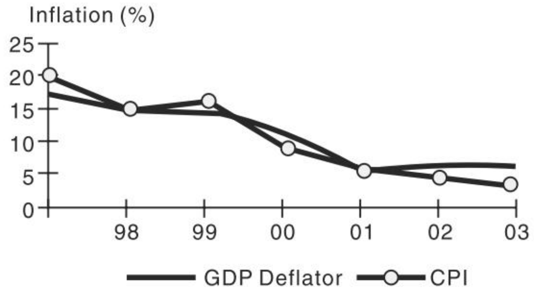

Fig. 27.2

External Sector

The total imports have recorded fall in 2004 and 2005, compared to the previous year. Mexican international reserves have reached historic maximum levels in recent months. The gross foreign exchange reserves and other assets amounted to 62.3 billions of US dollars in 2004.

Exchange Rate From December 1982 until November 1991, the Mexican peso had two rates of exchange against the United States dollar—the controlled or 'official rate' and the 'free rate.' In November 1991, the government eliminated all exchange controls, thereby unifying the various peso exchange rates.

When the new peso came under heavy speculative pressure in late 1995, Mexico's monetary authorities reacted by sharply raising the interest rates. However, the exchange rate of Mexico has shown continuous depreciation with respect to the US dollar. (5.3 in 1995 to 11.2 in 2004).

Foreign Direct Investment Foreign Direct Investment (FDI) presents a bright picture in the Mexican economy. In 2003, Mexico had received FDI $22.5 billion. FDI is concentrated in the manufacturing and financial sectors. The largest U.S. investment in the recent past was Citigroup's $12.2 billion acquisition of Banamex in Mexico.

Social Sectors

Poverty The bottom 40% of the population share only 11% of the wealth in Mexico. The Mexican standard of living is way below that of the US or Europe. The minimum wage is 40 pesos per day, about £2.80, or $4 US Dollars. There is little or no welfare state and no unemployment benefit. However, it is officially claimed that in Mexico, unemployment is only 2-3 per cent.

NAFTA and the Mexican Economy

Under the NAFTA, all non-tariff barriers to agricultural trade between the United States and Mexico were eliminated. In addition, many tariffs were eliminated immediately, with others being phased out over a period of 5 to 15 years. All agricultural provisions will be implemented by the year 2008. For import-sensitive industries, long transition periods and special safeguards will allow for an orderly adjustment to free trade with Mexico.

NAFTA and 1994 Peso Crisis

After NAFTA's first year, the Mexican economy had fallen into one of the worse crises it has ever experienced. The crisis erupted because Mexico's growing trade deficit was financed by foreign investment. Most of these investments were put in the stock market and the short-term bond market. When the bonds were not renewed, it led to bankruptcies and the devaluation.

Trade Liberalisation in Mexico

The trade liberalisation has brought about wide changes in Mexico's national industrial structure. Manufactured goods have increased as a percentage of total exports. Exports have also become less diversified. Since NAFTA began, manufactured exports have been concentrated in two manufacturing branches: 68% in machinery and equipment, basically the computer and automotive industries; and 8.6% in chemicals.

The changing structure of imports has also undermined Mexico's industrial development. A paradox situation can be observed with imports of capital goods used to produce exports increasing and those associated with the domestic market decreasing. In summary, a growing percentage of imports gets simply incorporated into export goods without any significant impact on the Mexican market.

Latest Economic Trends

In Mexico, total revenues of the government, particularly oil-related revenues, were lower than expected in the recent times. To compensate for the lower revenues, government spending was cut. Fiscal discipline has been the key to preserve stability. Public debt has been managed proactively.

Mexico has been experiencing a traditional business cycle. However, in the year 2005, there were some ambiguous economic signals. Mexico's Gross Domestic Product (GDP) maintained its positive performance . The Index of Aggregate Economic Activity (IAEA) increased. Foreign exchange market became highly volatile. Now, Mexico's country risk is low and stable. Inflation reached historic minimum levels during 2003 helping to bring down domestic interest rates. Mexico's international trade has remained stable during 2004 and 2005. Its foreign accounts are under control and its international reserves reached historic maximum levels. The main government strategies included maintaining monetary and fiscal discipline, speeding up the implementation of structural reforms, adopting measures to support the domestic market and diversifying exports markets.

Mexican Economy—Statistics

	2000	2001	2002	2003
GDP per head ($ at PPP)	8,939	9,005	9,080	9,200
GDP (% real change pa)	6.58	–0.12	0.73	1.30
Government consumption (% of GDP)	11.09	11.77	11.76	11.90
Budget balance (% of GDP)	–1.10	–0.69	–1.18	–0.70
Consumer prices (% change pa; av)	9.49	6.37	5.03	4.55
Public debt (% of GDP)	20.74	20.05	22.80	24.40
Labour costs per hour (USD)*	1.57	1.74	1.79	1.68
Recorded unemployment (%)	2.22	2.46	2.70	3.25
Current-account balance/GDP	–3.13	–2.90	–2.20	–1.50
Foreign-exchange reserves (mUS$)	35,509	44,741	50,594	58,956

Source: Compiled from www.en.wikipedia.org/wiki/mexico

The unemployment rate displayed a downward trend in 2004 and 2005. Wages also showed some stability. Another key factor for sustainable growth is macroeconomic stability, which has been in place in recent years and is mainly the result of responsible economic policy, both monetary and fiscal.

Chapter Summary

Several factors will affect the Mexican economy in future. On the external front, the pace of growth of the US economy will be of primary importance. Although it is likely that the US economy will keep growing, the growing trade and budget deficits represent a serious threat. On the domestic front, it is expected that economic policy will continue to be used responsibly, thus assuring macroeconomic stability and allowing growth to continue, despite the pressures expected from the political side.

Both the exchange rate and interest rates in Mexico might increase in response to higher interest rates in the United States. Hence, it would require a tight monetary policy to achieve the goals established.

Review Questions

1. Critically examine the recent developments and their implications on Canada's economy.
2. How do you rate the performance of Mexican economy during 1990s and 2000s?
3. Discuss the latest economic trends in Canada and Mexico.

Class/Field Exercise

1. Visit the website of NAFTA, and collect information the implications of NAFTA on USA and Mexico.
2. Use websites such as http://globaledge.msu.edu to complete the following task: You are working for a company which is considering investing in a foreign country. CEO of your firm has requested you to prepare a report regarding the attractiveness of North American countries. A friend mentioned about a useful tool called the 'FDI Confidence Index'. Your professor also told you about Market Potenital Index. Find these indices and choose the Best and Second Best attractive countries in North American based on these index values/ranks.

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Test Papers

TEST PAPER 1

Time Allowed: 10 minutes **Maximum Marks: 20**

Name : ______________________________

Roll No. : ______________________________

____

1. A firm can be privatised through strategic sale, by auction method. True/False
2. Commercial bank's credit creation capacity will ____________, if central bank increases CRR.
   (a) increase (b) come down (c) be unaffected (d) none of these
3. The extent of poverty in a community, with different features of depreciation in the quality of life, can be measured using ____________.
   (a) HDI (b) Human Poverty Index
   (c) GDI (d) HFI (e) None of the above
4. ____________ is included as one of the variables while constructing HDI.
   (a) GDP (b) GNP (c) NNP
   (d) Per Capital Income (e) None of these
5. Which agency publishes Human Development Report?
   (a) World Bank (b) IMF (c) WTO (d) UNICEF
   (e) UNDP
6. QR removal does not mean
   (a) Duty free imports (b) Removal of import licensing restrictions
   (c) Placing the items on freely importable list (d) None of these
7. Due to increase in BoP deficit, ____________ is likely to increase
   (a) FOREX Reserves (b) Integral Debt of the Govt.
   (c) Fiscal Deficit (d) Budgetory Deficit
   (e) External Debt
8. Globalisation is based on the theory of
   (a) Import substitution (b) Limited Openness
   (c) Mixed economy (d) Capitalism
   (e) Free Trade and Comparative Advantage
9. HDI has a value between
   (a) 0 to 100 (b) 1 to 100 (c) 0.1 to 1 (d) 0 to 1
   (e) None of these
10. QR on imports of 1429 items, in bulk, were taken away in India in ____________ and ____________
    (a) 1999 and 2000 (b) 1998 and 1999 (c) 2001 and 2002
    (d) 2002 and 2003 (e) 2000 and 2001
11. Which country pioneered the privatisation movement in Latin America?
    (a) Peru (b) Brazil (c) Argentina (d) Uruguay
    (e) Chile
12. Customs duty can be considered as
    (a) License (b) Non-tariff Barrier (c) OGL duty (d) Tax on imports
    (e) None of these

13. An example for Direct Transfer payment
    (a) Land Reform (b) Income Tax (c) Free education (d) Subsidy
    (e) None of these
14. When did Taiwan and China join WTO?
    (a) Jan. 1995 (b) April 1997 (c) Nov. 1999 (d) April 2003
    (e) Nov. 2001

True/False

1. Countries with deficit in the Balance of Payment can maintain import restrictions, as per the WTO provision.
2. Full Capital Account convertibility means repatriation of all types of foreign investments at the will of investors.
3. Fiscal Deficit and Budgetary Deficit are same.
4. Increase in Fiscal Deficit automatically leads to deficit in 'Balance of Payment' of a country.
5. Manufacturing sector has more weightage in the construction of index of industrial production.
6. Peak customs duty rate was reduced to 12.5% from 15% in 2006, and to 15% from 20%, on non-agricultural goods in Budget–in India.

TEST PAPER 2

Time Allowed: 45 minutes **Maximum Marks: 30**

Name : ____

Roll No. : ____

____

Part I: True or False (Negative marks for wrong answers; 5 × 1 = 5 marks)

1. % of SLR (Monetary Policy tool) in India (at present), to be maintained by the commercial banks is 25%
2. Malhotra Committee was constituted in 1991, and also in 1998, to suggest measures for insurance sector reforms in India.
3. Peak customs duty rate was reduced to 12.5% from 15% in 2006 and to 15% from 20% on non-agricultural goods in Budget–in India.
4. Government of India has enacted a new law, Competition Act, for upholding competition in Indian market.
5. Das Capital is the basic reference book for learning more about socialism (written by Karl Marx in 1886) and communism.

Part II: Fill in the Blanks (6 × 1 = 6 marks)

1. The first ministerial conference of WTO was held at ______________ (in December 1996).
2. Tax on perks to employees, as introduced in Budget 2005, in India, is known as ______________.
3. TRIPS stands for ______________
4. The rate at which the Reserve Bank gives loans to banks, by discounting bills, etc., is known as ______________.
5. ______________ tax got introduced from 1st April, 2005 in most of the Indian States.
6. Five year plans in India were launched in the year ______________.

Part III: Multiple Choice (6 × 1 = 6 marks)

1. IPO by a PSU can be seen as a step towards
   (a) Liberalisation (b) Globalisation (c) Disinvestment
   (d) Competition (e) None of these
2. ______________ is responsible for Fiscal Policy in India.
   (a) Ministry of Commerce (b) Ministry of Finance
   (c) Ministry of Economic Affairs (d) Ministry of Labour
   (e) RBI (f) None of these
3. HDI rank of ______________ is higher than GDP per capita rank.
   (a) Saudi Arabia (b) Switzerland (c) South Africa (d) Oman
   (e) Norway (f) None of these

4. An example for Progressive Redistribution of Asset Ownership:
   (a) Direct Tax (b) Indirect Tax (c) Wealth Tax
   (d) Land Reform (e) None of these
5. Macro Economic structure of Union Budget can be classified into
   (a) current and capital accounts (b) running and capital accounts
   (c) revenue and expenditure accounts (d) revenue and fiscal accounts
   (e) revenue and capital accounts (f) none of these
6. The modes of privatisation, adopted by the government in India, include
   (a) strategic sale by auction method (b) BPO
   (c) ADR and GDR (d) IPO and Strategic Sale
   (e) All of the above

Part IV: True or False (Negative marks for wrong answers; $5 \times 1 = 5$ marks)

1. Fiscal deficit and budgetary deficit are same.
2. Import duty is also known as customs duty.
3. Increase in fiscal deficit automatically leads to deficit in 'balance of payment' of a country.
4. New Industrial Policy, 1991 has the following provision (Indian):
   Foreign equity proposals need not be accompanied by foreign technology agreement.
5. Percentage contribution of industrial sector to the increase in GDP (at factor cost) has been more than that of service sector in China (during 1990-96 and 1997-2002).

Part V: Distinguish between:

1. Fiscal Policy and Monetary Policy (*4 marks*)
2. Privatisation and Disinvestment (*2 marks*)
3. Economic Growth and Development (*2 marks*)

TEST PAPER 3

Time Allowed: 60 minutes **Maximum Marks: 35**

Name : ______________________________

Roll No. : ______________________________

____

Part I: Fill in the Blanks (15 × 0.75 = 11.25 marks)

1. % of SLR (Monetary Policy tool) in India (at present) to be maintained by the commercial banks is ____________.
2. ____________ Committee was constituted in 1991, and also in 1998, to suggest measures for banking sector reforms in India.
3. Peak ____________ duty rate was reduced to 12.5% from 15% in 2006, and to 15% from 20%, on non-agricultural goods, in Budget–in India.
4. Govt. of India has enacted new law ____________ for upholding competition in the Indian market.
5. ____________ industries got 51% stake in BALCO, when it was subjected to disinvestment.
6. ____________ is known as the basic reference book for learning more about socialism and communism (written by Karl Marx in 1886).
7. Industrial growth is measured on the basis of ____________.
8. According to US Department of Commerce, FDI occurs whenever a citizen or organisation takes a stake of ____________ % or more, in a foreign business entity.
9. ____________ agreement of WTO recognises 'movement of natural persons' as one of the models for globalisation.
10. The first ministerial conference of WTO was held at ____________ (in December, 1996).
11. Tax on perks to employees, as introduced in budget 2005 in India, is known as ____________.
12. TRIPS stands for ____________.
13. Rate at which Reserve Bank gives loans to banks, by rediscounting bills, etc., is known as ____________.
14. ____________ tax got introduced from 1st April, 2005 in most of the Indian States.
15. Five year plans in India were launched in the year ____________.

Part II: Multiple Choice

(*Wrong answer carries negative marks. Attempt the question, only if you are sure about the answer. 13 × 0.75 = 9.75 marks*)

16. IPO by a PSU can be seen as a step towards
    (a) Liberalisation (b) Globalisation (c) Disinvestment
    (d) Competition (e) None of these
17. The % of ____________ tax remained the same in Budget 2006, in India.
    (a) Service Tax (b) Income Tax
    (c) Excise duty (d) Securities Transaction Tax
    (e) Income Tax and Excise Duty (f) None of these

18. ______________ is responsible for Fiscal Policy in India.
    (a) Ministry of Commerce (b) Ministry of Finance
    (c) Ministry of Economic Affairs (d) Ministry of Labour
    (e) RBI (f) None of these
19. HDI has a value between
    (a) 0 to 100 (b) 1 to 100 (c) 0.1 to 1 (d) 0 to 1
    (e) None of these
20. HDI rank of ______________ is higher than GDP per capita rank.
    (a) Saudi Arabia (b) Switzerland (c) South Africa (d) Oman
    (e) Norway (f) None of these
21. Which country pioneered the privatisation movement in Latin America?
    (a) Peru (b) Brazil (c) Argentina (d) Uruguay
    (e) Chile (f) None of these
22. An example for Progressive Redistribution of Asset Ownership
    (a) Direct Tax (b) Indirect Tax (c) Wealth Tax (d) Land Reform
    (e) None of these
23. KSIDC mooted a proposal for ______________ of a number of troubled seafood processing units in Kerala.
    (a) merger (b) acquisition (c) amalgamation (d) closure
    (e) nationalisation (f) none of these
24. Why did Toyota decide to choose France in 1997, for investing $656.8 million in car plant?
    (a) To create monopoly in France
    (b) Cheap labour available in France
    (c) With the sole purpose of exporting from France, to other European countries, including England
    (d) Availability of credit at low interest rate
    (e) *'a'* and *'b'*
    (f) none of these
25. By 1997, more than ______________ development projects were underway in Venezuela, involving co-operation between PDVSA and foreign oil companies.
    (a) 80 (b) 10 (c) 40 (d) 100
    (e) 125
26. The privatisation of British Telecom was done through
    (a) strategic sale (b) sale of shares to public
    (c) issue of ADR (d) auction with networth criteria as eligibility
    (e) none of these
27. Macro Economic structure of Union Budget can be classified into
    (a) current and capital accounts (b) running and capital accounts
    (c) revenue and expenditure accounts (d) revenue and fiscal accounts
    (e) revenue and capital accounts (f) none of these
28. One of the following countries did not deregulate the interest rates in 1980s!
    (a) Indonesia (b) Philippines (c) Sri Lanka (d) India
    (e) none of these

Part III: True or False (Negative marks for wrong answers; $9 \times 1 = 9$ marks)

29. Fiscal deficit and budgetary deficit are same.
30. Import Duty is also known as customs duty.
31. Increase in fiscal deficit automatically leads to deficit in 'balance of payment' of a country.
32. Manufacturing sector has got more weightage in the construction of index of industrial production.
33. Greater tax collections from a state have been considered as a criterion for increasing entitlement to central government funds, to the state.
34. New Industrial Policy, 1991 has the following provision (Indian).
    Foreign equity proposals need not be accompanied by foreign technology agreement.
35. Mining of atomic minerals is an exclusively reserved item for the public sector in India.
36. Percentage contribution of industrial sector to the increase in GDP (at factor cost) has been more than that of service sector in China (during 1990–96 and 1997–2002).
37. Cochin International Airport was set up under the public-private partnership scheme, and it functions outside the domain of Airports Authority of India.

Part IV (5 marks)

38. Discuss the important aspects of the developments in Indian economy during 1991–2005.

TEST PAPER 4

Time Allowed: 90 minutes **Maximum Marks: 35**

Name : ______________________________

Roll No. : ______________________________

____

Questions 1 to 50 (*each questions carries 0.5 marks*)

Fill in the Blanks

1. SLR (Monetary Policy tool) stands for ____________.
2. ____________ number of companies are included in the construction of NSE-NIFTY.
3. ____________ Committee was constituted in 1991, and also in 1998, to suggest measures for banking sector reforms in India.
4. Peak ____________ duty rate has been reduced to 15% from 20% on non-agricultural goods in Budget – 2005 in India.
5. ____________ publishes the Human Development Report.
6. Govt. of India has enacted a new law, ____________, for upholding competition in the Indian market.
7. ____________ was the Disinvestment Minister in the previous cabinet of the Government of India (NDA).
8. ____________ industries got 51% stake in BALCO, when it was subjected to disinvestment.
9. ____________ is known as the basic reference book for learning more about socialism (written by Karl Marx in 1886).
10. Industrial growth is measured on the basis of ____________.
11. SGSY programme of Government of India was earlier known as ____________.
12. ____________ scheme is meant for the poorest among the BPL families, covered under the targeted public distribution system (launched in 2000).
13. FERA has been replaced by ____________.
14. ____________ agreement of WTO recognises ‘movement of natural persons’ as one of the models for globalisation.
15. The first ministerial conference of WTO was held at ____________ (in December, 1996).
16. Tax on perks to employees, as introduced in budget, 2005, is known as ____________.
17. TRIPS stands for ____________.
18. NPA (in banking) stands for ____________.
19. Name the chief economist of IMF (Indian)?
20. Name the SEBI chairman?
21. Rate at which Reserve Bank makes short-term loans to banks, etc., is known as ____________.
22. Increase in the general price level in an economy is known as ____________.
23. ____________ committee suggested privatisation of insurance sector in India.
24. ____________ tax is supposed to be introduced from 1st April, 2005 in Indian States.
25. Name the Common Central Bank for ‘EURO-12’.

Multiple Choice Questions

26. Which country did not deregulate interest rates in the 1980s?
    (a) Philippines (b) Sri Lanka (c) India (d) None of these
27. Palm Oil is a surplus item in
    (a) South East Asian countries (b) South India
    (c) North India (d) None of these
28. Issue of shares at a stock exchange, by a PSU, can be seen as a step towards
    (a) Liberalisation (b) Globalisation (c) Privatisation
    (d) Competition (e) None of these
29. Removal of QRs means
    (a) Import without License (b) Duty Free imports
    (c) Removal of tariff barriers (d) Putting items under SIL
    (e) None of these
30. Name the credit card scheme for SSI
    (a) SIDBI Card (b) SISI Card
    (c) Smart Card (d) Grameen Card
    (e) Laghu Udyami Card (f) None of these
31. Which country has more share in India's FDI inflow
    (a) USA (b) UK (c) China (d) Australia
    (e) Mauritius
32. World Bank has ranked the countries, based on
    (a) HPI (b) HDI (c) GNP (d) GDP
    (e) Per capita income
33. The % of ______________ tax remained the same in Budget, 2005.
    (a) Service Tax (b) Income Tax
    (c) Excise duty (d) Securities Transaction Tax
    (e) Corporate Tax for domestic companies
34. Foreign Exchange Reserves include
    (a) gold with Central Bank (b) NRI deposits in banks
    (c) silver (d) foreign DDs issued by banks
    (e) None of these
35. Most of the exports from India were invoiced in ______________ during 1990s.
    (a) Pound Sterling (b) German Mark
    (c) Yen (d) US Dollar
    (e) None of these
36. ______________ is responsible for Fiscal Policy in India.
    (a) Ministry of Commerce (b) Ministry of Finance
    (c) Ministry of Economic Affairs (d) Ministry of Labour
    (e) RBI
37. ______________ is responsible for Monetary Policy in US.
    (a) Federal Reserve Bank (b) Ministry of Finance
    (c) Ministry of Economics (d) Ministry of Monetary Affairs
    (e) None of these

38. Which organisation publishes International Financial Statistics and World Investment Report?
    (a) IMF and UNCTAD respectively (b) IMF
    (c) World Bank (d) UNCTAD
    (e) None of these
39. One of the following countries could not meet the eligibility criterion to join Euro as a founder member
    (a) Germany (b) France (c) Italy (d) Spain
    (e) Greece (f) None of these
40. Global economic integration does not occur through
    (a) Foreign Trade (b) Migration (c) Capital Flows (d) Taxation
    (e) None of these
41. In the term 'BRIC' countries, 'I' stands for
    (a) Indonesia (b) Ireland (c) Iran (d) Iraq
    (e) India (f) None of these
42. Agreement on Technical Barriers to Trade, in the WTO system, is known as
    (a) ATBT (b) AOTBT (c) TBTT (d) TBT
    (e) None of these

TRUE or FALSE (Negative marking applicable)

43. Full Capital Account convertibility means repatriation of foreign investments at the will of investors.
44. As part of banking reforms, the minimum Capital Adequacy Ratio was raised to 9% in 2000.
45. At present Indian banks are permitted to offer loans at rates below Prime Lending Rates, to creditworthy borrowers.
46. Fiscal deficit and budgetary deficit are same.
47. Import duty is also known as customs duty.
48. Increase in fiscal deficit leads to deficit in 'balance of payment' of a country.
49. European Union has been enlarged from 15 to 25, with the accession of 10 countries.
50. Manufacturing sector has got more weightage in the construction of index of industrial production.

Descriptive

1. Discuss the developments in Indian economy during the period 1991–2004. **(5 marks)**
2. Discuss the economic environment in the US, Europe, Africa and the Asian countries. **(5 marks)**

Answers to Test Papers

Test Paper 1

1. True	2. (b)	3. (b)	4. (d)	5. (e)	6. (a)
7. (e)	8. (e)	9. (d)	10. (e)	11. (e)	12. (d)
13. (d)	14. (e)				

True/False

1. True	2. True	3. False	4. False	5. True	6. True

Test Paper 2

Part 1

1. True	2. True	3. True	4. True	5. True

Part 2

1. Singapore	2. Fringe Benefit Tax
3. Trade Related Intellectual Property Rights	4. Bank Rate
5. Value Added Tax	6. 1951

Part 3

1. (c)	2. (b)	3. (e)	4. (d)	5. (e)	6. (d)

Part 4

1. True	2. True	3. False	4. True	5. True

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