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GENERAL STUDIES

(Pre-cum-Main)

ECONOMY

SET-11

(Part - 1)

India's Economic Interactions *with* the World

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GS - ECONOMY

India's Economic Interaction with the World

1. BALANCE OF PAYMENTS(BOP)

It is the systematic record of all the economic transactions between a country and rest of the world over a period of time .It contains visible and invisible items, which means the trades of goods and services.

BoP comprises current account, capital account, errors and omissions, and change in foreign exchange reserves.

1.1 The Balance of Payments Divided

The BOP is divided into three main categories: the current account, the capital account and the financial account. Within these three categories are sub-divisions, each of which accounts for a different type of international monetary transaction

1.2 Current Account

Under current account of the BoP, transactions are classified into merchandise (exports and imports) and invisibles. Invisible transactions are further classified into three categories. The first component is Services comprising travel, transportation, insurance, government not included elsewhere (GNIE), and miscellaneous. Miscellaneous services include communication, construction, financial, software, news agency, royalties, management, and business services. The second component of invisibles is income. Transfers, payments or unilateral transfer (grants, gifts, remittances, etc.) which do not have any quid pro quo (exchange of mutual benefits) form the third category of invisibles.

The current account is used to mark the inflow and outflow of goods and services into a country. Earnings on investments, both public and private, are also put into the current account.

Within the current account are credits and debits on the trade of merchandise, which includes goods such as raw materials and manufactured goods that are bought, sold or given away (possibly in the form of aid). Services refer to receipts from tourism, transportation (like the levy that must be paid in Egypt when a ship passes through the Suez Canal), engineering, business service fees (from lawyers or management consulting, for example), and royalties from patents and copyrights. When combined, goods and services together make up a country's balance of trade (BOT). The BOT is typically the biggest bulk of a country's balance of payments as it makes up total imports and exports. If a country has a balance of trade deficit, it imports more than it exports, and if it has a balance of trade surplus, it exports more than it imports.

Receipts from income-generating assets such as stocks (in the form of dividends) are also recorded in the current account. The last component of the current account is unilateral transfers. These are credits that are mostly worker's remittances, which are salaries sent back into the home country of a national working abroad, as well as foreign aid that is directly received.

1.3 Capital Account

Under capital account, capital inflows can be classified by instrument (debt or equity) and maturity (short- or long-term). The main components of capital account include foreign investment, loans, and banking capital. Foreign investment comprising foreign direct investment (FDI) and portfolio investment consisting of foreign institutional investor (FIIs) investment and American depository receipts /global depository receipts (ADRs/GDRs) represents non-debt liabilities. Loans (external assistance, external commercial borrowings [ECB], and trade credit) and banking capital including nonresident Indian (NRI) deposits are debt liabilities.

The capital account is where all international capital transfers are recorded. This refers to the acquisition or disposal of non-financial assets (for example, a physical asset such as land) and non-produced assets, which are needed for production but have not been produced, like a mine used for the extraction of diamonds.

The capital account is broken down into the monetary flows branching from debt forgiveness, the transfer of goods, and financial assets by migrants leaving or entering a country, the transfer of ownership on fixed assets (assets such as equipment used in the production process to generate income), the transfer of funds received to the sale or acquisition of fixed assets, gift and inheritance taxes, death levies, and, finally, uninsured damage to fixed assets.

2. THE 1991 CRISIS: BACKGROUND

In 1991, India experienced a classic external payments crisis: high fiscal and current account deficits, external borrowing to finance the deficits, rising debt service obligations, rising inflation, and inadequate exchange rate adjustment.

In 1979, the oil shock, agricultural subsidies, and a consumption-driven growth strategy had pushed up the fiscal deficit. It further increased in the mid-1980s as defense expenditure was substantially increased and direct taxes were progressively reduced.1 The result was that the deficit ballooned from 1985 to reach 9.4 percent by 1990–1991.

India's current account position also worsened. Increasing dependence on foreign oil imports, vulnerability to oil price fluctuations, declining remittances from abroad, strong domestic demand (a result of public sector wage increases in the mid-1980s), and rising debt service payments ensured that the current account deficit averaged 2.2 percent of gross domestic product (GDP) during 1985–1990.

Also, export competitiveness was adversely affected by the rupee's steady appreciation: 20 percent between 1979 and 1986.3 In 1987 it steadily depreciated, but the real exchange rate remained overvalued until 1991.

To finance the twin deficits, India relied on external funds. Foreign investment at 0.1 percent of GDP during 1985–1990 was negligible. During 1980–1985, nearly half of external financing needs were met by external assistance. By the mid-1980s, "aid weariness" forced the government to rely more on commercial borrowing. Soft loans declined in proportion from 89 percent (1980) to 35 percent (1990). Thus, external debt (with a large proportion of short-term debt) started dominating the balance sheet, peaking at 38.7 percent of GDP in 1991–1992, with the debt-export ratio at 563 percent.

Notwithstanding the weakening fundamentals, one key factor that reduced vulnerability was the absence of private sector external debt. Unlike many other countries, individuals and firms could not raise foreign currency– denominated debt, and the banking sector was not allowed to hold financial assets abroad. One effect of this was that the private sector's interests were geared more toward internal deregulation than toward external liberalization.

Two immediate external shocks contributed to the large current account deficit of 3.1 percent in 1990–1991. First, the Gulf crisis in August 1990 exposed the Middle East's strategic relevance for India. Petroleum import costs in 1990–1991 increased by half to US$5.7 billion.

The government had to bear the additional burden of airlifting and rehabilitating 112,000 Indian workers from the Middle East as remittances from the region declined. The second shock was global recession: world growth had declined from 4.5 percent in 1988 to 2.25 percent in 1991.12 Export growth in the United States—India's largest market—turned negative in 1991.

Conditions in the Soviet Union, another major export destination, had also worsened. In 1990–1991 India's exports grew only 4 percent. India was also suffering from internal political instability. The fragile National Front coalition faced a nationwide crisis in the summer of 1990 over its affirmative action policies.

By autumn, a campaign by the BJP to build a Hindu temple at the site of a sixteenth-century mosque in Ayodhya resulted in widespread communal violence. The government collapsed when the

BJP pulled out. A new minority government failed to pass the scheduled budget in February 1991 when it lost the Congress Party's external support. In May 1991, while campaigning for the general elections, former prime minister Rajiv Gandhi was assassinated.

In reaction, and in parallel to these developments, the economic situation worsened. By September 1990, net inflows of Non-Resident Indian deposits had turned negative. Access to commercial borrowing had become more costly, and by December even short-term credit was restricted. Foreign exchange reserves fell to $1.2 billion in January 1991. By the time a new government took over in June, reserves could cover only two weeks of imports. India was close to defaulting on its sovereign debt for the first time in its history.

2.1 1991 India Economic Crisis: Causes and Consequences

- Crisis was caused by current account deficits and currency overvaluation.
- The economic crisis was primarily due to the large and growing fiscal imbalances over the 1980s. During mid eighties, India started having balance of payments problems. Precipitated by the Gulf War, India's oil import bill swelled, exports slumped, credit dried up and investors took their money out.
- Large fiscal deficits, over time, had a spill over effect on the trade deficit culminating in an external payments crisis. By the end of 1990, India was in serious economic trouble.
- The gross fiscal deficit of t he government (center and states) rose from9.0 percent of GDP in 1980-81 to 10.4 percent in 1985-86 and to 12.7percent in 1990-91 For the center alone, t he gross fiscal deficit rose from 6.1 percent of GDP in 1980-81 to 8.3 percent in 1985-86 and to 8.4 percent in 1990-91.
- Since these deficits had to be met by borrowings, the internal debt of the government accumulated rapidly, rising from 35 percent of GDP at the end of 1980-81 to 53 percent of GDP at the end of 1990-91.The foreign exchange reserves had dried up to the point that India could barely finance three weeks worth of imports.
- Devaluation of Indian Rupee started in 1960s due to the wars with China(1962) and Pakistan(1965). Due to large government budget deficits, drought there was a sharp rise in prices due to inflation.
- The Indian Government was forced to start liberal policies in order to stabilize the economy, which in turn resulted into the huge devaluation of Indian Rupee. Once again, the government decided to devaluate the rupee. Due to the currency devaluation the Indian Rupee fell from 17.50per dollar in 1991 to 26 per dollar in 1992

2.2 1991 Crisis: Summary

Influence of factors t hat precipitated Indian economic crisis:Import prices went up: Iraq's invasion of Kuwait and consequent run-up in t he world oil prices made petroleum imports expensive and exports declined.

Simultaneously, conditions in Soviet union, India's largest export market deteriorated due to middle east crisis and shaky growth in other trading partners also led to a slow export volume growth.

Foreign remittances from migrant Indian workers in t he middle east declined due to Iraq's invasion of Kuwait.

Credit dried up as foreign lenders refused to roll over their short term maturing debt and started pulling money out and Non Resident Indian (NRI) community also started to withdraw its savings in Rupees. Government was forced to devalue Rupee. Reserve Bank of India had to pledge India's gold reserve to secure an emergency loan from the IMF which caused national outrage resulting in the caretaker governments ouster and Congress won the fresh elections. PV Narsimha Rao took over as the Prime Minister in June 1991 and installed Dr. Manmohan Singh as the Finance Minister who used the crisis as an opportunity to start liberating the Indian economy from government regulations.

Root cause of the crisis:

Gross (state and center combined) fiscal deficit (Expenditure more than Revenue) reached 12.7% in 1990-91. The Government borrowed from RBI to cover up the shortfall (deficit) not covered by t he revenue. Money supply expanded as a result which led to high inflation. Government debt increased to53% of GDP at the end of 1990-91 and the interest payments increased to 20%of the total central government expenditure in 1990-91

2.3 Current CAD/BOP Scenario

- The highlights of BoP developments during 2010-11 were higher exports, imports, invisibles, trade, CAD and capital flows in absolute terms as compared to fiscal 2009-10.
- Both exports and imports showed substantial growth of 37.3 per cent and 26.8 per cent respectively in 2010-11 over the previous year.
- The trade deficit increased by 10.5 per cent in 2010-11 over 2009-10. However, as a proportion of gross domestic product (GDP), it improved to 7.8 per cent in 2010-11 (8.7 per cent in 2009-10).
- The CAD widened to US$ 45.9 billion in 2010-11 from US$ 38.2 billion in 2009-10, but improved marginally as a ratio of GDP to 2.7 per cent in 2010-11 vis-a-vis 2.8 per cent in 2009-10.
- Net capital flows at US$ 62.0 billion in 2010-11 were higher by 20.1 per cent as against US$ 51.6 billion in 2009-10, mainly due to higher inflows under ECBs, external assistance, short-term trade credit, NRI deposits, and bank capital.
- In 2010-11, the CAD of US$ 45.9 billion was financed by the capital account surplus of US$ 62.0 billion and it resulted in accretion to foreign exchange reserves to the tune of US$ 13.1 billion (US$ 13.4 billion in 2009-10).

3. REFORMS SINCE 1991

In order to reduce the ongoing crisis and to avoid repeating it in the future ,a comprehensive reforms process was started.

A new approach to economic development policy was initiated by the new government in July 1991. It recognised that only correcting the underlying macroeconomic imbalance and replacing the oppressive system of controls by the discipline of market competition could overcome the BOP crisis.

The new finance minister and his chosen team of advisors were aware that in many countries the classical macro solution for a BOP crisis had led to a slowing of private investment and growth in the two years (and often for longer periods) following the macro adjustment. They were also aware of the remarkable growth rates and poverty reduction achieved by the more open economies of East & South Asia during the previous two decades.

Extensive decontrol and de-licensing was recognised as necessary to release the productive potential of Indian entrepreneurs, reduce the period of private investment & growth slow down and raise the underlying growth rate of the Indian economy.

It was also clearly recognised that the best way to put the Balance of Payments on a long-term sustainable path was through comprehensive liberalisation of international trade, finance/capital inflows and the exchange regime.

Phasing and timing of liberalisation was however determined not only by the exigencies of the economic situation but also the problem of calming genuine fears, convincing ideological diehards and overcoming vested interests, both within and outside the government.

The comprehensive import control regime was gradually dismantled, starting with capital and intermediate goods and moving after a period of slowdown to consumer goods. The slowdown was due to the differing nature of these two sets of goods. In the former the gainers and losers are more evenly balanced while in the latter potential beneficiaries being fragmented and un-organised beneficiaries are no match for concentrated number of easily organised opponents.

Tariff rates were brought down over a decade from a peak rate of about 300% to a peak rate of 35%.

The problem of over dependence on debt and the high proportion of short term debt was addressed by liberalising FDI and foreign equity (FII) inflows while keeping a very tight lid on short term debt obligations and maintaining the control regime for external commercial borrowing. A comprehensive reform of the exchange control regime was undertaken based on thorough intellectual & administrative preparation.

The illegal foreign exchange markets and its link with smuggling and invisibles transactions was addressed by a comprehensive liberalisation of gold imports

3.1 Immediate Reform Measures

(i) Macro-Adjustment

The macro-economic response to BOP crisis as it existed at the start of 1991- 2 was expenditure compression through a sharp fiscal correction and expenditure switching through devaluation.

The fiscal deficit of the Centre was reduced from 7.8% of GDP in 1990-1 to 5.6% of GDP in 1991-2. The nominal exchange rate (NEER) was depreciated by 18% in 1991 resulting in a real effective depreciation of 12.4%. In terms of our estimated equation, the fiscal squeeze and the real depreciation reduced the current account deficit by 1.03% of GDP and 0.97% of GDP respectively.

The total effect of these two measures was therefore to reduce the CAD by 2.0% of GDP out of the total actual decline of 2.8% of GDP

(ii) Trade Reform

Though trade reform had begun in the 1980s, the import control regime was still incredibly complex in 1990-91. This was particularly true of the duty-free input import regime for exporters (based on the efficiency principle of either not taxing or refunding input taxes).

A significant effort was made to clean up this complex regime in July-August 1991 by introducing the "Exim Scrip" a freely tradable import licence (30% of export value as import entitlement from Limited permissible list) the premium on which effectively constituted a dual exchange rate.

The existing Cash Compensatory System, which varied by product category & perceived domestic value addition was abolished. QRs were eased on 96 items by moving them from Restricted to Limited permissible category.

Procedural improvements were also made in the capital goods import regime for exporters. Export controls were also lifted on 116 items. both NRIs.The trade policy of April 1 1992 freed imports of almost all Intermediate & capital goods. Only 71 items remained restricted/licensed (3 banned, 7 canalised).

These consisted mainly of dual use goods like office equipment and consumer goods. Special Import Licence (SIL) was given to star exporters for importing restricted items. The trade policy of April 1 1993 removed 146 items from the negative (restricted) list of exports. Kerosene, LPG, LSHS, waxes, fertiliser (Phosphoric potash) were de-canalised. In the April 1994 policy, the scope of Special Import

Customs Tariffs

The overall objectives of customs tariff reform were clear from the beginning: To reduce overall protection by reducing the average rate of tariffs and reduce the arbitrary distribution of protection among industries by reducing the dispersion of tariffs.

An incredible array of general, specific and end-use exemptions had also been built up over the decades in response to the demands of vested interests, backed by little or no economic analysis of the costs or benefits

The Chelliah committee on tax reform, which outlined a broad structure of peak tariff rates for different categories of goods, proved important in overcoming bureaucratic inertia. Its report helped reformers to keep the focus on peak tariff reductions despite pressures on customs revenue.

The peak customs tariff rate was at around 300% in 1990-91.The first step was therefore to cut the peak rate to half (150%) in the 1991-92 budget and follow it up by another cut in the peak rate to 110% in the 1992-93 budget.

Because of the potential role of capital goods imports in investment and modernisation the reduction of the import duty on capital goods was accelerated by reducing the general rate to 55% in 1992-3.

Some categories of capital goods were set even lower (50% for electronic industry). The momentum of peak-rate reductions (to 85% in 1993-4, 65% in 1994-5, and 50% in 1995-6) was maintained, often by taking recourse to the recommendations of the Cheliah committee.

(iii) Exports

The import control system for exports was primarily directed to providing duty free access to imported inputs (intermediate goods) and reduced duty access to capital goods used in export production. Profits from exports were completely exempt from income tax.

100% Export Oriented Units (EOU) and Export Promotion Zones (EPZ) had the additional incentive of 5/8 year tax holiday for profits arising from the 25% Domestic Tariff Area (DTA) sales that were allowed. This incentive system was pretty much in place by the end of the eighties.

The chief objective during the reforms was to simplify the system while making it as comprehensive as possible. In the April 1993 trade policy the EOU-EPZ system was expanded to agriculture & allied exports with 50% DTA sale allowed. Under the Export Promotion Capital Goods (EPCG) scheme for exporters (i.e. obligation to export) the concessional duty on capital goods was reduced to 25% (3 times import) & 15% (4 times import).

In April 1994 an Electronic Hardware Technology Park scheme was introduced on par with the EPZ. The concept of Free Trade Zone was finally accepted in 1999-2000.

(iv) Debt

The cautious policy towards debt flows was outlined in 1992-93. This included tight control on short-term borrowing and a cap on total External Commercial Borrowing (ECB). At this point, ECB was to have a minimum maturity of 5 years, and could only be used for purchasing capital goods abroad. Priority within the cap was given to Infrastructure, exports, small & medium Enterprises. This policy was gradually liberalised.

Another element of this policy was to eliminate external commercial borrowing by the government, increase scrutiny of borrowing by public sector companies and to increase the share of private sector in ECB. As a consequence government's share in external debt fell by about 20% points between March 1989 and March 2001, while external private debt had risen to 14.8% of total debt by March 1999.

New institutional structures were created to ensure that control and monitoring of External Commercial Borrowing was economically rational and consistent with the liberalised approach. A High Level Committee on debt management and a Task force on external debt statistics to provide regular reports were set up.

A unit was also set up for aggregate debt monitoring & management support. The first status report on External Debt was produced in October 1993. This unit evolved into the External Debt Management Unit (EDMU), which helped improve debt monitoring & management.

The External Commercial Borrowing policy was gradually liberalised, though the Asian crisis revived diffuse fears about liberalisation. It was clear to those who studied the Asian crises that the problem was one of short-term debt, which remained under strict control. In fact it was argued that the missed lesson of the Asian crisis was that medium-long term debt above 1 year (and certainly above 3 years) was not a problem and could freed completely. Greater attention would have to be paid to monitoring and modelling the residual maturity of this MLT debt.

3.2 Impact of Nineties' Reform

External sector reforms have been the most successful of all the reforms that were undertaken in the nineties. They have confounded all the fears of Indian critics and the sceptics that imports would go through the roof and current account deficits would balloon. They confirmed the faith of the reformers that a well-regulated market based foreign trade and payments system would be more efficient and equally stable. Both the trade and invisibles account are now much more resilient than they were in the eighties. Capital inflows are now much more diversified and therefore much less risky for the country. Both FDI and portfolio flows increased rapidly through the mid-nineties.

The strength of the external account rests substantially on the flexibility of the "managed float" in responding to changes in demand-supply conditions in the exchange market. Difficulties and temporary weakness have emerged and will arise in the future if and only if considerations other than market supply-demand determine the management of the floating exchange rate.

One result of the success of the capital flow liberalisation was the unprecedented surge in equity capital inflows between October 1993 and November 1994. Based on analysis and internal discussions we developed a macromanagement strategy for this "Dutch Disease" problem that was quite different from the standard one proposed by the IMF.Though other countries in other time periods have undoubtedly used variants of the same policy our experience in this regard may also have useful lessons for others.

3.3 Long Term Reform Measures

3.3.1 Devaluation

Devaluation means officially lowering the value of currency in terms of foreign currencies. There could be many motives of the devaluation. It stimulates exports of commodities. It restricts import demand for goods and services. It helps in creating a favourable balance of payments. Almost all the countries of the world have devalued their currencies at one time or the other with a view to achieving certain economic objectives.

In other words, it is a deliberate downward adjustment to a country's official exchange rate relative to other currencies. In a fixed exchange rate regime, only a decision by a country's government (i.e central bank) can alter the official value of the currency. A currency is considered devalued when it loses value relative to other currencies in the foreign exchange market. A currency's devaluation is the result of a nation's monetary policy.

Effects of Devaluation

a) A significant danger is that by increasing the price of imports and stimulating greater demand for domestic products, devaluation can aggravate inflation. If this happens, the government may have to raise interest rates to control inflation, but at the cost of slower economic growth.

b) Another risk of devaluation is psychological. To the extent that devaluation is viewed as a sign of economic weakness, the creditworthiness of the nation may be jeopardized. Thus, devaluation may dampen investor confidence in the country's economy and hurt the country's ability to secure foreign investment.

c) Another possible consequence is a round of successive devaluations. For instance, trading partners may become concerned that a devaluation might negatively affect their own export industries. Neighboring countries might devalue their own currencies to offset the effects of their trading partner's devaluation. Such "beggar thy neighbor" policies tend to exacerbate economic difficulties by creating instability in broader financial markets.

Pre Conditions to make devaluation successful:

1. Other countries should not retaliate
2. The price rise in domestic prices should be less than rate of devaluation
3. There should be no control on the exportable surplus .
4. According to Marshall Lerner Conditions devaluation could be more beneficial if demands of goods in highly elastic.

3.4 Valuation History of Indian Rupee

In early controlled exchange rate regime, the rupee exchange rate hovered around Rs 4.00 in the 1950s, Rs 5.00 in the 60s, Rs 7.00 in the 70s, and Rs 8.00 in the 80s. In the liberalised era of 90s, the rupee moved to Rs 20s and Rs 40 in the next decade of 2000.

During this period, the Government has declared two major devaluations. The rupee was devalued first in 1966 by 57% from Rs 4.76 to Rs 7.50 against the US dollar. In the 90s, the rupee was again devalued by 19.5% from Rs 20.5 to Rs 24.5 against the US dollar.

Indian Rupee has been devaluated 3 times

(1) 1949

(2) 1966

(3) 1991

3.4.1 1991 - Devaluation

In 1991, India still had a fixed exchange rate system, where the rupee was hooked to basket of currencies of major trading partner countries. At the end of 1990, the Government of India found itself in serious economic trouble. The government was close to financial default and its foreign exchange reserves had dried up to the point that India could barely finance three weeks of Imports. In July of 1991 the Indian government devalued the rupee by 19.5%. The government also changed its trade policy from its highly restrictive form to a system which allowed exporters to import 30% of the value of their exports.

3.4.2 Current Scenario

According to the Government, the reason for the current round of rupee depreciation is related more to current grim global economic environment. The currency of every other emerging economy (barring China that managed its currency peg against the US dollar) is falling. The currencies of Russia, Brazil, South Korea, and Indonesia have plunged by between 6% to 16%. So the 10% fall in the value of rupee against the US dollar is hardly out of context. The sovereign debt woes of European Union are shifting foreign investors from euro assets to dollar assets. There seems to be no other alternative to US dollar.

At the end of G-20 summit in Seoul recently, world leaders declared (in the backdrop of the US demanding that Chinese currency Yuan should be appreciated to check the Asian giant from taking advantage in international trade) "We will move towards more market determined exchange rate system and enhance exchange rate flexibility to reflect underlying economic fundamentals and refrain from competitive devaluation of currencies.

Advanced economies including those with reserve currencies will be vigilant against excess volatility and disorderly movement in exchange rates". Attending a meet in Seoul PM, Dr. Manmohan Singh agreed to refrain from "competitive devaluation" and bring in exchange rate flexibility to ensure that no country gets undue advantage.

4 CONVERTIBILITY

It refers to the exchange rate mechanism which is of two types

(1) Fixed or Controlled exchange rate system

(2) Free or Floating exchange rate system

Rupee convertibility means the system where any amount of rupee can converted into any other currency without any question asked about the purpose for which the foreign exchange is to be used. Though impressionistic reports suggest that the rupee is already convertible in the unofficial markets, this is an fact not the case Free convertibility refers to officially sanctioned market mechanism for currency conversion.

Convertibility is a two-step process- current account and capital account. Current account convertibility refers to freedom in respect of Payments and transfers for current international transactions. In other words, if Indians are allowed to buy only foreign goods and services but restrictions remain on the purchase of assets abroad, it is only current account convertibility. As of now, convertibility of the rupee into foreign currencies is almost wholly free for current account i.e. in case of transactions such as trade, travel and tourism, education abroad etc.

The government introduced a system of Partial Rupee Convertibility (PCR) (Current Account Convertibility) on February 29,1992 as part of the Fiscal Budget for 1992-93. PCR is designed to provide a powerful boost to export as well as to achieve as efficient import substitution.

It is designed to reduce the scope for bureaucratic controls, which contribute to delays and inefficiency. Government liberalized the flow of foreign exchange to include items like amount of foreign currency that can be procured for purpose like travel abroad, studying abroad, engaging the service of foreign consultants etc. What it means that people are allowed to have assess to foreign currency for buying a whole range of consumables products and services.

The objective of the entire trade policy reforms go far beyond mere balancing of imports and exports or a favorable balance of trade (BOT). There is growing inter-dependence among technology, Investment and production. Trade Policy, therefore, becomes the spearhead for better technology, greater investment and more efficient production.

To prepare roadmap towards Full Capital Account Convertibility (FCAC), Tarapore Committee was setup at the behest of Prime Minister Dr. Manmohan Singh. In Mumbai, on March 18, 2006, while addressing the audience at the Reserve Bank of India (RBI), he said Given the changes that have taken place over the past two decades, there is a merit in moving towards fuller capital account convertibility within a transparent frame work, I will, therefore, request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities.

Till 1992 India followed controlled exchange rate system .But in the wake of liberalization it becomes necessary to make it flexible.Hence LERMS was started.

5. LERMS

The Exchange market reform was an example of the most surprising (to the public & outside observers) yet most thoroughly prepared and carefully executed reform. A number of development policy research papers done at the Planning Commission between 1989 and 1991 had suggested the possibility of introducing a "dual exchange rate" system to ease the transition from a heavily controlled trade regime to a free market system encompassing both trade and payments.

The LERMS system was announced in the budget and spelled out by RBI the next day. Exporters & remittances would surrender 40% of exchange at the official rate (which was left unchanged at 25.89), while the rest would be converted at the free market rate. This effectively meant that export proceeds were taxed at 0.4 times the difference between the market and official exchange rate. 100% Export oriented units and Export Processing Zones could sell the entire amount at the market rate and were thus not taxed in this way. All capital act transactions (except IMF, multilateral flow against rupee expenditure) would also be at the market rate.

The announcement of this system in the budget for 1993-94 (18 months after the crisis) took the entire country as well as foreign observers and well-wishers completely by surprise. The extent of excitement among common people, those who may never have the opportunity to undertake foreign exchange transactions took even those involved in its preparation by surprise. Even the common person welcomed the freedom that it implied and the confidence that it denoted on the part of the government. Many intellectuals and economists predicted that there would be huge capital outflows and the rupee would sink to Rs. 40 per USD on the market channel.

By the end of 1992 it was clear that the scheme was even more successful than was hoped for by its initiator the ministry of finance. It had beenthought earlier that a second year of transition could perhaps be necessary, in which the surrender ratio would be reduced along with a reduction of the number of items on the official exchange channel.

The performance of the exchange market, however, gave decision makers the confidence to move directly to an integrated, market based exchange rate system in 1993-4 by eliminating the official channel.

5.1 Full Capital Account Convertibility

Capital Account convertibility in its entirety would mean that any individual, be it Indian or Foreigner will be allowed to bring in any amount of foreign currency into the country.

Full convertibility also known as Floating rupee means the removal of all controls on the cross-border movement of capital, out of India to anywhere else or vice versa.

Capital account convertibility or CAC refers to the freedom to convert local financial assets into foreign financial assets or vice versa at market-determined rates of interest.If CAC is introduced along with current account convertibility it would mean full convertibility.

Complete convertibility would mean no restrictions and no questions. In general, restrictions on foreign currency movements are placed by developing countries which have faced foreign exchange problems in the past is to avoid sudden erosion of their foreign exchange reserves which are essential to maintain stability of trade balance and stability in their economy. With Indias Forex reserves increasing steadily, it has slowly and steadily removed restrictions on movement of capital on many counts.

The last few steps as and when they happen will allow an Indian individual to invest in Microsoft or Intel shares that are traded on NASDAQ and invest the proceeds abroad without any restrictions.

5.2 Definition of CAC

The Tarapore Committee (I) had defined capital account convertibility as "The freedom to covert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. In other words, it means allowing Indians to purchase both the physical and financial assets abroad and vice-versa.

The first committee, the report of which was released on June 3, 1997, had recommended a three-year timeframe (1997-2000) for complete convertibility, subject to the fulfillment of preconditions. However, the Southeast Asian currency crisis simply put the CAC on the backburner.

The present committee has proposed a five-year timeframe, from 2006-2011, to move towards convertibility in three phases. 2006- 07 (Phase-I), 2007-08 & 2008-09 (Phase-II) and 2009-10 & 2010-11 (Phase-III). The panel has said that it would enable authorities to undertake a stock taking after each phase before moving on to the next phase.

The report provides an insight into India's financial sector and government finances reforms to date. Therefore, the details vary but both reports (Tarapore I & II) focus on fiscal consolidation and financial sector reforms as crucial preliminaries to full convertibility of the rupee.

It is clear that even after a decade we could not meet all the conditions enumerated in the report. Though some of the pre-conditions such as maintaining inflation rate, reduction in non-performing assets (NPAS) and debt servicing have been attained. Several other crucial pre-conditions like low fiscal and current account deficit, CRR are yet to be met.

The committee had recommended thatgross fiscal deficit must be contained at 3.5% of gross domestic product (GDP) before going fully convertible. As against this, the current gross fiscal deficit stands at 4.1% and is likely to come down to 3.8% by next fiscal.

Fiscal fundamentalists also talk of sustainable level of the deficit, which is 5-5.5% of GDP for the centre and states combined. But, the present combined fiscal deficit of both centre and states is around 8%.

The committee has made several recommendations:

- Removal of tax benefits to NRIs.
- Greater autonomy to RBI.
- Complete check on fiscal deficit.
- Disallowing investment channel led through a particular country (like Mauritius).
- Reduction of government stake in banks from 51 per cent to 33 per cent.
- Allowing industrial houses a stake in existing banks or allowing them to open a new banks.
- Allowing enhanced presence of foreign banks.
- 10 per cent voting limit for investment in banks should be scrapped.
- Non-resident corporates should be allowed to invest in Indian markets.

- All individual NRIs should also be allowed to invest in Indian Market.
- Revenue deficit of both central and states should be eliminated by 2008-09 and building a revenue surplus of 1 per cent by Financial Year 2011.
- Raising the ceiling on External Commercial Borrowing (ECB).
- Banning Participatory Notes (PNs) and phasing out the existing PNs within one year.
- Enhancing the ceiling on government debt from $2 billion to 10 per cent of issuance and $1-5 billion to 25 per cent of new issuances in a year of corporate debt.
- Building adequate reserve and limiting the current account deficit to under 3% of GDP.

All banks should be brought under Companies Act. The committee has suggested for providing greater financial freedom for all the three key stakeholders of this process— resident individuals domestic companies and foreign investors.

5.3 Distinction between Current and Capital Convertibility

The next step for India is to go for convertibility of the rupee on capital account also. Under capital account convertibility, (CAC), any Indian or Indian company is entitled to move freely from the Rupee to another currency, to convert Indian Financial assets into foreign financial assets and back, at an exchange rate fixed by the foreign exchange market and not by RBI. In a way, CAC removes all the restraints on international currency flows on India's capital account.

There is a basic difference between current account convertibility and capital account convertibility. In the case of current account convertibility, it is important to have a transaction – importing and exporting of goods, buying and selling of services, inward or outward remittances, etc. – payment or receipt of one currency against another currency. On the other hand, in the case of capital account convertibility, a currency can be converted into any other currency without any transaction.

5.4 Final Step Capital Account Convertibility (CAC): Tarapore Committee (1997)

When the convertibility of the rupee on the current account was successful and when RBI accumulated over $ 25 billion forex r4eserves it was ready to take the next step – capital account convertibility. The Reserve Bank of India appointed in 1997 the Committee on Capital Account Convertibility with Mr. S.S. Tarapore, former Deputy Governor of RBI, as its chairman.

The Tarapore Committee defined CAC as "the freedom to convert local financial assets with foreign financial assets and vice-versa at market determined rate of exchange". In simple language, CAC allowed any one to freely move from local currency into foreign currency and back. The purpose of CAC was

(a) To woo foreign investors by showing an easy market to move in and move out;

(b) To send a strong message that Indian economy was strong enough; and

(c) India had sufficient forex reserves to meet any flight of capital from the country to any extent.

The Tarapore Committee explained the benefits of CAC to India.

5.5 The Benefits of CAC

(i) Availability of large funds to supplement domestic resources and thereby promote economic growth,

(ii) Improved access to international financial markets and reduction in cost of capital,

(iii) Incentive for Indians to acquire and hold international securities and assets, and

(iv) Improvement of the financial system in the context of global competition.

Accordingly, the Tarapore Committee recommended the adoption of capital account convertibility. Under the System of CAC

(a) Indian companies would be allowed to issue foreign currency denominated bonds to local investors, to invest in such bonds and deposits, to issue Global Deposit Receipts (GDRs) without RBI or Government approval. To go for external commercial borrowings within certain limits, etc.

(b) Indian residents would be permitted to have foreign currency denominated deposits with banks in India, to make financial capital transfers to other countries within certain limits, to take loans from non-relatives and others up to a ceiling of $ 1 million, etc.

(c) Indian banks would be allowed to borrow from overseas markets for short term and long term up to certain limits, to invest in overseas money markets, to accept deposits and extend loans denominated in foreign currency. Such facilities would be available to financial institutions and financial intermediaries also.

(d) All-India financial institutions which fulfil certain regulatory and prudential requirements would be allowed to participate in foreign exchange market along with authorized dealers (ADs) who are, at present, banks. At a later stage, certain select NBFCs would also be permitted to act as Ads in foreign exchange market.

(e) Banks and financial institutions would be allowed to operate in domestic and international markets – they would be allowed to buy and sell gold freely and offer gold denominated deposits and loans.

6. PARTICIPATORY NOTES

The most unexpected suggestions from the panel is banning of fund inflows under participatory notes. The committee is of the view that foreign institutional investors (FIIs) should be prohibited from investing fresh money raised through participatory notes (PNs) and the existing PN-holders may be provided an exit route and phased out completely within one year.

Participatory notes or contract notes are the financial paper or instruments representing Indian shares, issued by foreign financial institutions to overseas Investors who are not eligible to invest in India.

The committee observes that "in case of PNs, the nature of the beneficial ownership or the identify is not known unlike in the case of FIIs. These PNs are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner".

In November 2005 a committee, appointed by the Ministry of Finance under the chairmanship of Dr. Ashok Lahiri, Chief Economic Advisor to the Government of India strongly suggested widening the scope of PNs. Insisting on greater transparency would be more appropriate than calling for a ban. If the PNs are banned, fund flows into Indian Markets are likely to dry up.

Proposed Changes by Tarapore Committee

Investment Relaxation	Phase-I 2006-07	Phase-II 2007-09	Phase-II 2009-11
External commercial borrowing	Status quo on ECB limit of $18 billion	Gradual increase, but automatic limit to be raised from $500 million to $750 million	Gradual increase, but limit to be raised to $1 billion per financial year
Resident individual's overseas investment	$25,000 limit should be hiked to $50,000 per calendar year	Raised to $1,00,000	Raised to $2,00,000
MFs overseas investment	$2 billion investment limit to be raised to $3 billion	Further raised to $4 billion	Further raised to $5 billion
FII investment	Fresh participatory notes should be banned	Ban to continue	Ban to continue
FIIs' debt investment	G-Sec investment limit of $2 billion to be modified as 6 per cent of gross borrowing	8 per cent of total gross borrowing	10 per cent of gross borrowing
JVs / Wholly-owned subsidiary abroad investment	200 per cent of net worth limit should be raised to 250 percent	Further raised to 300 per cent of net worth	Further raised to 400 per cent

Source: RBI appointed Tarapore Committee Report 2006

7. EXPORT PROMOTION MEASURES

7.1 Assistance to State Governments to Infrastructure Development of Exports (ASIDE)

Assistance to State Governments to Infrastructure Development of Exports (ASIDE) Scheme for Assistance to States for Infrastructure Development of States for Exports (ASIDE) is formulated to encourage participate in promoting exports, and is administered by Department of Commerce (DoC). Objectives of ASIDE include:

1. Developing infrastructure such as roads connecting production centers with ports,
2. Setting up of Inland Container Depots (ICD) and Container Freight Stations (CFS),
3. Creation of new State level export promotion industrial parks/ zones,
4. Augmenting common facilities in existing zones,
5. Equity participation in infrastructure projects,
6. Development of minor ports and jetties,
7. Assistance in setting up of common effluent treatment facilities,
8. Stabilizing power supply, and
9. Any other activity as may be notified by DoC.

7.2 Market Access Initiative(MAI)

MAI scheme is intended to provide financial assistance for medium term export promotion efforts with sharp focus on a country / product, and is administered by DoC.

Financial assistance is available for Export Promotion Councils (EPCs), Industry and Trade Associations (ITAs), Agencies of State Governments, Indian Commercial Missions (ICMs) abroad and other eligible entities as may be notified.

A whole range of activities can be funded under MAI scheme. These include, amongst others,

1. Market studies,
2. Setting up of showroom / warehouse,
3. Sales promotion campaigns,
4. International departmental stores,
5. Publicity campaigns,
6. Participation in international trade fairs,
7. Brand promotion,
8. Registration charges for pharmaceuticals, and term export promotion efforts with sharp focus on a country / product,
9. Testing charges for engineering products.

Each of these export promotion activities can receive financial assistance from Government ranging from 25% to 100% of total cost depending upon activity and implementing agency.

7.3 Market Development Assistance(MDA)

MDA Scheme is intended to provide financial assistance for a range of export promotion activities implemented by EPCs, ITAs on a regular basis every year. The scheme is administered by DoC.

Assistance includes, amongst others, participation in

1. Trade Fairs and Buyer Seller meets abroad or in India, and
2. Export promotion seminars.

Financial assistance with travel grant is available to exporters traveling to Latin America, Africa, CIS region, ASEAN countries, Australia and New Zealand. In other areas, financial assistance without travel grant is available. MDA assistance is available for exporters with annual export turnover upto 15 Crores.

7.4 Export and Trading Houses

Merchant as well as Manufacturer Exporters, Service Providers, Export Oriented Units (EOUs) and Units located in Special Economic Zones (SEZs), Agri Export Zones (AEZs), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio-Technology Parks (BTPs) shall be eligible for Status. Applicant shall be categorized depending on his total FOB (FOR - for deemed exports) export performance during current plus previous three years (taken together) upon exceeding limit given below. For Export House (EH) Status, export performance is necessary in at least two out of four years (i.e., current plus previous three years).

Status Category	Export Performance FOB/FOR Value (Rupees in Crores)
Export House (EH)	20
Star Export House (SEH)	100
Trading House (TH)	500
Star Trading House (STH)	2500
Premier Trading House (PTH)	7500 [Old - 10000]

7.5 Software Technology Parks (STPs)

For the promotion of Software exports from the country, the Software Technology Parks of India was set up 1991 as an Autonomous Society under the Department of Electronics and Information Technology. The services rendered by STPI for the Software exporting community have been statutory services, data communications servers, incubation facilities, training and value added services. STPI has played a key developmental role in the promotion of software exports with a special focus on SMEs and start up units. The STP Scheme has been extremely successful in fostering the growth of the software industry. The exports made by STP Units have grown many folds over the years. Today the exports made by STPI registered unit during 2008-09 are INR 215571 Crores about 90% of total software exports from the Country.

THE STPI Scheme is lauded as one of the most effective schemes for the promotion of exports of IT and ITES. The 51 STPI centres that have been set up since inception of the programme have given a major boost to IT and ITES exports. Apart from exemption from customs duty available for capital goods (with a few exemptions) there are also exemptions from service tax, excise duty, and rebate for payment of Central Sales Tax. But the most important incentive available is 100 percent exemption from Income Tax of export profits, which has been extended till 31st March 2011. The strength of the scheme lies in the fact that, it is a virtual scheme, which allows, software companies to set up operations in the most convenient and cheapest locations and plan their investment and growth solely driven by business needs. STP Scheme is a pan India Scheme, which has centres spread across India, over 8000 units are registered under STP Scheme.

Benefits under STP Scheme:

- Customs Duty Exemption in full on imports.
- Central Excise Duty Exemption in full on indigenous procurement.
- Central Sales Tax Reimbursement on indigenous purchase against from C.
- All relevant equipment / goods including second hand equipment can be imported (except prohibited items).
- Equipment can also be imported on loan basis/lease.
- 100% FDI is permitted through automatic route.
- Sales in the DTA up to 50% of the FOB value of exports permissible.
- Use of computer imported for training permissible subject to certain conditions.
- Depreciation on computers at accelerated rates up to 100% over 5 years is permissible.
- Computers can be donated after two years of use to recognized non-commercial Educational Institutions/Hospitals without payment of duty.
- Export proceeds will be realized within 12 months.

7.6 Special Economic Zones (SEZ) Scheme

In 2005, the Ministry of Commerce, Government of India has enacted the Special Economic Zone (SEZ) Act, with an objective of providing an internationally competitive and hassle free environment for exports. A SEZ is defined as a "specifically demarked duty-free enclave and shall deemed to be foreign territory (out of Customs jurisdiction) for the purpose of trade operations and duties and tariffs". The SEZ Act, 2005, supported by SEZ Rules, came into effect on 10th February, 2006. It provides drastic simplification of procedures and a single window clearance policy on matters relating to central and state governments. The scheme is ideal for bigger Industries and has a significant impact on future Exports and employment

The SEZ Scheme offers similar benefits to SEZ units as compared to those under STPI in respect of indirect taxes, with some minor differences in operational details. There is a however a significant difference, in respect of income tax holiday. In SEZ Scheme the exemption from income tax is tapered down over 15 years from the date of commencement of manufacture. There is 100% exemption of export profits from income tax for the first five years, 50% for the next five years and 50% for the five years subject to transfer of profits to special reserves.

The SEZ policy aims at creating competitive, convenient and integrated Zones offering World class infrastructure, utilities and services for globally oriented businesses. The SEZ Act 2005 envisages key role for the State Governments in Export Promotion and creation of related infrastructure. A few salient features of SEZ scheme are as under:

- Special Economic Zones (SEZs) are being set up to enable hassle free manufacturing and trading for export purposes.
- Sales from Domestic Tariff Area (DTA) to SEZs are being treated as physical export. This entitles domestic suppliers to Drawback/ DEPB benefits, CST exemption and Service Tax exemption.
- 100% Income Tax exemption on export profits available to SEZ units for 5 years, 50% for next 5 years and 50% of ploughed back profits for 5 years thereafter.

7.7 Free Trade Zone (Export Processing Zones)

These are also referred to as Export Processing Zones, are set up with the intension of providing an internationally competitive duty free environment for export production, at low cost. This enables the products of EPZ to be competitive, both quality wise and price wise, in the international market. India has seven EPZ at different parts of our country. EPZ operating units broadly under the product groups of electronics, engineering items, chemicals and allied products, gems and jewellery, textiles, garments, plastics and rubber products.The objectives of these units are:

1. To earn foreign exchange
2. To generate employment opportunities
3. To facilitate transfer of technology by foreign investment and other means.
4. To contribute to the overall development of the economy.

Entitlement for EPZ Units:Each of the zones provides basic infrastructure such as developed land for construction of factory sheds, standard design factory buildings, roads, power, water supply and drainage. In addition customs clearance is arranged within the zone at noextra charge. Provision is made for locating banking\post office facilities and offices of clearing agents in the service centers located in each of the zones.Foreign equity up to 100% is permissible in the case of EPZ unitsProcurement of raw materials, components and consumables and export of finished products shall be exempt from central levies

7.8 Export Oriented Units (EOU)

The purpose of the scheme was basically to boost exports by creating additional production capacity. Under this scheme, the units undertaking to export their entire production of goods are allowed to be set up. These units may be engaged in the manufacture, services, development of software, trading, repair, remaking, reconditioning, re-engineering including making of gold/silver/platinum jewellery and articles thereof, agriculture including agro-processing, aquaculture, animal husbandry, bio-technology, floriculture, horticulture, pisciculture, viticulture, poultry, sericulture and granites.

The EOUs can export all products except prohibited items of exports in ITC (HS). Under the EOU scheme, the units are allowed to import or procure locally without payment of duty all types of goods including capital goods, raw materials, components, packing materials, consumables, spares and various other specified categories of equipments including material handling equipments, required for export production or in connection therewith.

However, the goods prohibited for import are not permitted. In the case of EOUs engaged in agriculture, animal husbandry, floriculture, horticulture, pisciculture, viticulture, poultry, sericulture and granite quarrying, only specified categories of goods mentioned in the relevant notification have been permitted to be imported duty-free.

The EOUs are licensed to manufacture goods within the bonded premises for the purpose of export. As per the policy, the period of bonding is initially for five years, which is extendable to another five years by the Development Commissioner. On completion of the bonding period, it is for the unit to decide whether to continue under, or to opt out, of the scheme. The imported capital goods are allowed to be warehoused for a period of 5 years. For other goods, the warehousing period is one year, which can be extended further by the Commissioner / Chief Commissioner of Customs. On an application being made by the unit, extension of the time limit is granted in all cases unless there is malafide and diversion of duty free materials

7.9 DEPB

DEPB (Duty Entitlement Pass Book) is an export incentive scheme of Indian Government provided to Exporters in India.

The objective of DEPB is to neutralize the incidence of customs duty on the import content of export product.The neutralization shall be provided by the grant of duty credit against the export product. Under this scheme,an exporter may apply for credit, as a specific percentage of FOB value of exports, made in freely convertible currency or the payment made from the foreign currency account of SEZ unit in case of supplyby DTA to SEZ UNIT. The credit shall be available against such export products and at such rates as may be specified mt DGFT.The credit may also be used for payment of customs duty on any item which is freely importable.

The DEPB and the items imported against it are freely transferable(on specified ports) .

7.10 Focus Market Scheme (FMS)

The objective of this scheme is to offset high freight cost and other externalities to select international markets with a view to enhance India's export competitiveness in these countries.

The scheme is operationalized vide Notifications dated 11-9-2009.

The exporters of all products to countries, as notified, are entitled for Duty Credit Scrip equivalent to 3% of FOB value of exports in free foreign exchange.

In the annual supplement to the Foreign Trade Policy, announced by DGFT on 13.10.2011, a new scheme – "Special Focus Market Scheme (SFMS)" has been introduced.

Under this scheme exports to 41 countries would be incentivized with additional 1% duty credit for exports made with effect from 01.04.2011. This duty credit is over and above the duty credit granted under FMS i.e. if an item covered under FMS is exported to the countries listed under SFMS, then the total duty credit would be 4%.

In terms of Notification, dated 11-9-2009 the following categories of export products/sectors are ineligible for Duty Credit Scrip, under FMS:

(a) Supplies made to SEZ units;

(b) Service exports;

(c) Diamonds and other precious, semi precious stones, gold, silver, platinum and other precious metals in any form, including plain and studded jewellery;

(d) Ores and concentrates, of all types and in all forms;

(e) Cereals, of all types;

(f) Sugar, of all types and in all forms;

(g) Crude/petroleum oil and crude/petroleum based products

(h) Milk and milk products

7.11 Focus Product Scheme (FPS)

The objective of this scheme is to incentivise export of specified products. The exporters are entitled for Duty Credit Scrip @ 2% of FOB value of exports in free foreign exchange. However, Special Focus Product(s)/sector(s), are eligible for Duty Credit Scrip equivalent to 5% of FOB value of exports in free foreign exchange. This scheme is operationalized vide Notification ,dated 11-9-2009.

In the annual supplement to the Foreign Trade Policy, announced by DGFT on 13.10.2011, a new scheme – "Special Bonus Benefit Scheme" has been introduced. Under this scheme 50 products of engineering, pharamaceutical and chemical sectors have been granted duty credit @ 1% of the value.

This scheme will be available on exports made on or after 01.10.2011 and would automatically sunset on 31.03.2012.

7.12 Market Linked Focus Products Scrip (MLFPS)

The export of products/sectors of high export intensity/employment potential (which are not covered under present Focus Product Scheme List) are incentivized at 2% of FOB value of exports in free foreign exchange under Focus Product Scheme when exported to the Linked Markets (countries), which are not covered in the present FMS list.

7.13 Export Promotion Capital Goods (EPCG) Scheme

Under EPCG scheme, import of capital goods which are required for the manufacture of resultant export product specified in the EPCG Authorization is permitted at nil/ concessional rate of Customs duty.

This Scheme enables upgradation of technology of the indigenous industry. For this purpose EPCG Authorizations are issued by RA (Regional Authority) of DGFT on the basis of nexus certificate issued by an independent chartered engineer.

At present the EPCG Authorization holder is permitted to import capital goods at 0% or 3% Customs duty. Under the 0% duty EPCG scheme the Authorization holder is required to undertake export obligation (EO) equivalent to 6 times of the duty saved amount on the capital goods imported within a period of 6 years reckoned from the date of issue of Authorization. Under the 3% duty EPCG scheme, the Authorization holder has to fulfill EO equivalent to 8 times of the duty saved amount on the capital goods imported in 8 years.

Since this scheme permits import of capital goods at nil/concessional Customs duties subject to conditions specified in the Customs notifications, monitoring of fulfilment of EO is essential, the Customs are directed to put in place a mechanism to effectively monitor all imports under the EPCG scheme and take action to recover the Customs duty in case of default. Further, they should maintain close liaison with the Regional Licensing Authority (RLA) of the DGFT. The Commissioners of Customs have also been advised to put in place an institutional mechanism whereby they meet the RLA at least once every quarter to pursue issues relating to EO fulfilment status so that the concerted action is taken against defaulters.

8. FOREIGN DIRECT INVESTMENT

An investment made by a company or entity based in one country, into a company or entity based in another country. Foreign direct investments differ substantially from indirect investments such as portfolio flows, wherein overseas institutions invest in equities listed on a nation's stock exchange. Entities making direct investments typically have a significant degree of influence and control over the company into which the investment is made. Open economies with skilled workforces and good growth prospects tend to attract larger amounts of foreign direct investment than closed, highly regulated economies.

The investing company may make its overseas investment in a number of ways - either by setting up a subsidiary or associate company in the foreign country, by acquiring shares of an overseas company, or through a merger or joint venture.

The accepted threshold for a foreign direct investment relationship, as defined by the OECD, is 10%. That is, the foreign investor must own at least 10% or more of the voting stock or ordinary shares of the investee company.

FDI could be of the following types:

(1) Green Field FDI

A form of foreign direct investment where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up. In addition to building new facilities, most parent companies also create new long-term jobs in the foreign country by hiring new employees.This is opposite to a brown field investment.

(2) Brown Field FDI:

When a company or government entity purchases or leases existing production facilities to launch a new production activity. This is one strategy used in foreign-direct investment.

(3) Acquisition and Merger(A & M):

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world.

When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new company stock is issued in its place. 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. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

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, employees and shareholders.

The forms in which business can be conducted by a foreign company in India:

A foreign company planning to set up business operations in India may:

- Incorporate a company under the Companies Act, 1956, as a Joint Venture or a Wholly Owned Subsidiary.
- Set up a Liaison Office / Representative Office or a Project Office or a Branch Office of the foreign company which can undertake activities permitted under the Foreign Exchange Management (Establishment in India of Branch Office or Other Place of Business) Regulations, 2000.

FDI Routes

An Indian company may receive Foreign Direct Investment under the two routes as given under:

i) Automatic Route

FDI is allowed under the automatic route without prior approval either of the Government or the Reserve Bank of India in all activities/sectors as specified in the consolidated FDI Policy, issued by the Government of India from time to time.

ii) Government Route

FDI in activities not covered under the automatic route requires prior approval of the Government which are considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance.

The Indian company having received FDI either under the Automatic route or the Government route is required to comply with provisions of the FDI policy including reporting the FDI to the Reserve Bank.

Foreign investment is reckoned as FDI only if the investment is made in equity shares , fully and mandatorily convertible preference shares and fully and mandatorily convertible debentures with the pricing being decided upfront as a figure or based on the formula that is decided upfront. Any foreign investment into an instrument issued by an Indian company which:

- gives an option to the investor to convert or not to convert it into equity or
- does not involve upfront pricing of the instrument

FDI is prohibited under the Government Route as well as the Automatic Route in the following sectors:

i) Atomic Energy

ii) Lottery Business

iii) Gambling and Betting

iv) Business of Chit Fund

v) Nidhi Company: Nidhi company is a company registered under Companies Act and notified as a nidhi company by Central Government under Section 620-A of Companies Act. It is a non-banking finance company doing the business of lending and borrowing with its members or shareholders.

vi) Agricultural (excluding Floriculture, Horticulture, Development of seeds, Animal Husbandry, Pisciculture and cultivation of vegetables, mushrooms, etc. under controlled conditions and services related to agro and allied sectors) and Plantations activities (other than Tea Plantations)

vii) Housing and Real Estate business (except development of townships, construction of residen-tial/ commercial premises, roads or bridges)

viii) Trading in Transferable Development Rights (TDRs).

ix) Manufacture of cigars, cigarillos and cigarettes , of tobacco or of tobacco substitutes.

Foreign Investment in India is governed by the FDI policy announced by the Government of India and the provision of the Foreign Exchange Management Act (FEMA) 1999. The Reserve Bank of India ('RBI') in this regard had issued a notification,which contains the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000. This notification has been amended from time to time.

The Ministry of Commerce and Industry, Government of India is the nodal agency for motoring and reviewing the FDI policy on continued basis and changes in sectoral policy/ sectoral equity cap. The FDI policy is notified through Press Notes by the Secretariat for Industrial Assistance (SIA), Department of Industrial Policy and Promotion (DIPP).

The foreign investors are free to invest in India, except few sectors/activities, where prior approval from the RBI or Foreign Investment Promotion Board ('FIPB') would be required.

9. FDI POLICY WITH REGARD TO RETAILING IN INDIA

Press Note of 2006 issued by DIPP and consolidated FDI Policy issued in October 2010 which provide the sector specific guidelines for FDI with regard to the conduct of trading activities as enumerated below:

a) FDI up to 100% for cash and carry wholesale trading and export trading allowed under the automatic route.

b) FDI up to 51 % with prior Government approval (i.e. FIPB) for retail trade of 'Single Brand' products.

c) FDI is not permitted in Multi Brand Retailing in India.

Entry Options For Foreign Players prior to FDI Policy

Although prior to Jan 24, 2006, FDI was not authorised in retailing, most general players ha\d been operating in the country. Some of entrance routes used by them have been discussed in sum as below:-

1. Franchise Agreements

It is an easiest track to come in the Indian market. In franchising and commission agents' services, FDI (unless otherwise prohibited) is allowed with the approval of the Reserve Bank of India (RBI) under the Foreign Exchange Management Act. This is a most usual mode for entrance of quick food bondage opposite a world. Apart from quick food bondage identical to Pizza Hut, players such as Lacoste, Mango, Nike as good as Marks as good as Spencer, have entered Indian marketplace by this route.

2. Cash And Carry Wholesale Trading

100% FDI is allowed in wholesale trading which involves building of a large distribution infrastructure to assist local manufacturers.The wholesaler deals only with smaller retailers and not Consumers. Metro AG of Germany was the first significant global player to enter India through this route.

3. Strategic Licensing Agreements

Some foreign brands give exclusive licences and distribution rights to Indian companies. Through these rights, Indian companies can either sell it through their own stores, or enter into shop-in-shop arrangements or distribute the brands to franchisees. Mango, the Spanish apparel brand has entered India through this route with an agreement with Piramyd, Mumbai, SPAR entered into a similar agreement with Radhakrishna Foodlands Pvt. Ltd

4. Manufacturing and Wholly Owned Subsidiaries.

The foreign brands such as Nike, Reebok, Adidas, etc. that have wholly-owned subsidiaries in manufacturing are treated as Indian companies and are, therefore, allowed to do retail. These companies have been authorised to sell products to Indian consumers by franchising, internal distributors, existent Indian retailers, own outlets, etc. For instance, Nike entered through an exclusive licensing agreement with Sierra Enterprises but now has a wholly owned subsidiary, Nike India Private Limited.

9.1 FDI in Single Brand Retail

The Government has not categorically defined the meaning of "Single Brand" anywhere neither in any of its circulars nor any notifications.

In single-brand retail, FDI up to 51 per cent is allowed, subject to Foreign Investment Promotion Board (FIPB) approval and subject to the conditions mentioned in Press Note 3 that (a) only single brand products would be sold (i.e., retail of goods of multi-brand even if produced by the same manufacturer would not be allowed), (b) products should be sold under the same brand internationally, (c) single-brand product retail would only cover products which are branded during manufacturing and (d) any addition to product categories to be sold under "single-brand" would require fresh approval from the government.

While the phrase 'single brand' has not been defined, it implies that foreign companies would be allowed to sell goods sold internationally under a 'single brand', viz., Reebok, Nokia, Adidas. Retailing of goods of multiple brands, even if such products were produced by the same manufacturer, would not be allowed.

Going a step further, we examine the concept of 'single brand' and the associated conditions:

FDI in 'Single brand' retail implies that a retail store with foreign investment can only sell one brand. For example, if Adidas were to obtain permission to retail its flagship brand in India, those retail outlets could only sell products under the Adidas brand and not the Reebok brand, for which separate permission is required. If granted permission, Adidas could sell products under the Reebok brand in separate outlets.

But, what is a 'brand'?

Brands could be classified as products and multiple products, or could be manufacturer brands and own-label brands. Assume that a company owns two leading international brands in the footwear industry – say 'A' and 'R'. If the corporate were to obtain permission to retail its brand in India with a local partner, it would need to specify which of the brands it would sell. A reading of the government release indicates that A and R would need separate approvals, separate legal entities, and may be even separate stores in which to operate in India. However, it should be noted that the retailers would be able to sell multiple products under the same brand, e.g., a product range under brand 'A' Further, it appears that the same joint venture partners could operate various brands, but under separate legal entities.

Now, taking an example of a large departmental grocery chain, prima facie it appears that it would not be able to enter India. These chains would, typically, source products and, thereafter, brand it under their private labels. Since the regulations require the products to be branded at the manufacturing stage, this model may not work. The regulations appear to discourage own-label products and appear to be tilted heavily towards the foreign manufacturer brands.

There is ambiguity in the interpretation of the term 'single brand'. The existing policy does not clearly codify whether retailing of goods with sub-brands bunched under a major parent brand can be considered as single-brand retailing and, accordingly, eligible for 51 per cent FDI. Additionally, the question on whether co-branded goods (specifically branded as such at the time of manufacturing) would qualify as single brand retail trading remains unanswered.

9.2 FDI in Multi Brand Retail

The government has also not defined the term Multi Brand. FDI in Multi Brand retail implies that a retail store with a foreign investment can sell multiple brands under one roof.

In July 2010, Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce circulated a discussion paper on allowing FDI in multi-brand retail. The paper doesn't suggest any upper limit on FDI in multi-brand retail. If implemented, it would open the doors for global retail giants to enter and establish their footprints on the retail landscape of India. Opening up FDI in multi-brand retail will mean that global retailers including Wal-Mart, Carrefour and Tesco can open stores offering a range of household items and grocery directly to consumers in the same way as the ubiquitous 'kirana' store.

Foreign Investor's Concern Regarding FDI Policy in India

For those brands which adopt the franchising route as a matter of policy, the current FDI Policy will not make any difference. They would have preferred that the Government liberalize rules for maximizing their royalty and franchise fees. They must still rely on innovative structuring of franchise arrangements to maximize their returns. Consumer durable majors such as LG and Samsung, which have exclusive franchisee owned stores, are unlikely to shift from the preferred route right away.

For those companies which choose to adopt the route of 51% partnership, they must tie up with a local partner. The key is finding a partner which is reliable and who can also teach a trick or two about the domestic market and the Indian consumer. Currently, the organized retail sector is dominated by the likes of large business groups which decided to diversify into retail to cash in on the boom in the sector – corporates such as Tata through its brand Westside, RPG Group through Foodworld, Pantaloon of the Raheja Group and Shopper's Stop. Do foreign investors look to tie up with an existing retailer or look to others not necessarily in the business but looking to diversify, as many business groups are doing?

An arrangement in the short to medium term may work wonders but what happens if the Government decides to further liberalize the regulations as it is currently contemplating? Will the foreign investor terminate the agreement with Indian partner and trade in market without him? Either way, the foreign investor must negotiate its joint venture agreements carefully, with an option for a buy-out of the Indian partner's share if and when regulations so permit. They must also be aware of the regulation which states that once a foreign company enters into a technical or financial collaboration with an Indian partner, it cannot enter into another joint venture with another Indian company or set up its own subsidiary in the 'same' field' without the first partner's consent if the joint venture agreement does not provide for a 'conflict of interest' clause. In effect, it means that foreign brand owners must be extremely careful whom they choose as partners and the brand they introduce in India. The first brand could also be their last if they do not negotiate the strategic arrangement diligently.

Concerns for the Government for only Partially Allowing FDI in Retail Sector

A number of concerns were expressed with regard to partial opening of the retail sector for FDI. The Hon'ble Department Related Parliamentary Standing Committee on Commerce, in its 90th Report, on 'Foreign and Domestic Investment in Retail Sector', laid in the Lok Sabha and the Rajya Sabha on 8 June, 2009, had made an in-depth study on the subject and identified a number of issues related to FDI in the retail sector. These included:

It would lead to unfair competition and ultimately result in large-scale exit of domestic retailers, especially the small family managed outlets, leading to large scale displacement of persons employed in the retail sector. Further, as the manufacturing sector has not been growing fast enough, the persons displaced from the retail sector would not be absorbed there.

Another concern is that the Indian retail sector, particularly organized retail, is still under-developed and in a nascent stage and that, therefore, it is important that the domestic retail sector is allowed to grow and consolidate first, before opening this sector to foreign investors.

Antagonists of FDI in retail sector oppose the same on various grounds, like, that the entry of large global retailers such as Wal-Mart would kill local shops and millions of jobs, since the unorganized retail sector employs an enormous percentage of Indian population after the agriculture sector; secondly that the global retailers would conspire and exercise monopolistic power to raise prices and monopolistic (big buying) power to reduce the prices received by the suppliers; thirdly, it would lead to asymmetrical growth in cities, causing discontent and social tension elsewhere. Hence, both the consumers and the suppliers would lose, while the profit margins of such retail chains would go up.

9.3 Limitations of the Present Setup

Infrastructure

There has been a lack of investment in the logistics of the retail chain, leading to an inefficient market mechanism. Though India is the second largest producer of fruits and vegetables (about 180 million MT), it has a very limited integrated cold-chain infrastructure, with only 5386 stand-alone cold storages, having a total capacity of 23.6 million MT. , 80% of this is used only for potatoes. The chain is highly fragmented and hence, perishable horticultural commodities find it difficult to link to distant markets, including overseas markets, round the year. Storage infrastructure is necessary for carrying over the agricultural produce from production periods to the rest of the year and to prevent distress sales. Lack of adequate storage facilities cause heavy losses to farmers in terms of wastage in quality and quantity of produce in general. Though FDI is permitted in cold-chain to the extent of 100%, through the automatic route, in the absence of FDI in retailing; FDI flow to the sector has not been significant.

Intermediaries dominate the value chain

Intermediaries often flout mandi norms and their pricing lacks transparency. Wholesale regulated markets, governed by State APMC Acts, have developed a monopolistic and non-transparent character.

According to some reports, Indian farmers realize only 1/3rd of the total price paid by the final consumer, as against 2/3rd by farmers in nations with a higher share of organized retail.

Improper Public Distribution System ("PDS")

There is a big question mark on the efficacy of the public procurement and PDS set-up and the bill on food subsidies is rising. In spite of such heavy subsidies, overall food based inflation has been a matter of great concern. The absence of a 'farm-to-fork' retail supply system has led to the ultimate customers paying a premium for shortages and a charge for wastages.

No Global Reach

The Micro Small & Medium Enterprises ("MSME") sector has also suffered due to lack of branding and lack of avenues to reach out to the vast world markets. While India has continued to provide emphasis on the development of MSME sector, the share of unorganised sector in overall manufacturing has declined from 34.5% in 1999-2000 to 30.3% in 2007-08. This has largely been due to the inability of this sector to access latest technology and improve its marketing interface.

Rationale behind Allowing FDI in Retail Sector

FDI can be a powerful catalyst to spur competition in the retail industry, due to the current scenario of low competition and poor productivity.

The policy of single-brand retail was adopted to allow Indian consumers access to foreign brands. Since Indians spend a lot of money shopping abroad, this policy enables them to spend the same money on the same goods in India. FDI in single-brand retailing was permitted in 2006, up to 51 per cent of ownership. Between then and May 2010, a total of 94 proposals have been received. Of these, 57 proposals have been approved. An FDI inflow of US$196.46 million under the category of single brand retailing was received between April 2006 and September 2010, comprising 0.16 per cent of the total FDI inflows during the period.

The policy of allowing 100% FDI in single brand retail can benefit both the foreign retailer and the Indian partner – foreign players get local market knowledge, while Indian companies can access global best management practices, designs and technological knowhow. By partially opening this sector, the government was able to reduce the pressure from its trading partners in bilateral/ multilateral negotiations and could demonstrate India's intentions in liberalising this sector in a phased manner.

Permitting foreign investment in food-based retailing is likely to ensure adequate flow of capital into the country & its productive use, in a manner likely to promote the welfare of all sections of society, particularly farmers and consumers. It would also help bring about improvements in farmer income & agricultural growth and assist in lowering consumer prices inflation.

Apart from this, by allowing FDI in retail trade, India will significantly flourish in terms of quality standards and consumer expectations, since the inflow of FDI in retail sector is bound to pull up the quality standards and cost-competitiveness of Indian producers in all the segments. It is therefore obvious that we should not only permit but encourage FDI in retail trade.

Lastly, it is to be noted that the Indian Council of Research in International Economic Relations (ICRIER), a premier economic think tank of the country, which was appointed to look into the impact of BIG capital in the retail sector, has projected the worth of Indian retail sector to reach $496 billion by 2011-12 and ICRIER has also come to conclusion that investment of 'big' money (large corporates and FDI) in the retail sector would in the long run not harm interests of small, traditional, retailers.

In light of the above, it can be safely concluded that allowing healthy FDI in the retail sector would not only lead to a substantial surge in the country's GDP and overall economic development, but would inter alia also help in integrating the Indian retail market with that of the global retail market in addition to providing not just employment but a better paying employment, which the unorganized sector (kirana and other small time retailing shops) have undoubtedly failed to provide to the masses employed in them.

Industrial organisations such as CII, FICCI, US-India Business Council (USIBC), the American Chamber of Commerce in India, The Retail Association of India (RAI) and Shopping Centers Association of India (a 44 member association of Indian multi-brand retailers and shopping malls) favour a phased approach toward liberalising FDI in multi-brand retailing, and most of them agree with considering a cap of 49-51 per cent to start with.

The international retail players such as Walmart, Carrefour, Metro, IKEA, and TESCO share the same view and insist on a clear path towards 100 per cent opening up in near future. Large multinational retailers such as US-based Walmart, Germany's Metro AG and Woolworths Ltd, the largest Australian retailer that operates in wholesale cash-and-carry ventures in India, have been demanding liberalisation of FDI rules on multi-brand retail for some time.

Thus, as a matter of fact FDI in the buzzing Indian retail sector should not just be freely allowed but per contra should be significantly encouraged. Allowing FDI in multi brand retail can bring about Supply Chain Improvement, Investment in Technology, Manpower and Skill development,Tourism Development, Greater Sourcing From India, Upgradation in Agriculture, Efficient Small and Medium Scale Industries, Growth in market size and Benefits to govemment through greater GDP, tax income and employment generation.

9.4 Prerequisites before allowing FDI in Multi Brand Retail and Lifting Cap of Single Brand Retail

FDI in multi-brand retailing must be dealt cautiously as it has direct impact on a large chunk of population. Left alone foreign capital will seek ways through which it can only multiply itself, and unthinking application of capital for profit, given our peculiar socio-economic conditions, may spell doom and deepen the gap between the rich and the poor. Thus the proliferation of foreign capital into multi-brand retailing needs to be anchored in such a way that it results in a win-win situation for India. This can be done by integrating into the rules and regulations for FDI in multi-brand retailing certain inbuilt safety valves. For example FDI in multi –brand retailing can be allowed in a calibrated manner with social safeguards so that the effect of possible labor dislocation can be analyzed and policy fine tuned accordingly. To ensure that the foreign investors make a genuine contribution to the development of infrastructure and logistics, it can be stipulated that a percentage of FDI should be spent towards building up of back end infrastructure, logistics or agro processing units. Reconstituting the poverty stricken and stagnating rural sphere into a forward moving and prosperous rural sphere can be one of the justifications for introducing FDI in multi-brand retailing. To actualize this goal it can be stipulated that at least 50% of the jobs in the retail outlet should be reserved for rural youth and that a certain amount of farm produce be procured from the poor farmers. Similarly to develop our small and medium enterprise (SME), it can also be stipulated that a minimum percentage of manufactured products be sourced from the SME sector in India. PDS is still in many ways the life line of the people living below the poverty line. To ensure that the system is not weakened the government may reserve the right to procure a certain amount of food grains for replenishing the buffer. To protect the interest of small retailers the government may also put in place an exclusive regulatory framework. It will ensure that the retailing giants do resort to predatory pricing or acquire monopolistic tendencies. Besides, the government and RBI need to evolve suitable policies to enable the retailers in the unorganized sector to expand and improve their efficiencies. If Government is allowing FDI, it must do it in a calibrated fashion because it is politically sensitive and link it (with) up some caveat from creating some back-end infrastructure.

Further, To take care of the concerns of the Government before allowing 100% FDI in Single Brand Retail and Multi- Brand Retail, the following recommendations are being proposed :-

- Preparation of a legal and regulatory framework and enforcement mechanism to ensure that large retailers are not able to dislocate small retailers by unfair means.
- Extension of institutional credit, at lower rates, by public sector banks, to help improve efficiencies of small retailers; undertaking of proactive programme for assisting small retailers to upgrade themselves.
- Enactment of a National Shopping Mall Regulation Act to regulate the fiscal and social aspects of the entire retail sector.
- Formulation of a Model Central Law regarding FDI of Retail Sector.

Back-end logistics must for FDI in multi-brand retail

The government has added an element of social benefit to its latest plan for calibrated opening of the multi-brand retail sector to foreign direct investment (FDI). Only those foreign retailers who first invest in the back-end supply chain and infrastructure would be allowed to set up multi brand retail outlets in the country. The idea is that the firms must have already created jobs for rural India before they venture into multi-brand retailing.

It can be said that the advantages of allowing unrestrained FDI in the retail sector evidently outweigh the disadvantages attached to it and the same can be deduced from the examples of successful experiments in countries like Thailand and China; where too the issue of allowing FDI in the retail sector was first met with incessant protests, but later turned out to be one of the most promising political and economical decisions of their governments and led not only to the commendable rise in the level of employment but also led to the enormous development of their country's GDP.

Moreover, in the fierce battle between the advocators and antagonist of unrestrained FDI flows in the Indian retail sector, the interests of the consumers have been blatantly and utterly disregarded. Therefore, one of the arguments which inevitably needs to be considered and addressed while deliberating upon the captioned issue is the interests of consumers at large in relation to the interests of retailers.

It is also pertinent to note here that it can be safely contended that with the possible advent of unrestrained FDI flows in retail market, the interests of the retailers constituting the unorganized retail sector will not be gravely undermined, since nobody can force a consumer to visit a mega shopping complex or a small retailer/sabji mandi. Consumers will shop in accordance with their utmost convenience, where ever they get the lowest price, max variety, and a good consumer experience.

The Industrial policy 1991 had crafted a trajectory of change whereby every sectors of Indian economy at one point of time or the other would be embraced by liberalization, privatization and globalization.FDI in multi-brand retailing and lifting the current cap of 51% on single brand retail is in that sense a steady progression of that trajectory. But the government has by far cushioned the adverse impact of the change that has ensued in the wake of the implementation of Industrial Policy 1991 through safety nets and social safeguards. But the change that the movement of retailing sector into the FDI regime would bring about will require more involved and informed support from the government. One hopes that the government would stand up to its responsibility, because what is at stake is the stability of the vital pillars of the economy- retailing, agriculture, and manufacturing. In short, the socio economic equilibrium of the entire country.

10. PORTFOLIO INVESTMENT

A portfolio investment is a passive investment in securities, none of which entails active management or control of the securities' issuer by the investor. Portfolio investment is investment made by investors are not particularly interested in involvement in the management of a company.

It is also the investment in securities that is intended for financial gain only and does not create a lasting interest in or effective management control over an enterprise.

It includes investment in an assortment or range of securities, or other types of investment vehicles, to spread the risk of possible loss due to below expectations performance of one or a few of them.

Foreign Institutional Investors (FIIs) are allowed to invest in India in the securities traded in both primary and secondary capital markets. These securities include shares, debentures, warrants, and units of mutual funds, government securities and derivative instruments.

The term FII is defined as an institution established or incorporated outside India for making investment in Indian securities and also includes a sub-account of an FII. FIIs include Asset Management Companies, Pension Funds, Mutual Funds, Investment Trust as nominee companies, Incorporated/ Institutional Portfolio managers or their power attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies.

FIIs, must register with Securities and Exchange Board of India (SEBI) and shall comply with the Exchange Control Regulations of RBI.

10.1 Policy on FII Investment

Main features of the policy on investment by FII are :

- FIIs are required to allocate their investment between equity and debt instruments in the ratio of 70:30. However, it is also possible for an FII to declare itself a 100% debt FII in which case it can make its entire investment in debt instruments.
- FIIs can buy/sell securities on Stock Exchanges. They can also invest in listed and unlisted securities outside Stock Exchanges where the price has been approved by RBI.
- No individual FII/sub-account can acquire more than 10% of the paid up capital of an Indian company.
- All FIIs and their sub-accounts taken together cannot acquire more than 24% of the paid up capital of an Indian Company.
- Indian Companies can raise the above mentioned 24% ceiling to the Sectoral Cap / Statutory Ceiling as applicable by passing a resolution by its Board of Directors followed by passing a Special Resolution to that effect by its General Body in terms of Press Release dated Sept.20, 2001 and FEMA Notification No.45 dated Sept. 20, 2001.
- No permission from RBI is needed so long as the FIIs purchase and sell on recognized stock exchange. All non-stock exchange sales/purchases require RBI permission the regulations regarding Portfolio Investments by SEBI registered Foreign Institutional Investors (FIIs)
- Investment by SEBI registered FIIs is regulated under SEBI (FII) Regulations, 1995 and Regulation 5(2) of FEMA Notification No.20 dated May 3, 2000, as amended from time to time. FIIs include Asset Management Companies, Pension Funds, Mutual Funds, Investment Trusts as Nominee Companies, Incorporated / Institutional Portfolio Managers or their Power of Attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies.
- SEBI acts as the nodal point in the registration of FIIs. The Reserve Bank of India has granted general permission to SEBI Registered FIIs to invest in India under the Portfolio Investment Scheme (PIS).
- Investment by SEBI registered FIIs and its sub accounts cannot exceed 10per cent of the paid up capital of the Indian company. However, in case of foreign corporates or High Networth Individuals (HNIs) registered as sub accounts of an FII, their investment shall be restricted to 5 per cent of the paid up capital of the Indian company. All FIIs and their sub-accounts taken together cannot acquire more than 24 per cent of the paid up capital of an Indian Company. An Indian company can raise the 24 per cent ceiling to the sectoral cap / statutory ceiling, as applicable, by passing a resolution by its Board of Directors followed by passing a Special Resolution to that effect by their General Body. The Indian company has to intimate the raising of the FII limit to the Reserve Bank to enable the Bank to notify the same on its website for larger public dissemination.
- SEBI registered FIIs/sub-accounts of FIIs can invest in primary issues of Non-Convertible Debentures (NCDs)/ bonds only if listing of such bonds / NCDs is committed to be done within 15 days of such investment. In case the NCDs/bonds issued to the SEBI registered FIIs / sub-accounts of FIIs are not listed within 15 days of issuance to the SEBI registered FIIs / sub-accounts of FIIs, for any reason, then the FII/sub-account of FII shall immediately dispose of these bonds/NCDs either by way of sale to a third party or to the issuer and the terms of offer to FIIs / sub-accounts should contain a clause that the issuer of such debt securities shall immediately redeem / buyback the said securities from the FIIs/sub-accounts of FIIs in such an eventuality.

11. External Debt

External debt (or foreign debt) is that part of the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the International Monetary Fund (IMF) and World Bank. Note that the use of gross liability figures greatly distorts the ratio for countries which contain major money centers, e.g. United Kingdom, because of London's role as a major money centre. Contrast Net international investment position.

11.1 SHORT-TERM DEBT

An account shown in the current liabilities portion of a governments balance sheet. This account is comprised of any debt incurred by a government that is due within one year. The debt in this account is usually made up of short-term bank loans taken out by the government

11.2 LONG-TERM DEBT

Loans and financial obligations lasting over one year. Long-term debt for a company would include any financing or leasing obligations that are to come due in a greater than 12-month period. Such obligations would include company bond issues or long-term leases that have been capitalized on a firm's balance sheet.

11.3 GOVERNMENT DEBT

Maintaining sustainable levels of government debt is critical to sustained high macroeconomic outcome. In fact, typically the fiscal rules under the fiscal responsibility and budget management framework entail assessment of what is usually a sustainable level of public debt for the country. The FRBMA 2003 had an incremental debt assumption rule in addition to the cap on fiscal deficits envisaged by the terminal year 2008-09. On account of the fiscal expansion in 2008-09 and 2009-10, the targets had to be relaxed and a new FRBM framework was necessitated. Even in the years of fiscal expansion there has been marginal decline in outstanding liabilities as a proportion of GDP. These declined from 56.9 per cent in 2007-08 to 51.2 per cent in 2010-11 (RE) and are budgeted at 48.8 per cent in 2011-12 (.As against the targets set by the Thirteenth Finance Commission and the Government Debt Report 2010, there has been overperformance in terms of reduction in government debt, driven by the favourable dynamics of the positive and sizeable differential between GDP growth rates and interest rates.

11.4 EXTERNAL DEBT STATISTICS

At end March 2011, India's external debt stock was US$ 306.4 billion (Rs 13,68,477 crore) recording an increase of US$ 45.4 billion (17.4 per cent) over the end March 2010 level of US$ 261.0 billion (Rs 11,78,994 crore). Component-wise, long-term debt increased by 15.7 per cent to US$ 241.4 billion at end March 2011 from US$ 208.7 billion at end March 2010 while short-term debt based on original maturity, showed an increase of 24.2 per cent to US$ 65.0 billion from US$ 52.3 billion at end March 2010.

India's external debt stock increased by US$ 20.2 billion (6.6 per cent) to US$ 326.6 billion at end September 2011 over end March 2011 estimates of US$ 306.4 billion. This increase was primarily on account of higher commercial borrowings and shortterm debt, which together contributed over 80 per cent of the total increase in external debt. The rise in short-term trade credits is in line with the increase in imports associated with reasonably strong domestic economic activity.

The maturity profile of India's external debt indicates the dominance of long-term borrowings. Long-term external debt at US$ 255.1 billion at end September 2011, accounted for 78.1 per cent of total external debt. Long-term debt at September 2011 increased by US$ 13.6 billion (5.6 per cent) over the end March 2011 level, while short-term debt (original maturity) registered an increase of US$ 6.5 billion Under long-term debt, components such as commercial borrowings, NRI deposits, andmultilateral borrowings taken together accounted for 61.3 per cent of total external debt at the end of September 2011 while other long-term debt components (bilateral borrowings, export credit, IMF, and rupee debt) accounted for 16.8 per cent. Thus long-term debt, taking into account all the components, accounted for 78.1 per cent of total external debt, while the remaining (21.9 per cent) was short-term debt at end September 2011.

The currency composition of India's total external debt shows that the share of US dollar denominated debt was the highest in external debt stock at 55.8 per cent at end September 2011, followed by Indian rupee (18.2 per cent), Japanese yen (12.1 per cent), SDR (9.1 per cent), and euro (3.5 per cent). The currency composition of government (sovereign) debt indicates predominance of SDR denominated debt (37.3 per cent), which is attributable to borrowing from the IDA, i.e. the soft loan window of the World Bank under the multilateral agencies, and SDR allocations by the IMF. The share of US dollar-denominated debt was 26.5 per cent followed by Japanese yen denominated (19.9 per cent).

Under India's external debt, government (sovereign) external debt stood at US$ 79.3 billion, while non-government debt amounted to US$ 247.3 billion at end September 2011. The share of government external debt in total external debt declined from 25.5 per cent at end March 2011 to 24.3 per cent at end September 2011. The ratio of government debt to GDP also posted a decline and remained in the range of 4.6 to 5.1 per cent over the past three years.

Over the years, India's external debt stock has witnessed structural change in terms of composition. The share of concessional in total debt has declined due to the shrinking share of official creditors and government debt and the surge in nonconcessional private debt. The proportion of concessional in total debt declined from 42.9 per cent (average) during the period 1991-2000 to 28.1 per cent in 2001-10 and further to 14.7 per cent at end September 2011. The rising share of nongovernment debt is evident from the fact that such debt accounted for 65.6 per cent of total debt during the 2000s vis-a'-vis 45.3 per cent in the 1990s. Nongovernment debt accounted for over 70 per cent of total debt in the last five years and stood at 75.7 per cent at end September 2011.

The share of ECBs in India's total external debt has increased substantially over the past few years. While between end March 2001 and end March 2006, the share of ECBs in total external debt declined from 24.1 per cent to 19.0 per cent, the compound annual growth in such borrowings was 1.7 per cent. However, between end March 2006 and end March 2011, ECBs have registered a compound annual growth rate of 27.4 per cent with the share in total external debt climbing up to 30.3 per cent at end September 2011. The increase in ECBs in the recent period caused some concern given the depreciation of the rupee as it would mean a higher debt service burden in rupee terms that could impact profitability and the balance sheets of corporate borrowers.

India's foreign exchange reserves provided a cover of 95.4 per cent to the total external debt stock at end September 2011 vis-à-vis 99.5 per cent at end March 2011. The ratio of short-term external debt to foreign exchange reserves was at 22.9 per cent at end September 2011 as compared to 21.3 per cent at end March 2011. The ratio of concessional debt to total external debt declined steadily and worked out to 14.7 per cent at end September 2011 as against 15.5 per cent at end March 2011.

India's external debt has remained within manageable limits as indicated by the external debt to GDP ratio of 17.8 per cent and debt service ratio of 4.2 per cent in 2010-11. This has been possible due to an external debt management policy of the government that emphasizes monitoring long- and short-term debt, raising sovereign loans on concessional terms with long maturities, regulating ECBs through end-use and all-in-cost restrictions, and rationalizing interest rates on NRI deposits.

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