Box 23.2

Tracks in time

1844-46: MacDonald Stephenson asks the Bengal government, administered by the East India Company (EIC), to build a railway line from Calcutta to the North West Frontier. Bombay businessmen ask for a line across the Western Ghats. Two companies, the East India Railways (EIR) and the Great Indian Peninsular Railways (GIPR) are formed and the directors of the EIC approve their proposals. Lord Hardinge, the governor general, argues that railways will facilitate, "the rapid concentration of infantry and artillery," and promote "the cheap prevention of insurrection, speedy termination of war and safety of the empire."

1850: The EIR and GIPR begin railway construction.

1853-1859: The first experimental railway line, running between Bombay and Thane, opens. Lord Dalhousie, the new governor general, sees this as a means to expand trade and writes in his famous Railway Minutes, "Great tracts are teeming with produce they cannot dispose of." The railways have the expected explosive impact on trade: imports of cotton and woollens grow over 100 per cent and machinery over 250 per cent from 1848 levels. Exports of raw cotton grow by 240 per cent, and that of foodgrains by a whopping 580 per cent in the same 10 years. India begins to globalise.

1860-1868: Over 4,000 miles of lines are built at a cost of Rs.89 crore by eight private sector companies. To promote infrastructure investment, the government issus guarantees: an assured rate of return of 4.5 to 5 per cent on capital, at a fixed exchange rate of 22 shillings to a rupee. By 1869, the flaws of these guarantees become apparent-goldplating imposes huge costs on the government. Costs, initially estimated at £9,000 to £15,000 per mile, shoot upto £20,000 per mile, with EIR building lines at £23,000 per mile. Reformers ask for guarantees to be scrapped.

1869: Though the old railway companies remain, the government decides to implement new projects by itself. This boosts efficiency: new lines cost 30 per cent less than the company lines, and 88 per cent new lines are added in 10 years. But company lines have higher returns than state lines.

1882-1900: Famines and war drain government finances. And stoke demand for bigger railways investment as well. The government decides to call back private investors. This time, guaranteed returns are lower at 3.5 per cent and the state and companies decide to split profits. Though operations on company lines are privately managed, the state retains notional ownership over lines. By 1900, railway tracks cover over 24,000 miles. However, administration-split between companies, the British government, princely states, native states and foreign governments-is chaotic.

1920: World War I takes a heavy toll on the railways. The cash strapped government neglects new investments for many years, and the quality of service drops dramatically. A committee chaired by Sir William Acworth, decides to separate the railway budget from the consolidated budget of the government. This, Sir William believes, will sever the railways' dependence on government funds. This is also why India continues to have a rail budget apart from the Budget of the Union government.

1947 to the present: At Independence, India gets 34,083 miles of railway tracks; about 7,000 miles go to Pakistan. India's early planners put great store by railway development and fund it generously. However, political interests, state ownership, controls and corruption in the railway bureaucracy turn it into a trundling dinosaur-vast but liked by nobody. Route kilometres expand by about 290 per cent in 50 years, a growth rate of a little more than two per cent per year.

Compared to Chinese railways, IR is a poor cousin.

IR is managed by the Railway Board which in turn is supervised by the Ministry of Railways. The actual management of IRs operations is vested in nine zonal offices. Each zone is further subdivided into 60 divisions, each being headed by a divisional railway manager.

The Ministry of Railways has set up several public sector units to handle different areas of activities. These include Rail India Technical and Economic Services, which offers consultancy services in India and abroad; Ircon International Ltd., which is engaged in construction activities in India and abroad; the Indian Railways Finance Corporation, which helps monitor finance; the Container Corporation of India, which handles domestic and international container cargo; and RailTel Corporation of India which is spearheading IRs telecom sector.

IR has also developed two special purpose vehicles-Gujarat Pipavav Port Ltd., for improved rail connectivity to ports; and Rail Vikas Nigam Ltd., to implement projects such as the Golden Quadrilateral and port connectivity.

All these details are, no doubt impressive, but do not compare well with those of China for example, as Table 23.3 reveals. Over a period of 50 years, IR's progress in various dimensions has been almost stagnant while in the same period China's railways witnessed meteoric rise.

With corporatisation of its organisation and structure, commercial autonomy, involvement of private sector and foreign investment, Chinese Railways (CR) has been steadily downsizing, hiving off non-core businesses, introducing fare and freight tariffs consistent with market economy tenets, and constantly improving freight and passenger services. Indian Railways, on the contrary, remains engrossed mostly with trivial issues.

Table 23.3

The Long and Short of it

	China Railways*		Indian Railways**	
	[illegible]	[illegible]	1950-51	2002-03
Route km	[illegible]	73,002	53,596	63,122
No.of passengers (million)	[illegible]	973	973	4,971
Total passengers km (billion)	[illegible]	479	63	515
Average journey length (km)	[illegible]	92	52	104
Freight carried (million tonnes)	[illegible]	2,212	93	543
Freight tonne km (billion)	[illegible]	[illegible]	44	356
Average lead (km)	[illegible]	780	470	656

(**Source**: *Tiedao Zhishi, **Ministry of Railways, India)

The problem is, unlike Chinese railways, IR has been run on ideological grounds and not as a commercial enterprise.

IR has been run on ideological grounds and not as a commercial enterprise. It has been operating uneconomical routes, and cross-subsidising losses in passenger traffic through revenues from cargo movement. IR has excess staff and 50 per cent of revenue goes to employee remuneration and benefits. Ever increasing freight tariffs are forcing several customers to shift to roads. There has been considerable loss of traffic in cement, petroleum and iron and steel.

By and large, the railway journey is still a nightmarish experience as it was 100 years ago (See Box 23.3). Obviously, many passengers are shifting to road transport. Journey by trains is not safe too as a major accident occurs every three months (see also Box 23.4). By the turn of the millennium, a quarter of the tracks, 40,000 coaches and wagons, several hundred bridges and thousands of signals had outlived their service life.

Box 23.3

Facilities in Railways 86 years ago

(Letter written by a traveller in 1909)

Dear Sir,

I am arrive by passenger train Ahmedpur station and my belly is too much swelling with jackfruit.

I am therefore went to privy, just doing the nuisance that guard making whistle blew for train to off and I am running with lotah in one hand and dhoti in the next when I am fall over and expose all my shocking to man and female women on platform. I am got leaved at Ahmedpur station. This too much bad. If passenger go to make dung that dam guard not wait train five minutes for him. I am therefore pray your honour to make big fine on that guard for public sake. Otherwise I am making big reports to papers.

Your faithful servant

Okhil Ch.Sen.

It is argued that it is difficult to make IR accident-free because of its sheer size. One train is added nearly every day to its 63,000 km plus long network. Though most are freight trains, the addition of four express trains every month further burdens the staff who are already grappling with the task of transporting over 500 crore passengers every year.

IR has been initiating measures to improve its operations. Much attention is being focussed on upgradation of technology. Some of the high points have been the manufacture of the state-of-the-art electronic locomotives (through technology transfer from ABB), diesel locomotives (technology transfer from GE) and light weight coaches with anticlimbing features.

The Special Railway Safety Fund (SRSF) amounting to Rs.170 billion has been set up for the replacement of overdue renewal assets by the end of 10th plan period.

> Excess staff is the bone of contention with the IR.

One criticism against the IR relates to its excess staff strength. It has been limiting the hiring of additional staff. Between 1991-2001, the staff strength was cut by 2,62,000 reducing the number to 1.545 million. The target is to further trim the staff strength to 1.18 million by 2010 (Read also Box 23.5).

Roads occupy pivotal role in the economic development of any country. Road is the oldest and the most popular mode of transportation.

India has one of the largest road networks in the world (3.3 million km), comprising national highways (6556.9 km), state highways (131,899 km), district roads, rural roads, urban roads and special roads designed for defence purposes and for port connectivity. Together, Indian roads carry 85 per cent of passenger and 70 per cent of freight traffic.

> India has one of the largest road networks in the world.

Box 23.4

OFF TRACK: The Railway Accident Roster

	Brief Particulars	Killed	Injured
18 Apr' 89	Derailment of 927 Dn Karanataka Express between Lalitpur and Dailwara stations of Central Railway	69	216
1 Nov' 89	Derailment of 8 Dn Udyan Abha Toofan Express at Sakaldiha stations of Eastern Railway	50	60
16 Apr' 90	Fire in a coach of 383 passenger train near Gulzarbagh stations of Eastern Railway	75	47
21 Sep' 93	1593 Dn collied with 'N' SRE Up Goods between chhabra Gugur and Bhulon stations of Western Railway	78	88
14 May' 95	Head-on collision of 6019 Dn Madras kanya Kumari Express with Up Empty Super Jumbo goods train between Lokur and Danishpet stations on Palghat Division of Southern Railway	54	50
20 Aug' 95	Rear-end collision of 2801 Purshottam Express and 4023 Kalindi Express at Firozabad Station on Allahabad Division of Northern Railway	310	252
18 Apr' 96	Head-on collision between 583 Up Passenger and Dn GKP Tank Empty at Domingargh station of North Eastern Railway	54	84
14 Sep' 97	Derailment of 8033 Ahmedabad-Howrah Express between Naila and Champa stations on South Eastern Railway	88	369
5 Jan' 98	Rear end collision between 136 Dn passenger and 4258 Dn Kashi Vishwanath Express between Masit and Karna stations on Northern Railway	51	66
26 Nov' 98	Side collision between 3152 Dn Jammu Tawi-Sealdah Express and 2903 Up Golden Temple Mail between Khanna and Chawapil Stations on Northren Railway Ambala Division	209	140
21 Apl' 2005	Sabarmati Express rammed into goods train near Vadodara in Gujarat	18	114

Organisational arrangements include the Ministry of Road Transport and Highways and the National Highways Authority of India to monitor and supervise national highways. State highways are managed by public works departments of respective state governments. Some states have specific road and building departments to develop and maintain state road networks.

The National Highways Authority of India has started the National Highways Development Programme (NHDP) aiming to four – laning of 13,146 km of national highways.

The NHDP involves three phases. The Golden Quadrilateral Project (in Phase 1) spans a length of 5,846 km of national highways and is designed to connect four metro cities - Delhi, Mumbai, Chennai and Kolkotta. The project is scheduled to be completed by December 2005. Phase 2 spans a length of 7,300 kms of national

Box 23.5

Strengths, Weaknesses and Remedies (Railways)

A.Strengths
* Historical advantage- 85 percent of track being inherited from the British
* Largest in Asia and the third largest in the world
* Substantial electrified tracks
* Competitive advantage in project consultancy and construction
* Agenda for national integration

B.Weaknesses
* Ever increasing traffic load
* Inadequate finance
* Low productivity
* Low speed of goods as well as passenger trains
* Poor service to the passengers
* Absence of suitable transportation policy
* Too many social objectives
* Unslite Travel

C.Remedies
* Corporatise with detailed terms of reference approved by the Parliament
* Unbundle disparate operations like transportation of freight and passengers and equipment-manufacture
* Corporatise all manufacturing units and privatise them gradually
* Commercialise passenger services by abolishing all free travel, and privatise ticket-checking
* Phase out cross-subsidisation of passenger fares, through freight charges, so as to reflect real costs
* Make commercial use of railway property by selling or leasing it, to the private sector

(**Source:** Remedies from *Business Today*, October-November, 1996)

highways. This phase, also called North-South-East-West (NSEW), seeks to cut across the country diagonally, linking the northern tip at Srinagar to the southern tip at Kanyakumari and Porbandar in the west to Silchar in the east. Phase 3 involves the development of 10,000 km of roads.

> The NHDP involves three stages- Phase 1 – 5846 km Phase 2 – 7300 kms Phase 3 – 10000 kms

Road conditions in general are not good. Arterial roads suffer from severe capacity constraints. Most national highways are two-lane or single-lane. Only recently four-laning of national highways has started. Connectivity is another issue as 40 per cent of inhabitants are not connected by good roads. In addition, road safety is low. India has nine per cent of the world's road facilities while only 4.2 per cent of the world's vehicles fly on the Indian roads (Read also Box 23.6).

Shipping plays a crucial role in a nation's economy. Nearly 90 per cent of India's trade is handled by ships. India has 62.5 ships with gross registered tonnage of 69,44,206.

India has a rich maritime history, thanks to an extensive coastline and strategic location. During the 1970s and early 1980s, the Indian shipping industry flourished, achieving significant milestones. It had a well diversified fleet, soaring business and a well-developed shipping building and repairing industries. But today, Indian shipping is a miniscule component of the world's shipping industry.

> India has a rich maritime history thanks to an extensive coastline and strategic location.

Box 23.6

Strengths, Weaknesses and Remedies (Road Transport)

A. Strengths

* One of the world's largest, stretching for almost 3.3 million across the country.
* Relatively low vehicle density per km.
* Ease the burden on railways.

B. Problems

* Only 1.6 percent of road strength is occupied by national highways, 5.86 percent by state highways and 92.54 percent by district and village roads. Except the national highways, the condition of other roads is pathetic.
* Several missing links, unbridged river crossings, weak culverts and inadequate road pavement enroute.
* Remote parts of the country are still not connected.
* Veritable death traps.
* Lack of adequate finance.
* Increasing pollution.

C. Remedies

* Allocate additional resources for upgrading and widening existing national and state highways.
* Create a highway development fund as an extra-budgetary development fund for funding highways.
* Set up a financing mechanism for funding road construction, using the toll system for cost recovery.
* Encourage private sector participation in highways by institutionalising build-operate-transfer schemes.
* Earmark a proportion of the state's levies on vehicles and fuels for road maintenance.
* Amend the loans to allow for Right of Way in land acquisition for laying roads.

(**Source**: Remedies from *Business Today*, Oct-Nov, 1996)

Shipping is a central subject. The National Shipping Board advises the government on shipping matters. The industry is governed by three separate acts - the Merchant Shipping Act, 1958; the Inland Vessels Act, 1917; and the Coastal Vessels Act, 1838.

The state-owned Shipping Corporation of India dominates the industry. There is private sector participation also with Great Eastern Shipping, Essar Shipping, Varun Shipping and Shabi Shipping playing their due shares. In ship building, state owned Hindustan Shipyard based in Visakapatnam is the leader. India has seven public sector shipyards and about 20 small-to-medium sized shipyards in the private sector.

The present fleet of shipping companies is quite diversified as it has modern liner vessels, tankers, bulk carriers and semi-container ships as also ships catering to refrigerated cargos. But there are problems. The shipping industry was hit by severe recession, through since 2000 it has improved. Domination of foreign lines is another problem. Port facilities have not kept pace with the advancements made in shipping industry.

When we talk about shipping, ports cannot be left out. India has 160 odd ports along its coastline. But only a few of these are cargo handling installations. These include 12 major ports (controlled by the Union Government) and 40 minor ports in the private sector. 12 major ports handle three-fourths of the cargo traffic and the remaining carry one-fourth of the cargo.

Each major port is managed by a port trust, with a chairman appointed by the Central Government. The minor ports are under the administrative control of the respective state governments. Gujarat leads in minor ports having 20 of them.

Indian ports are governed by the Indian Ports Act, 1908, and the Major Port Trusts Act, 1963. All the major ports are under the regulatory authority of the Tariff Authority for Major Ports (TAMP), which determines tariff. Maritime boards oversee minor ports in Gujarat, Maharastra and Tamil Nadu.

Ports in general face several problems. Lack of modernisation, ineffective managerial practices, excess staffing, cumbersome operational procedures and absence of a multi-modal network are some of them.

The phenomenal growth of our merchant navy from a modest base of 0.2 m.GRT in 1947 to 6.3 m.GRT has placed our country 17th among the maritime nations of the world, realising the dream of Jawaharlal Nehru, who was *"impatient to see Indian ships carrying the flag of India across the distant seas to far away countries."* Today, our shipping industry can boast of a modern versatile and technically superior fleet with an average of 13 years as against the world average of 17 years and is well equipped to compete in the international markets.

On the flip side, it needs to be stated that the nation is losing more than $10 billion because of the lack of efficient shipping services. China, which is keen on importing coal and chemicals from us and has recently signed air and shipping agreements is facing a unique predicament: *lack of direct shipping links*. This results in a loss of $1 billion. Other serious problems related to the congestion and poor turnaround time for ships. Around half the time at ports is used for unloading a ship (Read also Box 23.7).

The country is losing more than $10 billion because of the lack of efficient shipping services.

Civil Aviation has three functional sub sectors: operational, infrastructural and regulatory-cum-developmental. On the operational side, Indian Airlines Limited, Vayudoot (which functions as a separate identifiable division of Indian Airlines Limited) and private air lines (Scheduled and Non-Scheduled) provide domestic air services. Air India Limited and Indian Airlines Limited are domestic airlines which provide international air services. Pawan Hans Limited provides helicopter support services, primarily to the petroleum sector. Infrastructural facilities are provided by the International Airports Authority of India (IAAI) and the National Airports Authority (NAA). These two authorities are being merged to form a single authority *viz*. Airports Authority of India as a result of the enactment of the Airports Authority of India Act, 1994. The regulatory and developmental functions are looked after by the Ministry of Civil Aviation and the offices of the Directorate General of Civil Aviation.

The Air Corporation Act, 1953, was repealed on March 1, 1994, ending the monopoly of Indian Airlines, Air India and Vayudoot over scheduled air transport services. Six private operators, who were hitherto operating as air taxis, have since been granted scheduled airlines status.

The competitive environment on domestic services has been, in effect, existent since April, 1993. By March 1994, 19 aircraft in the 120 plus category, belonging to private air taxis, were in operation. The natural consequence of creating a competitive environment in this sector was that, by March 1994, 25 per cent of the market was being catered to by private air taxis. The number of passengers carried by air taxi

Box 23.7

Strengths, Weaknesses and Remedies (Shipping)

A.Strengths

* Long coastline of over 5700 kms and almost the whole of foreign trade passing across the seas.
* Largest merchant shipping fleet among the developing countries and 14th in the world in shipping tonnage.
* Skilled and competent managerial and ship board personnel.
* Huge potential in the wake of India becoming one of the signatories of the WTO. There will be considerable increase in sea-borne trade.

B.Weaknesses

* Limited cargo handling capacities of ports
* Challenge from containerisation which is highly prevalent in advanced countries.
* Fund starving.
* Undue hardships to ship owners due to conversion of FOB items into CIF which has been introduced because of decanalisation.

C.Remedies

* Amend the Major Port Trust Act, 1963, to allow private sector BOT projects at the 11 major ports.
* Raise the capital expenditure ceiling of the port trust boards from Rs.5 crore to Rs.200 crore.
* Abolish the need for PIB approvals for private projects that do not need port trust investment.
* Unbundle activities like cargo handling and warehousing into profit centres.
* Allow port-based businesses to create captive facilities for themselves under the BOT system.
* Initiate restraining programmes to reduce labour resistance to private sector participation.

(Source: Remedies from *Business Today, Oct 22-Nov 6, 1996)*

With the policy of open skies, competition in the airline industry is heating up.

operators has increased from 15,000 in 1990 to 4.1 lakh in 1992, 29.2 lakh in 1993 and is expected to cross 35 lakh during 1994. Thus, Indian Airlines, on the one hand, had to share the market on its profitable trunk routes. On the other hand, it faced the threat of loss of critically skilled personnel to private operators who offered much higher emoluments. This affected its ability to optimally deploy its existing aircraft capacity. Indian Airlines has also geared itself since June, 1993 to the challenging task of adapting itself to a competitive environment. Several measures have been taken, mainly centred on making the organisation adopt a marketing approach to decision-making and considerably improve the quality of its product. It has improved its passenger facilities both on board and on the ground, on time performance, flight safety measures and has also increased employee participation to provide better services.

The Indian Airlines suffered a loss of Rs.235 crore during 1993-94, up by Rs.66 crore over the previous year. However, Air India earned a profit of Rs.200 crore in 1993-94 down by 40 per cent compared to the profit of the corresponding previous year.

There are problems at the aviation front. Poor service, mediocre designs, poor maintenance, indifferent standards of operation and resource crunch are the major problems beguiling our civil aviation network.

As on today there are five categories of air ports - international, joint venture, custom, domestic, and others. The total passenger traffic across all these five categories rose by 27.2 per cent during April-June 2004 as compared to April-June 2003. There was also an increase in the aircraft and cargo movements during this period. Aircraft traffic increased by 17.8 per cent in the same period and that of cargo traffic rose by 18.5 per cent.

Poor service, mediocre designs, poor maintenance, indifferent standards of operation and resource crunch are the major problems of civil aviation network.

Indian airports handled an all-time high of 59.3 million passengers in 2005. The figure, released by the Airport Authority of India, represents a 21.7% growth over the 48.7 million passengers handled in 2004. The huge growth places Indian airports among the fastest-growing in the world next only to China, where a few airports have reported higher growth.

The AAI manages 126 airports, which include 11 international and 89 domestic ones. Mumbai's Chhatrapati Shivaji Airport has historically been the top performer, with an 18% growth in traffic handling 15.7 million passengers in the year ended March 2005. Delhi airport grew faster at 23%, handling 12.8 million passengers. Domestic passenger numbers grew at a faster clip at 24.2%, while international passenger growth in 2005 was 16.7%.

Telecommunications

One infrastructural facility that has witnessed a revolutionary change is the telecom sector. This sector is witnessing technological advancements, greater competition, better service standards and lower prices. Consumers now have choices in any segment of any circle.

Basic services In the ongoing developments worst hit segment is the fixed line service. The subscriber base in this segment grew from 41.48 million on March 31, 2003 to 42.84 million on March 31, 2004, a growth of just three per cent. Experts believe that with this trend the fixed line service will be overtaken by mobile subscriber base in the immediate future.

Fixed line service is the worst hit.

The low growth in the fixed line segment is due to a combination of a low subscription rate and many subscribers surrendering their fixed line phones.

The talking point in the basic service segment has been the phenomenal growth achieved by CDMA-based WLL (M) operators. From a subscriber base of only 320,000 in March 2003, the industry added 7.25 million new subscribers by March 2004, thus registering an incredible growth rate of 2266 per cent. Reliance Infocom emerged as the largest WLL(M) operator with 6.47 million subscribers. The other key player is the Tata Teleservices Limited which had a subscriber base of 1.62 million by March 2004.

Cellular services By September 2004, the total number of cellular subscribers was 33.55 million. This sector has been attracting 1.4 million subscribers per month. The main reasons for this rapid expansion are aggressive marketing, and the falling prices of airtime and hand sets. The public perception of cellular phones has changed from that of a luxury item to an utilitarian device needed by even those in lower income groups.

Internet services The Internet subscriber base has grown from 3.32 million in 2003 to 4.92 million in 2004. There are about 189 Internet service providers operating across India. BSNL, VSNL and MTNL are the top players in Internet segment.

For a population of billion plus, an Internet subscriber base of 4.92 million is miniscule.

For a population of 1.08 billion, a subscriber base of 4.92 million is not encouraging. The main reason for low penetration of Internet is the high cost. Lack of accessibility is another reason for low subscriber base. However, realising the importance of information networking, the government has decided to give a major thrust to Internet connectivity and subscriber additions. It has announced a policy on accelerating Internet and broadband penetration in October 2004.

Box 23.8

Milestones in India's Telecom

Year	Milestone
1851	First telephones in India
1943	Government of India nationalised private telephone companies.
1984	Manufacture of subscriber equipment commences in private sector.
1985	Creation of Telecommunications Board and DoT within the Ministry of Communications.
1986	Creation of MTNL and VSNL
1989	Telecommunications Board replaced by Telecommunications Commission.
1991	Telecom equipment manufacture opened up to private sector. Major international players entered equipment manufacture.
1992	Value added services opened to private sector (subject to licence fees).
1993	Private networks allowed in industrial areas.
1994	Licences for paging in 27 cities issued.
May 1994	New Telecom Policy announced.
Sept 1994	Broad guidelines for private entry into basic services announced.
Nov 1994	Licences for cellular services in four metros issued.
Dec 1994	Tenders floated for bids in cellular services in 19 cities (other than four metros) on a duopoly business.
Jan 1995	Tenders floated for 2nd operator in basic services(in addition to DOT) on a circle basis.
July 1995	Cellular tender bid opened.
Aug 1995	Basic service tender bid opened amidst controversy. Most bids considered 'too low'. VSNL's Internet services commence.
Dec 1995	LoIs issued to some operators for cellular.
Jan 1996	Rebidding took place for basic services in 13 circles. The response was poor. TRAI formed.
March 1996	LoIs issued for basic service.

(Source: Rakesh Mohan Expert Group Report (1996) CMIE and other sources.)

Private sector operators like Sify, Bharti, Reliance and TTSL are vigorously promoting Internet solutions like kiosks, cyber cafes, wireless broadband through mobile, and the like (Also read Box 23.8 and Box 23.9).

India has the largest network of *Post Offices* in the world. By the end of March 1994, the national postal network had over 1.5 lakh post offices. The long term objective

Box 23.9

Strengths, Weaknesses and Remedies (Telecommunications)

A. Strengths

* Huge potential for expansion.
* Rapid growth in the last couple of years with annual growth of 13 percent between 1984 and 1994 and 20 percent thereafter.
* Relatively high density with 7.97 phones per 100 towns people ahead of China and Indonesia.
* High technology- 66 percent of exchanges are digital.

B. Weaknesses

* Waiting period of nearly two years to get new connections
* Poor maintenance- 218 faults for 100 lines every year.
* Privatisation efforts not successful.

C. Remedies

* Accelerate the clearance process for private sector entry into basic telecom services.
* Offer incentives to private telecom companies for meeting connection and low-fault targets.
* Resolve disputes between private operators and the DoT over long-distance connections immediately.
* Convert the DoT into a holding corporation, with its subsidiaries operating services in different circles.
* Replace the Indian Telegraph Act, 1885 with a new Act incorporating the impact of technology changes.

(Source: Remedies from *Business Today*, Oct 22-Nov 26, 1996)

was to locate a post office within 3 kms of every village. During 1993-94, a total of 637 additional extra-departmental branch post offices and 116 departmental sub-post offices were sanctioned. The department has also worked out plan to accelerate this effort by providing basic postal facilities on a contractual basis by utilising the existing infrastructure of Panchayats in these areas. The Panchayat Dak Sewa Scheme, formulated in this regard, has the twin advantage of reducing dependence on budgetary resources for expanding postal facilities to the needy areas and generating employment opportunities in such areas.

India has the largest network of post offices.

CONCLUSION

Though the picture presented till now is impressive, there is no gainsaying the fact that our country lags behind in overall infrastructure development. Whether it is per capita energy consumption, number of telephone installations or percentage of good roads, we rank the lowest (See Table 23.4). Consequently, our country ranks very poorly in global competitiveness. Obivously, this is not a good sign for a country which wants to invite foreign investments in a big way.

With regard to overall infrastructure development, India lags behind China.

Take a look at China, instead. In the past decade, China has built at least 12 major international airports, 29,000 kilometres of high quality four-lane highways and numerous renovated city centres and bustling shopping districts. It is using cutting technologies, including high-speed trains and newest telecommunication technologies. Its Guangzhou airport can handle 27 million passengers and one

Table 23.4
Critical Comparisons

	Per capita energy use*	Telephone lines per 1,000 persons	% of paved roads in good condition
India	235	6	20
Pakistan	[illegible]	8	18
Brazil	681	63	30
Malaysia	1445	89	n.a.
Mexico	1525	66	85
S.Korea	2569	310	70
Indonesia	303	6	30
Thailand	614	24	50
USA	7662	545	85+

*Equivalent to kg oil

(**Source** : *World Development Report*, 1994)

Table 23.5
India's Ranking in Global Competition

(out of 48 countries)

Years	Ranking
1991	10
1992	13
1993	14
1994	41
1995	43

(**Source** : *World Competitiveness Report*, 2004)

million tonnes of cargo a year. In comparison, all of India receives barely three million visitors a year.

In 2002, China made English a mandatory language starting from an early age and it is the top destination for foreign investment for three years running. Its Haier group (white goods), TCL Corp (electronics and telecommunications), Bird International (mobile phones) and Lenovo group (computers) are expected to become global brands within 20 years. The Chinese are also very significant in oil, gas and energy, and heavy industries. No wonder, China is ahead of us in all respects.

QUESTIONS

1. Outline the present status of infrastructual facilities in our country.
2. Point out the constraints which inhibit the rapid growth of infrastructual facilities.
3. Bring out the role of infrastructure in the economic growth of a country.
4. Bring out the strengths, weaknesses and remedies for different areas of infrastructure.
5. Comment on the new budget proposals for infrastructure development.

CHAPTER

24

Development Banks

CHAPTER OUTLINE

Operations and Trends

Critical Assessment

- *Promotion of Small Scale Industries*
- *Promotion of Entrepreneurs*
- *Development of Backward Areas*
- *Industrial Development*
- *Other Features*

Narasimham Committee on FDIs

- *Appreciation*
- *Weaknesses of DFIs*
- *Recommendations*

The Road Ahead

LEARNING OBJECTIVES

After reading this Chapter, you should be able to:

1. *Understand the meaning of development banks.*
2. *Analyse the operations and describe the trends of DFIs.*
3. *Make a critical evaluation of the role played by DFIs.*
4. *Recollect the findings of the expert committee on DFIs.*
5. *Carve the role of DFIs during the days ahead.*

The financial sector is another segment of an economy, covering such areas as development banks, stock exchanges and monetary policy. Development banking is covered in this chapter. Stock exchanges and monetary policy will be discussed in the next two chapters.

Financial institutions, also called development banks or development financing institutions (DFIs), are owned and managed by the Central Government or the concerned State Government. This is so because, with the adoption of economic planning, building up an appropriate structure of financial institutions has become a necessity.

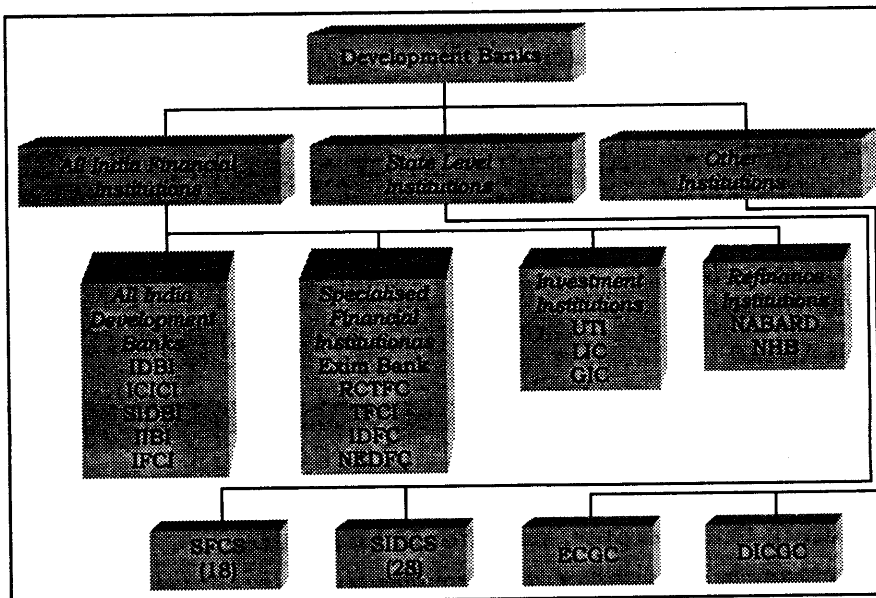
Development banks are owned and managed by the Central Government. There are 57 such banks in existence as on today.

"It would be inconsistent," wrote E.Nevin, "with a general development programme if the financial mechanism by which the programme must be applied in practice is operating in a direction different from the priorities laid down by the government's economic policy."[1]

Naturally, the government should make finance available to business, in an organised way, as an integral part of its broad strategy of planned development. The first step towards building up a structure of financial institutions was taken with the establishment of the Industrial Finance Corporation of India in 1948. Since then ,there was no going back. At regular intervals, either a new institution was setup or an existing unit in the private sector was taken over by the government. As of today, we have 57 DFIs in our country, catering to the different needs of industry. The break-up is as follows: (Also see Fig. 24.1)

Figure 24.1

All Financial Institutions



A. All-India Financial Institutions (AFIs)

Industrial Development Bank of India (IDBI) (now merged with IDBI Bank).
Industrial Finance Corporation of India Ltd (IFCI).
Industrial Credit and Investment Corporation of India Ltd. (ICICI).
Life Insurance Corporation of India(LIC).

- General Insurance Corporation of India(GIC).
- Unit Trust of India(UTI).
- Industrial Investment Bank of India Ltd.
- National Housing Bank.
- Infrastructure Development Finance Co. Ltd.
- Export-Import Bank of India(EXIM Bank).
- Small Industries Development Bank of India(SIDBI).
- Risk Capital and Technology Finance Corporation Ltd. (RCTFC).
- Technology Development and Information Company of India Ltd.(TDICI).
- North-Eastern Development Finance Corporation.
- Tourism Finance Corporation of India Ltd.(TFCI).
- National Bank for Agriculture and Rural Development(NABARD).

B. State-Level Institutions

- State Financial Corporations(SFCs)-there are 18 SFCs in operation.
- State Industrial Development Corporation(SIDCs)-there are 28 SIDCs in operation.
- Technical Consultancy Organisation(TCOs)-there are 17 TCOs in operation.
- IDBI is the premier institution which coordinates the activities of all other DFIs at the national and state levels.

C. Other Institutions

- Export Credit and Guarantee Corporation (ECGC).
- Deposit Insurance and Credit Guarantee Corporation(DICGC).
- IDBI is the premier institution which coordinates the activities of all other DFIs at national and state levels.

Among the all India institutions, IDBI, IFCI and ICICI provide financial assistance to medium and large industries, whereas SIDBI caters to the needs of small and tiny industries. These institutions also undertake promotional and developmental activities. RCTC, TDICI and TFCI are called the specialised financial institutions. RCTC and TDICI provide risk capital, venture capital and technology development finance. TFCI extends finance to hotels and tourism related projects. LIC, GIC and UTI are called the investment institutions. The first two deploy their funds in accordance with the priorities set for them. UTI mobilises the savings of the society through the sale of units and channelises them into corporate investments. The investment institutions are major players in the secondary market; they also extend assistance to the corporate sector by way of term loans/underwriting/direct subscription to equity and debentures. The SFCs provide finance mainly to small and medium enterprises, whereas SIDCs cater to the needs of medium and large industries in their respective states. Apart from providing financial assistance, the SFCs and SIDCs also play promotional and developmental roles. TCOs provide, under a single roof, a total package of consultancy services to small and medium enterprises at reasonable rates. TCOs render consultancy services to individual entrepreneurs, government departments and agencies, various state level developmental/ financial institutions, commercial banks and other institutions in their tasks relating to industrial development and financing.

IDBI, IFCI and ICICI cater to the needs of medium and large scale units. SIDBI finances small scale units.

The financial institutions have been providing term finances to the industry in the form of loans, underwriting/direct subscriptions to shares/debentures and guarantees for almost four decades. Over the years, the institutions have developed

Financial institutions lend term loans to business units in the form of loans, equity participation and guarantees.

and introduced a variety of products and services to meet the growing needs of the corporate sector. Besides expanding the scope of their financing activity, the institutions have diversified into newer fee-based services offering an array of services such as merchant banking, debenture trusteeship and forex services.

In tune with the demands of liberalisations, these institutions have come out with new products and services.

In tandem with the emerging needs of industry in the liberalised environment, these institutions have reoriented their policies and assistance structure with much sharper customer focus, by developing and introducing a variety of products and services. In the post-reform period, AFIs set up several subsidiaries/associate concerns for offering a wide range of such newly developed products and services as also for capital market infrastructure development covering such areas as commercial banking, investment banking, non-banking finance, investor servicing, broking, venture capital financing, infrastructure financing, custodial services, electronic trading in stock exchanges, capital market regulation, registration and transfer services, credit rating and e-commerce.

OPERATIONS AND TRENDS

The aggregate sanctions and disbursements of all financial institutions are shown in Table 24.1.

As seen from Table 24.1, the cumulative sanctions and disbursements during 1999-2000 stood at Rs.10,43,408 million and Rs.684,804 million respectively. Certain trends can be observed from the assistance provided by the financial institutions.[2]

Table 24.1 *Assistance Sanctioned and Disbursements by All Financial Institutions*

(Rs.million)

Year	Sanctions	Growth Rate %	Disbursements	Growth Rate %
1990-91	191361.0	32.8	128101.0	32.9
1991-92	[illegible]	16.2	162729.0	27.0
1992-93	[illegible]	48.8	231525.0	42.3
1993-94	408570.0	23.5	266248.0	15.0
1994-95	576324.0	41.1	335772.0	26.1
1995-96	[illegible]	3.6	386979.7	15.3
1996-97	[illegible]	(-)16.3	429421.4	11.0
1997-98	749265.0	49.4	536660.1	24.9
1998-99	[illegible]	11.8	583942.3	8.8
1999-00	1043407.6	24.5	684804.2	17.3
Cumulative upto end March 2000	[illegible]		4354065.1	

(**Source**: IDBI, *Report on Development Banking in India*, 1999-2000, p.6)

1. While the absolute amount of assistance provided has increased over the years, there has been a continuous decline in the share of assistance in the total cost of projects sanctioned. The decline has been mainly due to the increasing contribution made by the promoters of projects. Another factor has been the absence of large projects seeking assistance.

2. The development banks which concentrated largely on long-term finances have now widened their operations to medium term finance such as asset financing, deferred payment system and the like.
3. The repeal of the convertibility clause since 1992 has its impact on lending. Financial institutions are now demanding equity participation from borrowers at the time of loan negotiation. There is also some trade-off between equity participation and the rate of interest. The equity offering encourages institutions to consider charging lower rates of interest. The companies also prefer to raise the debt component of the project through the capital market either fully or to some extent.
4. The relative role of development banks is on the decline while that of the investment institutions- LIC, UTI and GIC is on the rise. With access to concessional funds being phased out, development banks have lost their competitive advantage. At the same time, much of their funds are tied up in long term loans, resulting in a shortage of lendable funds. They have to rely increasingly on capital markets to raise funds which are more expensive.

CRITICAL ASSESSMENT

The role of development banks has been praiseworthy in the following areas:

Promotion of Small Scale Industries

Small-scale industries, as was stated in an earlier chapter, have a place of importance in achieving the national objectives of increased industrial production, generation of additional employment, more equitable distribution of income and reducing regional disparities.

> Financial institutions have done immense service to the cause of SSI sector.

Among the development finance institutions, SFCs operating at the state level promote and provide assistance to small industries. The National Small Industries Corporation at the state level assists small units in the procurement of raw materials and in marketing their products. They also operate hire-purchase schemes for the purchase of machinery and equipment.

With increasing support of DFIs, the small-scale industries have played a vital role in the economy. The contribution of small-scale industries to the net domestic product of the manufacturing sector as a whole is about 50 per cent at present. Nearly a fifth of the country's total export earnings is earned by the SSI sector.

Promotion of Entrepreneurs

The development finance institutions have taken a number of measures aimed at the identification and training of potential entrepreneurs. The IDBI along with other financial institutions and commercial banks has sponsored 17 technical consultancy organisations (TCOs) covering the entire country. The basic objective of TCOs is to provide to entrepreneurs a package of services such as preparation of feasibility studies and project reports, providing technical and management services for sorting out operational problems etc. Financial institutions have also been regularly sponsoring appropriate entrepreneur development programmes. They also extend assistance to new technicians and professional entrepreneurs who have the necessary ability to run and manage projects

> Financial institutions have been promoting entrepreneurial activities.

but lack the necessary financial resources. To supplement the efforts of such promoters to raise adequate equity capital, institutions have introduced special Seed Capital Schemes to provide assistance in the form of equity capital to new entrepreneurs. The IDBI operates its Seed Capital Scheme directly as well as through SIDCs and SFCs. Under the scheme, eligible new technical and professional entrepreneurs are extended seed capital assistance, subject to a maximum of Rs.55 lakh per project on very soft terms, to fill in the gap between the equity capital an entrepreneur can actually bring in and what is normally expected from him. The IFCI also provides seed capital in the form of interest-free loans to entrepreneurs. For this purpose, it has sponsored an institution - the Risk Capital Foundation.

Development of Backward Areas

At the time of independence, the Indian economy had already acquired a modest industrial base. Whatever industrial development that had taken place, however, was in response to the emerging market conditions and as a result of planned effort. After independence, balanced regional growth became a major goal of the national economic policy. The financial institutions have been encouraging the flow of assistance to industrially-backward areas by offering concessional interest rates and liberal financing norms, such as lower promoter's contribution, higher debt-equity ratio and longer moratorium and amortisation period.

The role of financial institution in the removal of imbalances is no less significant.

As seen in the Table 24.2, cumulatively upto March 31, 1994 sanctions to backward areas aggregated to Rs.26,286.3 crore.

Table 24.2

Assistance to Backward Areas

(Rs.crore)

Sector	1991-92	1992-93	1993-94	Cumulative upto end March, 1994*
Backward areas	2131.6	2958.0	3403.0	26286.3
Non-backward areas	4399.1	6240.1	9508.1	46825.8
	6530.7	9198.1	12911.1	73112.1

*Includes assistance to the small scale sector upto end March, 1990.

(**Source**: IDBI, *Development Banking*, 1993-94).

Development of backward regions is a highly complex process. Even with the best of intentions and change in attitudes, financial incentives alone will not be adequate to ensure the setting up of projects in backward areas at the desired pace. Considerable preparatory and promotional work has to be done to instill an industrial culture. The promotional efforts should include identification of project ideas, preparation of feasibility studies and managerial and entrepreneurial talents, providing managerial and technical assistance, continuous follow-up and monitoring projects.

Industrial Development

The DFIs have come to occupy a place of importance in the planning and promotion of industries in the country. Responding to the emerging requirements of industrial and economic growth, they have not only continuously increased the flow of assistance, (Read Table 24.3 for lending to corporate sector by just one institution, viz., IDBI) but

Table 24.3 IDBI's Financial Assistance

(Rs.Crores)

	Sanctions	Disbursements
1990-91	6331	4501
1991-92	6339	5769
1992-93	9285	6737
1993-94	12153	8100
1994-95	18607	10648
1995-96	19469	10636

(**Source**: *Report on Development Banking in India*, 1995-96, IDBI)

also developed a coordinated approach towards industrial financing. Within a span of 25 years or so, a wide network of DFIs has been established with some of them specialising in particular areas of development finance. At the same time, all DFIs have introduced important organisational changes, including decentralisation and delegation of powers to their branch offices. Lending procedures have undergone changes in response to the emerging requirements and as a result, the process of appraisal of project finance proposals as also sanctioning and the disbursal of assistance has become considerably simpler and quicker. Simultaneously, consistent with their role as catalysts in economic development, the financial institutions have been continuously enlarging the scope of theiroperations from providing financial assistance to the identification of industrial opportunities, identification and training of entrepreneurs, provision of techno-economic consultancy facilities, industrial research and other promotional activities.

Other Positive Features

- Long-term finance has been provided at fixed interest rates, thus doing away with considerable uncertainty to cash flow that a variable interest rate mechanism would have imparted;
- A substantial portion of equity of the new projects has been taken up by these institutions;
- These institutions have by and large, kept their financial position on sound lines; and
- They have promoted specialised financial institutions during the past decade[3].

The weaknesses of development banks are many. The prominent among them are:

Profitability wise financial institutions have lost heavily.

1. The profitability of the financial institutions has been low for obvious reasons. In the first place, quality of their portfolio has been poor. Until recently, there was a system of industrial licensing and once a licence was granted to an industrial unit, the term lending institutions did not bother to follow the required standards of project evaluation for loan approval. Besides, sick units were financed for employment considerations. Asset quality has, therefore, been poor.

Certain financial institutions have been specialising in unisectoral lending. This sectoral concentration does not permit the diversification of portfolio and the total risk, therefore, increases. This has also led to the poor quality of portfolio.

2. The financial institutions have been operating in a competition- free environment. Development banks join hands with investment institutions and operate on a consortium basis. They act like a cartel. This is an unhealthy practice, particularly when these institutions jointly own a large part of the corporate debt and equity. The borrowers, however, have found the consortium approach advantageous as they were assured of the required finance. But it is high time that a competitive environment is gradually introduced for the efficient functioning of these institutions, for better customer service at low cost and for safeguarding against scandals.

Development banks have joined hands with investment institutions to form cartels thus killing competition.

3. Government control and political influence are damaging the institutions to a considerable extent. The situation is much worse at the state level, where state financial institutions are treated like government departments by the political bosses. These institutions should be made autonomous in the true sense by appointing professional people, rather than politicians at the top management levels. Loan sanction should be based on proper financial and technical criteria of the project and not be guided by extraneous considerations[4].

4. Majority of the financial institutions have shown interest in the direct market purchase of shares than providing initial capital or underwriting issues. A close look at the activities of some of those development banks would reveal that they have mainly purchased shares of erstwhile FERA companies than financing new projects. The motive has been to earn more profits. Even where these institutions can underwrite the economically viable and socially necessary but smaller projects, they have preferred to invest their funds in subscribing to the new issues of the existing companies.

Several financial institutions are showing interest in purchase of shares than lending initial capital or underwriting issues.

This coupled with the latest trend of investing more in debenture stocks for a secured interest earning as well as limited-time liability and convertible bonds, diverts investible funds more to existing large companies than to the upcoming small and young entrepreneurs.[5]

5. The gap between sanctions and disbursements has been widening as shown in Table 24.4

Table 24.4

Disbursement / Sanction Ratio

(Percentage)

	1992-93	*1993-94*	*1994-95*	*1995-96*
IDBI	69.78	64.61	53.55	44.6
ICICI	57.44	51.97	45.66	38.9
SCICI	63.91	59.27	38.78	28.6
IFCI	73.83	57.75	49.63	33.1

(**Source**: *Business World*, 10-23, July 1996)

This gap reflects laxity on the part of term-lending institutions in the area of resource mobilisation.

6. Though tall claims are made about the role of development banks in removing regional imbalances, analysis of their lending reveals a totally different picture. For instance, during 1994-95, the four industrially advanced states like Gujarat, Maharastra, Tamil Nadu and West Bengal were sanctioned projects worth impressive sums of Rs.15,031 crore, Rs.10,492 crore, Rs.7,507 crore and 7,108 crore respectively, industrially backward states *viz.*, Uttar Pradesh, Rajasthan, Orissa and Madhya Pradesh could get sanctioned measly sums of Rs.2,303 crores, Rs.2,269 crores, Rs.2,197 crores and Rs.1,359 crores respectively. Development banks, as with captains of industry, have gone in search of green pastures to invest their funds.

Claims notwithstanding, regional inbalances continue to persist.

7. Development banks could not tackle the problem of growing sickness. The approach, to remedy sick units, till now has been on predictable lines-deferment of interest, funding of interest, rescheduling of loans, and provision of further finance- which has not made any dent. What is needed is pro-active approach to anticipate maladies early and to take steps in order to prevent their occurrence.

Nor the role of development banks in removing sickness is noteworthy.

8. State Financial Corporations have their own weaknesses. There were times, not long ago, when commercial banks were envious of State Financial Corporations (SFCs), the main direct term lending institutions for small scale industries (SSIs) and other small businesses, on the ground that the SFCs were empowered by statute to seize assets in case of overdues, while banks and central financial institutions had to put up with inordinate judicial delays to lay their hands on collateralised assets.

Now, the position is reversed. Banks and central FIs have been empowered copiously by the new law on recovery of dues, while SFCs face an uncertain future. A working group appointed by the Reserve Bank of India (RBI) on development financial institutions (DFIs) has recommended the winding up of the SFCs, saying they have "outlived their utility". The group (headed by N.Sadasivan, Banking Ombudsman, Maharashtra) pointed out that the non-performing assets (NPAs) of the 18 SFCs varied from 38 per cent to 99 per cent, and that hardly four of them were viable. It blamed the "single product" (term loan) character of SFCs, lack of professional expertise, lack of clarity as to who was the statutory regulator of SFCs and emergence of universal banking practices by commercial banks for the present plight of SFIs.

9. Development banks, over the years, have acquired majority stakes in several firms in the private sector as box 24.1 indicates. Their nominees are board members of these companies. But these directors have not been playing proactive roles in running the companies successfully. The directors are being accused of being indifferent and apathetic. Things have now changed for better. The nominee directors are now taking active interest in the affairs of the loanee companies.

The role of nominee directors in the boards of loanee firms has not been effective.

NARASIMHAM COMMITTEE ON DFIS

The Narasimham Committee which submitted its report in 1991 has both appreciation and criticism on DFIs. Following are its views and recommendations:

Appreciation

The Committee feels that in the last 40 years or more, the DFIs have largely succeeded in meeting their primary objective of providing funds for industrial investment. They have also tried to channel increasing flow of assistance to industrially less developed states and backward areas. The corporate sector has come to rely increasingly on the DFIs. Over the years, the DFIs have been increasing their share in the equity of the private corporate sector, have representation in the boards of management of companies (see box 24.1) and played a major role in corporate mergers and acquisitions.

Box 24.1

FIs in drivers' seats

Name of Company	*Group Share(%)*	*Promoters*	*FIs Share (%)*
ACC	*Tata*	*11.96*	*40.70*
TISCO	*Tata*	*10.85*	*44.93*
TELCO	*Tata*	*19.26*	*40.73*
Mysore Cement	*Birla*	*20.66*	*48.07*
VXL	*Birla*	*18.54*	*35.12*
Mahindra & Mahindra	*Mahindra*	*8.35*	*46.35*
Mahindra Ugine	*Mahindra*	*23.73*	*64.11*
Kirloskar Pneumatic	*Kirloskar*	*23.53*	*60.63*
Best & Crompton	*Mallya*	*18.38*	*55.78*
Modi Rubber	*Modi*	*26.49*	*51.08*
Calcutta Electric	*Goenka*	*12.19*	*48.94*
Kamani Engineering	*Goenka*	*32.00*	*41.00*
Dunlop	*Chabria*	*5.39*	*34.69*
Ashok Leyland	*Hinduja*	*3.46*	*38.68*
Larsen & Toubro			*41.04*
S.I.Shipping	*Essar*	*26.48*	*58.51*
Usha Rectifier	*Rai*	*24.63*	*66.30*
SPIC	*MA Chindambaram*	*14.36*	*46.81*
Escorts	*Nanda*	*14.39*	*44.54*
Bharat Gears	*Raunaq Singh*	*14.82*	*42.18*
TVS Electronics	*TVS*	*12.14*	*58.69*
India Cements	*Sankar*	*11.65*	*50.46*
SRF	*DCM*	*1.3*	*56.57*
Lakshmi Machines	*Lakshmi*	*20.75*	*44.49*
Premier Tyres	*Desai*	*19.34*	*51.73*

(Source: *Economic Times*, June 19, 1992)

From the very beginning, DFIs have enjoyed a privileged and concessional access to resources through the SLR mechanism. Besides, they were able to raise funds from the market at the relatively low and stable rate because of the guarantee offered by the government. At the same time, the lending rates of the DFIs were also low and stable, but the spread between the borrowing and lending rates was reasonable and enabled the DFIs to earn a reasonable rate of return.

In recent years, however, these conditions have been changing. There has been increasing competition from other parts of the financial sector, there is pressure on the availability of privileged and concessional funds through banks, SLR investments and there is progressive deregulation of interest rates. All these points clearly indicate the need for DFIs to become more competitive, more efficient and more profitable.

Weaknesses of DFIs

According to the Committee, the DFIs have suffered some decline in profitability in recent years, even though the all-India institutions, by and large, have managed to retain their financial viability. This has been due to certain weaknesses in their loan operations.

In the first place, the Indian licensing system has been deficient in the sense that it has led to the promotion of several unviable projects by entrepreneurs without proven competence. The DFIs have been induced to finance them, often through considerable and unwanted relaxation in the appraisal standards.

Secondly, the government's policy regarding the nursing of sick units has forced DFIs to provide financial support to sick units against their better commercial judgment.

Thirdly, state level institutions have been working as wings of State Governments rather than as autonomous financial institutions.

Finally, there is a total absence of competition to DFIs' operations in the field of term finance.

DFIs have been operating almost like a cartel, since different institutions join together and offer consortium finance. Borrowers have a limited choice in the matter of selecting an institution for financing their projects. The advantage of the system of consortium finance is that the borrowers need not approach several institutions for arranging their finance, but the disadvantages as pointed out by the Committee are:

- if the consortium rejected an application of a borrower, he did not have any other option and
- it militates against the participating institutions developing a sense of accountability and responsibility for a large portion of their portfolio.

Recommendations

The recommendations of the Committee are based on its assumption that the DFIs are relevant in the Indian context, even though their promotional and developmental role can be expected to diminish as the Indian economy acquires greater sophistication with greater industrial development. At the same time, with the progressive deregulation of the industry and curtailment of the area of industrial licensing, the responsibility of developing on DFIs would be much greater. The major recommendations can be summarised as follows:

(i) The ownership pattern of DFIs should be broad-based, like that of ICICI.

(ii) The government should work out an action plan to be implemented in the next three years which would usher in a measure of autonomy of the DFIs in matters of internal administration.

(iii) The appointment of chief executives of DFIs (as in the case of banks) should be men of proven professional competence and should be selected on the recommendations of a panel of eminent persons.

(iv) The boards of DFIs should include representatives from the industrial sector.

(v) In the case of state-level financial institutions, the link with the State Governments should be broken and these institutions should be helped to work with improved efficiency, take up only that number of projects which they can efficiently follow up and recover their dues and approach the capital market for their funds.

(vi) The DFIs should raise their funds from the capital market at market-related rates. They should also mobilise the savings of the household sector through some schemes which do not conflict with the commercial banks.

(vii) As regards loan sanctions, each DFI should have the sole responsibility in loan sanctions. It should be guided by professional appraisal of the technical and economic aspects of the project evaluation of the promoters, competence and integrity. The DFIs should supervise their own loan implementation.

(viii) The present system of consortium funding should be given up. The cross-representation in each other's boards is no more necessary with the giving up of consortium funding.

(ix) The role and functions of IDBI should be changed. The IDBI should retain only its apex refinancing role and its direct lending function should be transferred to a separate institution which could be incorporated as a company.

(x) In the matter of corporate take-overs, DFIs should lend support to existing managements with proven record beneficial to all concerned, except in these cases where the new management can do better. In all cases, the DFIs should exercise their individual professional judgements free of any pressures.

The Committee has proposed that DFIs should adopt internationally accepted norms, restore capital adequacy, inject an element of competition in term lending finance with a view to providing greater choice to the borrowers. The Committee has also recommended that commercial banks should be encouraged to extend term finance while the DFIs should start extending loans for short periods for working capital requirements.

THE ROAD AHEAD

The days ahead offer the following new vistas for development banks:

1. As box 24.1 shows, development banks are holding majority stake in the equity of the borrowing companies. They are in a vantage position to bring about better corporate governance which will be the need during the coming days. Regretfully, role of the financial institutions till now has been passive as revealed by the recent happenings in ITC.
2. There is a need for gradual privatisation of the development banks in a phased manner. Ensuring true autonomy to these institutions will generate competitive spirit and will subject them to market discipline. Besides, privatisation will gve them the incentive to introduce financial innovation

and improve their financial viability. The process of disinvestment can start with ICICI, which is the most successful institution.

3. As mentioned earlier, the approach of development banks towards project evaluation should be different in the post-liberalisation era. In the pre-reform days, any licensed unit could get loans without detailed evaluation. Infact, licence itself was enough to obtain loans. In the days ahead, any project must be subject to close scrutiny to determine its economic viability before sanctioning assistance.
4. Concessional funds have almost dried up and as a result, financial institutions are forced to mobilise their own resources from money and capital markets through innovative products. Securitisation of assets has a potential to resolve the resource crisis through the faster turnover of assets. Asset securitisation, which was widely used elsewhere, has not taken off in our country, largely due to problems associated with stamp duty, income tax and accounting treatment.
5. Technology development financing would be another new direction in which institutional finance would flow in future. The objectives of this would be towards induction, absorption and development of the latest technologies into the country, in 'sunrise' industries like electronics, bio-technology, pharmaceuticals, engineering, plastics etc. Venture Capital Financing (VCF) introduced by the ICICI and other institutions would be a major instrument in this respect. Unlike traditional financing, the VCF would largely relate to high-technology projects in the small and medium scale selectors. VCF would also contribute to new entrepreneurial development. One distinguishing feature of VCF would, however, be the institutional right to share in the prosperity of the venture as a reward for the risks undertaken by them. VCF would, thus, be a blend of developmental and commercial approaches to project financing.
6. Concomitant with the maturing of the Indian economy and the rapid industrial development planned for the future, service sectors like transportation, communications, medicare, recreation and tourism, consultancy and computer software services, insurance and investment banking would assume greater importance in future. Institutions which have already made a beginning in this direction by financing hospitals, hotels, airlines and computer software houses would need to gear themselves to assist this sector in a larger way in future.
7. Turnaround finance or asset restructuring finance would be another major direction in which institutional finance would flow in future. Resulting from the extensive liberalisation measures introduced by the present government, the Indian corporate sector would have to move from the sheltered market of the past, and face the harsh but healthy winds of competition in future. This might necessitate companies to reorganise themselves to remain competitive by several means like disinvestments and acquisitions. An institutional portfolio is today burdened with non-performing loans, resulting predominantly from projects assisted because of developmental consideration. Considering the era of low spreads that is emerging for institutions, henceforth, a selective

approach with a view to minimising non-performing loans would need to be followed in future. This could be achieved partly by mutual take-over, induction of new managements etc. Institutional support would need to be provided in future to the corporate section in the afore-mentioned efforts.

8. The shift in the flow of institutional finance covered till now relates mainly to the large and medium scale industries. However, the small sector assumes vital importance in the nation's efforts to achieve industrial pre-eminence by the turn of the century. Today's small-scale entrepreneurs are tomorrow's medium and large-scale industrialists. Hence, the need to focus institutional efforts in this direction. It is in recognition of this need that the government has formed the Small Industries Development Fund (SIDF) with a corpus of Rs.2,500 crore. This is expected to give a further boost to institutional assistance to the small-scale sector which has shown rapid growth during the last one decade. The small-scale sector has a tremendous potential, particularly in fields like ancillary units for automobile and engineering industries, textiles, garments, pharmaceuticals and pesticide formulations, food processing etc. In some of these fields, the small-scale sector cannot only produce for the domestic market, but with a conscious effort towards quality and cost, can also contribute substantially to the country's export drive. Besides, ensuring a growing flow of financial and non-financial assistance to the small-scale industry sector, the SIDF has the responsibility to provide a focal point for effectively coordinating the activities of the various organisations engaged in promoting the growth of this sector and also give a new thrust to their activities.

   In line with the segmentation of the private sector investment in future into mega projects, large-scale projects, medium-scale projects and small projects, the future may witness a greater segmentation of the industrial sector, to service the needs of each of these sectors with greater efficiency.

9. The financial institutions recently have been instructed to monitor the end-use of funds raised by private sector units. This is an additional responsibility which the institutions must shoulder with competence in order to ensure that the funds raised by the companies are used for the purpose intended.

QUESTIONS

1. Review the performance of DFIs over a period of 10 years.
2. What are the new directions in which DFIs must proceed?
3. Bring out the recommendations of the Narasimham Committee.
4. Explain the challenges lying ahead of financial institutions.

REFERENCE

1. E.Nevin, *Capital Funds in Developed Countries*, p.56.
2. Ishwar C.Dhingra, *Indian Economy,* New Delhi, Sultan Chand and Sons, 1997, p.660.
3. *Ibid*, p.661.
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CHAPTER

25

Stock Exchanges

CHAPTER OUTLINE

Nature of Stock Exchanges
Functions of Stock Markets
Benefits of Share Markets
Growth of Stock Exchanges
Dealings in Share Markets
Organisation of Stock Markets
The Securities Contracts Act
– *Provisions of the Act*
Positive Features
Negative Features
Reforms

LEARNING OBJECTIVES

After reading this Chapter, you should be able to:

1. *Define a stock exchange and describe its functions*
2. *Explain the benefits of share markets*
3. *Bring out the growth of stock markets*
4. *Describe the speculative dealings*
5. *Bring out the organisation structure of stock exchanges*
6. *List the provisions of the Securities Contracts Act*
7. *Evaluate functioning of all stock exchanges*
8. *Bring out the reforms of stock exchanges*

Stock exchanges have attracted unusual public attention in the recent past. It all started with the unprecedented boom in share prices a couple of years back (BSE Sensitive Index touched a record 4,467 points from a base of 100 in 1978-79) followed by a series of setbacks. The downfall started with the unearthing of the securities scam. This is followed by free pricing of share issues with the repealing of the Capital Issues Control Act; strict enforcement of rules by SEBI and consequent skirmishes between SEBI and brokers; income tax raids; poor results revealed by companies and the absence of direct budget benefits to investors. The consequence of all these developments is that share prices got crashed and stock markets have become cool to new issues by companies.

For whatever the reason, share markets are in the news everyday. Unusual interest in the shares and stock exchanges has resulted in the addition of a few more words to the English language. For example, 'Big Bull', 'Scam', 'Bourse' and the like are readily used in conversation and writings on stock exchanges these days.

A time has, therefore, come to take a close look at the stock exchanges and the legislation which governs their functioning.

NATURE OF STOCK EXCHANGE

A stock exchange is a market where securities, i.e., shares, debentures and government securities are bought and sold. The Securities Contracts (Regulation) Act, 1956, defines a stock exchange as

> "an association, organisation, or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities."

A share market exists because certain owners of securities wish to sell them, others wish to buy them and the titles to the securities are transferable. A securities exchange does not itself engage in the purchase or sale of securities. Rather, its function is to make such trading as smooth and efficient as possible.

FUNCTIONS

The share market performs certain essential economic functions. It :

- Provides a ready market for buying and selling of securities;
- Performs an 'act of magic' as it enables long-term investments to be financed by funds provided by individuals who are otherwise interested in short-term or medium-term investment;
- Directs the flow of capital in the most profitable channels;
- Induces corporate enterprises to raise their standards of performance;
- Offers an easily understood evaluation of the financial conditions and prospects of listed firms;
- Facilitates speculation;
- Promotes the habit of saving and investment among the general public and thereby helps capital formation and
- Promotes industrial growth and economic development of the country by encouraging industrial investments rather than hoarding or investing in gold.

Because of its functions, the stock exchange is regarded as an essential concomitant of the capitalist system of economy. It is indispensable for the proper functioning of

an corporate enterprise. It brings together large amounts of capital necessary for the economic progress of a country. It is the citadel of capital and the pivot of the money market. It provides necessary mobility to the capital and directs the flow of capital into profitable and successful enterprises. It is the barometer of general economic progress in a country and exercises a powerful and significant influence as a depressant or stimulant of business activity.[1]

BENEFITS

Speaking in the Lok Sabha in connection with his motion for reference of the Securities Contracts (Regulation) Bill to a joint committee of the Parliament in 1955, the then Finance Minister said; "The economic services, which a well-constituted and efficiently run securities market can render to a country with a large private sector, operating under the normal incentives and impulses of private enterprise, are considerable. In the first place, it is the only organised securities market which can provide sufficient marketability and price continuity for shares, so necessary for the needs of investors. Secondly, it is only such a market that can provide a reasonable measure of fair dealing in the buying and selling of securities. Thirdly, through the interplay of demand for and supply of securities, a properly organised stock exchange assists in a reasonably correct evaluation of securities in terms of their real worth. Lastly, through such an evaluation of securities, the stock exchange helps in the orderly flow and distribution of saving as between different types of competitive investments." Though the Finance Minister summed up the benefits of share markets succinctly, for the sake of greater clarity, its advantages can be analysed as follows:

Benefits to the Community

- Stock exchange encourages people to save and invest their savings in shares and debentures. The recent boom in share markets has created financial awareness among the middle class. The stock market has become a central factor in household financial planning.
- By encouraging people to save and invest, the stock exchange helps capital formation which is an essential ingredient for quicker industrial development.
- Through capital formation, the stock exchange enables companies to undertake expansion and modernisation schemes. Every company talks in terms of hundreds of crores of rupees of investments in new projects these days. The stock exchange is an Alibaba Cave from which business community can draw unlimited money.
- Stock exchanges encourage several closely-held companies to go public. This means that ownership is broad-based, management is diffused and more scrips are offered to the public for trading.
- Superior performance of companies is reflected through stock exchanges. Companies with a proven track record are considered to be blue chip companies and their shares and debentures are briskly traded in the share markets.

When an efficiently-run company issues shares or debentures the to public for subscription, there is a tremendous response from investors. A sort of record was established by Kinetic Honda when its issue was over subscribed by 150 times. Hero Honda Motors was offered Rs.46.8 crore for an offer of just Rs.4.46 crore. The role of share bazaars is no less in this unbelievable response.

- Stock exchanges provide a market for the government to sell its securities in order to raise funds for meeting developmental activities.
- Stock market acts as a mirror through which the general economic condition is clearly reflected.

Benefits to Investors

- Stock exchange is a money spinner-an El Dorado for millions of investors across the country. Investors become overnight rich, thanks to the stock exchange. "Bimal Jain, a New Delhi housewife", writes *India Today* (of July 31, 1985), "bought 500 debentures of Reliance Textiles a year ago at the then market price of Rs.92. The company then offered to convert these into shares, which are ruling at record levels. Jain's initial investment of Rs.46,000 is now worth Rs.1.56 lakh in barely a year."
- Stock exchange offers a ready market for buying and selling the securities. Share bazaar is the busiest market with crores of rupees being put at stake. The Bombay Stock Exchange, the premier share market, registers dealings worth several hundred crore a day.
- The interest of investors is safeguarded by the strict enforcement of rules and regulations. Every share market has its own by-laws besides complying with the provisions of the Securities Contracts (Regulation) Act, 1956. By-laws and provisions of the legislation protect the interests of investors, big or small.
- The stock exchange provides information about the scrips dealt therein and the prices at which they are quoted. All newspapers and periodicals carry columns on the stock markets. This enables investors in making a sound investment choice.
- More important is the fact that the stock exchange is a powerful hedge against inflation.

Benefits to Companies

- Wide market for shares and debentures.
- Image of the company goes up once the shares are listed on a stock exchange.
- Quicker response from the investors to the listed securities.
- The market rates of shares and debentures will be higher because of daily dealings on the stock markets. This enhances the bargaining position of a company in the event of its merger with some other company.

GROWTH

There has been a phenomenal increase in the number of stock exchanges, number of investors, the number of listed companies and market value of listed companies over a period of time. Between 1980 and today, the number of exchanges has gone up from nine to 23. The number of listed companies went up from 2265 from 1980 to 6480 in 1992, and the number of listed stocks increased from 3697 to 9642 (See Table 25.1 for more details).

DEALINGS

Stock exchange dealings are subject to the rules and regulations of the market and the provisions of the Securities Contracts (Regulation) Act, 1956. Dealings on the

Table 25.1 Growth Pattern of Listed Stock

(Rs.crore)

	1980	1985	1991	1992
No.of stock exchanges	9	14	20	21
No.of listed companies	2265	4344	6229	6480
No.of stock issues of listed companies	3697	6174	8967	9642
Market value of capital of listed companies (Rs.Crore)	6750	25302	110279	354106

(**Source**: Bombay Stock Exchange *Official Directory*, Vol.9)

floor of any market are permitted only in the listed securities through the members and their authorised clerks during fixed working hours.

Membership is limited to Indian citizens. To become a member of a stock exchange, one should be above 21 years of age. Only an individual (not a firm or a company) can become a member. The application for membership should be sponsored at least by two existing members.

Two types of dealings are carried on the stock exchange: ready delivery contracts and forward delivery contracts; in two kinds of scrips, namely, 'A' group and 'B' group securities. Ready delivery contracts, also known as cash contracts or cash trading, are to be settled on the same day on which they are entered into, or within a period of seven days. Cash trading is allowed in 'B' group scrips. Forward transactions are settled on specified days which are fixed at fortnightly intervals. The buyer can carry transactions to another, sometimes for years together. Forward dealings are allowed in 'A' group scrips. 'A' group securities are also known as 'specified' securities and are big daddies of the market, like ACC, TISCO, Reliance and Century. It may be noted that forward dealings were banned by the government in 1969 and were reintroduced later.

Speculation

Transactions on a stock exchange are carried on either for investment or for speculation. Investment transactions are made with the intention of holding the investments more or less permanently. Ready delivery contracts, referred to above, are generally for investment purposes. Speculative transactions, on the other hand, are made with the intention of making quick money by selling securities when their prices shoot up. Forward transactions, described above, are generally carried on for speculative gains. Speculative transactions are more in number, and they keep stock exchanges active and busy.

Types of Speculators

Members of a stock market are of three types: bulls, bears and the stags. A bull, also known as the *tejiwala*, is a speculator who buys shares in the expectation of selling them later at higher prices. He makes money when the share prices are rising. When the share prices are rising, it is called a *bullish* trend. How does a bull ride the wave up? He buys low and waits. When the settlement day comes, he can take delivery of the shares, which means that he will now hold shares valued at higher

than the prices he paid. If he does not have the money to take delivery or if he is very daring-nowadays the two go together-he can carry forward the transaction, paying another person contango charges (*badla* charges in the vernacular) to put the money on his behalf. These days, with hundreds of badlas every day, the badla financiers are making a packet. To cool the market down, the authorities impose margins, which means that a percentage of the money has to be paid to the stock exchange authorities.[2]

A bear, also known as *mandiwala*, is one who sells securities in the expectation of a fall in their prices in future. A bear rides the scrip on the way down by selling short, that is, selling a scrip at, say, Rs.100 and hoping to buy it back when it touches, say, Rs.80. His profit on a scrip which he may never have held in his hot little hands is the difference between the two prices.[3]

A stag neither buys nor sells but applies for subscription to the new issues expecting that he can sell them at a premium. The bulls, the bears and the stags are collectively known as *jobbers* or brokers. Brokers or their clerks, as mentioned earlier, alone can trade on a stock exchange.

ORGANISATION

There is no uniformity in the form or ownership of 23 stock exchanges that are functioning in the country today. Mumbai, Indore and Ahmedabad exchanges are organised as voluntary associations. Calcutta and Delhi Exchanges are limited companies and those of Chennai and Hyderabad are guaranteed companies. 14 exchanges are organised as limited companies six as companies limited by guarantee and three are voluntary non-profit agencies of the 23, only nine have permanent recognisation others seek renewal of recognition every year. Table 25.2 reveals the type of ownership of the first 15 stock exchanges.

Whatever the form of ownership, the stock exchange is managed by an executive committee/council of management/governing body to which the government is empowered to nominate not more than three members. The rules and by-laws of the share market shall be in conformity with such conditions as may be prescribed by the government from time to time.

THE SECURITIES CONTRACTS (REGULATION) ACT, 1956

The Securities Contracts (Regulation) Act, 1956, is a legislation which empowers the government to regulate the functioning of stock exchanges in the country. The Act applies to the whole of India and has the following objectives:

(i) To prevent undesirable transactions in securities.
(ii) To regulate dealings in securities.
(iii) Regulation of stock exchanges.
(iv) Regulation of buying and selling of securities outside the limits of stock exchanges.

Provisions of the Act

The provisions of the Act provide for: (See Fig.25.1)

1. Grant of recognition to the stock exchanges.
2. Submission of periodical returns.

Table 25.2

Types of Ownership

Name of Exchange	Type of Ownership
1. The Ahmedabad Stock Exchange	Association
2. The Stock Exchange, Bombay	Ltd.Company
3. Bangalore Stock Exchange	Ltd.Company by shares
4. The Calcutta Stock Exchange	do
5. Cochin Stock Exchange	Ltd.Co.by guarantee
6. Delhi Stock Exchange	Ltd.Co. by shares
7. Gauhati Stock Exchange	do
8. Hyderabad Stock Exchange	Ltd.Co.by guarantee
9. Kanara Stock Exchange	Ltd.Co.by shares
10. Ludhiana Stock Exchange	do
11. Madras Stock Exchange	Ltd.Co.by guarantee
12. Madhya Pradesh Stock Exchange	Ltd.Co.by shares
13. Pune Stock Exchange	do
14. The Uttar Pradesh Stock Exchange	do
15. Magadh Stock Exchange	do

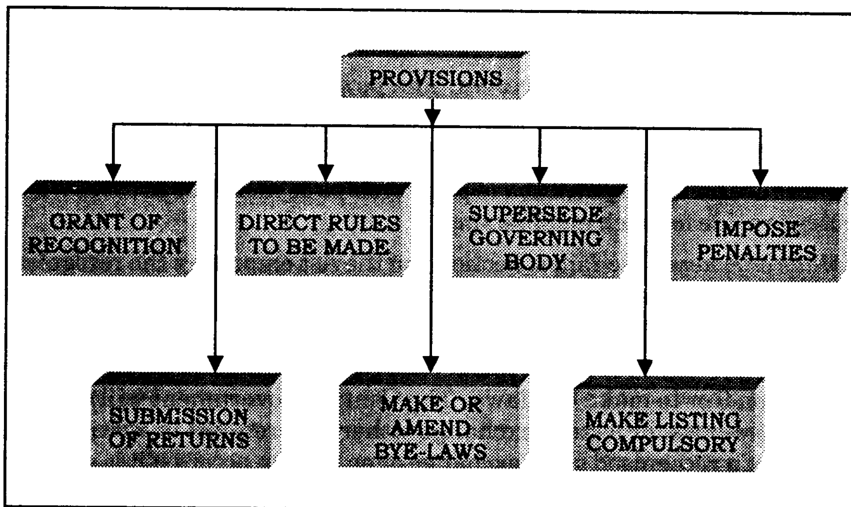

Figure 25.1

Provisions of the Securities Contracts (Regulation) Act

3. Power to direct rules to be made or to make rules.
4. Power to make or amend by-laws.
5. Power to supersede the governing body and suspend business.
6. Power to make listing of securities compulsory.
7. Power to impose penalties.

Grant of Recognition: The Act provides that only recognised stock exchanges can function in the country. As of today; all the 23 stock exchanges have been recognised by the government. Any exchange which is desirous of getting recognition should apply to the Central Government in a prescribed form, giving necessary details.

If the Central Government is satisfied that the information furnished is adequate, and the stock exchange concerned is willing to comply with the necessary conditions and it will be in the interest of trade and public to grant recognition to the stock exchange, then the Central Government shall grant recognition to the applicant stock exchange.

The grant of recognition of the stock exchange shall be published in the Gazette of India and will come into effect from the date of publication in the Gazette.

Submission of Returns: Sec.6 of the Act lays down that every stock exchange shall furnish to the Central Government such periodical returns as may be prescribed relating to its affairs. The periodical returns shall be filed by the recognised stock exchange before 31st January each year along with the detailed information as laid down in the Securities Contracts (Regulation) Rules, 1957.

Section 6 further provides that every stock exchange and every member thereof shall maintain and preserve for a period of five years such books of accounts and other documents as may be required by the Central Government.

Power to Direct Rules to be Made or to Make Rules: Section 8 of the Act empowers the Central Government to direct the stock exchange to frame rules or to amend rules already made in respect of the following:

(a) *Management of Stock Exchange*: Constitution of management of stock exchange and the manner in which the business of a recognised stock exchange will be transacted.

(b) *Duties and Powers of Office-Bearers*: The powers and duties of the office-bearers of the stock exchange; the admission of members into the stock exchange and their suspension, expulsion and re-admission.

(c) The procedure for the registration of partnerships as members in cases where the rules provide for such membership.

Power to Make or Amend Bye-Laws: Section 9 of the Act empowers the recognised stock exchange to make by-laws for the regulation and control of contracts with the previous approval of the Central Government.

Section 10 of the Act empowers the Central Government to amend the bye-laws as framed under Section 9 or to make bye-laws. The Central Government will exercise its power to make bye-laws for a stock exchange either on a request in writing from the governing body of a recognised stock exchange or on its own accord if it is satisfied that it is necessary or expedient to do so.

Power to Supersede Governing Body and Suspend Business: Sections 11 and 15 of the Act empower the Central Government to supersede the governing body of a stock exchange and to suspend the business of a recognised stock exchange if the Central Government is of the opinion that an emergency has arisen and for the purpose of meeting the emergency, the Central Government should suspend the business for a period not exceeding seven days.

Power to Make Listing of Securities Compulsory: Section 21 of the Act empowers the Central Government to make listing of securities by public companies compulsory.

Listing has the following advantages and to realise these benefits, companies are required to get their shares listed. The advantages are:

(i) The regular and latest reports on listed companies help the investing public in saving for investment in the securities of the company which are listed on the stock exchange;

(ii) The companies are under an obligation in terms of the listing agreement to inform its shareholders about the various corporate details and therefore, the listed companies keep approaching unintentionally to the investors, from time to time;

(iii) The transactions in listed securities are published widely in leading newspapers and journals and therefore, corporate details like working results, dividend announcements, expansion and diversification plans of the listed companies are also published.

(iv) On account of the liquidity, marketability and free transferability, which are conferred by the listing of the securities on a stock exchange, securities of the listed company qualify for preferential treatment for investment by institutional investors and foreign investors;

(v) An official quotation on the floor of the stock exchange is an important indicator to the company as well as to the investors as prices are arrived at publicly on the basis of demand and supply;

(vi) Listing of shares results in improved marketability as the confidence of the investors is enhanced due to regulation of the stock exchanges, trading procedures, greater liquidity, reduced risk etc. These, in turn, influence the price of a share;

(vii) Listing also adds to the prestige and importance of the listed companies;

(viii) Listed companies also enjoy certain concessions under the direct tax laws and official quotations are accepted by the tax authorities. If the shares are quoted on a stock exchange, the company will be treated as a company in which the public are substantially interested. Hence, there is benefit of lower tax rate and no compulsion to distribute profit.

(ix) Listing confers a collateral value for credit facilities for borrowing from banks; and

(x) Listing requirements provide for compulsory and timely disclosure of corporate information relating to dividend, bonus or rights issue, advance notice for closing the register of members etc., facilities for transfer, registration of rights and fair and equitable allotment.

Listing Requirements and Obligations

A company shall satisfy certain conditions for enlisting. Once listed, the company shall follow specific obligations. The following are the requirements and obligations:

(i) The memorandum and articles of association of the company must contain prescribed provisions;

(ii) The company must offer for public subscriptions through a prospectus at least the prescribed minimum percentage of its issued capital;

(iii) The company should inform the exchange authorities about the dividend distribution immediately after the board meeting;

(iv) The company should give an undertaking that it will comply with the provisions of the Companies Act and the Securities Contracts (Regulations) Act as well as the rules made thereunder;

(v) The company should notify to the stock exchange, without delay, of the date of meeting of its Board of Directors at which the recommendations or declaration of a dividend issue of right or bonus shares or convertible debentures or the passing over the dividend is due to be considered. Information must be given to the stock exchange in respect of the decision taken by the Board of Directors as referred to above;

(vi) Companies have to promptly forward to the stock exchange copies of the annual reports, notices, resolutions and circulars sent to the shareholders in order that those investors who are not shareholders of the company should also be informed of the affairs of the company;

(vii) The company should publish, in a form approved by the stock exchange, such periodical interim statements on its working and earning as it shall, from time to time, agree upon with stock exchange; and

(viii) The company shall keep the stock exchange informed of events like strikes, lockouts, closure on account of power cuts and so on, both at the time of occurrence of the events and subsequently, after the cessation of events in order to enable the shareholders and the public to appraise the position of the company.

Power to Impose Penalties

Section 23 of the Act lays down penalties for offence committed by individuals. Section 24 of the Act provides for the same but for offence committed by companies. The penalty may include imprisonment for a period of one year or fine or both.

Directorate of Stock Exchanges

The Directorate of Stock Exchanges is the implementing agency of the provision of the Act. The Directorate was set up in 1959 and is headquartered at Mumbai with branch offices in Delhi and Calcutta. The functions of the Directorate include the following:

(a) Acting as a link between stock exchanges and the Central Government;

(b) Keeping a close watch over the day-to-day operations of the stock exchanges and, in particular, checking over-trading or illegal transactions by brokers;

(c) Advising appropriate authorities in regard to untoward developments or expected crisis;

(d) Ensuring strict compliance with listing requirements on the part of companies and

(e) Issuing licence to dealers and brokers in securities in areas beyond the jurisdiction of recognised stock exchanges.

POSITIVE FEATURES

Stock exchanges in our country have grown in all directions overtime. Whether it is the volume of business transacted, mobilising resources for the corporate sector, promoting the habit of saving among people, or professionalising the management of

the share markets themselves, the growth has been phenomenal. Particularly the eighties have been eventual in the history of the stock exchanges. A few important developments observed in the recent past in functioning of the stock exchanges are listed below:

1. The stock exchanges in our country have grown so sharply in the eighties that the decade itself has been christened as a decade of the capital market. The extent of growth can easily be measured by the fact that as against an annual average amount or just Rs.90 crore raised from the new issues market in the seventies, Rs.6,000 is being raised during 1989-90. The daily turnover in the Bombay Stock Exchange alone has shot up from about Rs.10 crore in 1979 to about Rs.300 crore in 1989-90. The turnover of National Stock Exchange now stands at Rs.1500 crore per day.
2. The number of shareholders has risen sharply from about a million in the beginning of the eighties to 12 million by the end of the decade. Shareholding population-wise, our country is the third largest in the world, next only to the US and Japan which have about 50 million and 25 million investors respectively. Along with the increase in the number of investors, the number of brokers has also gone up to about 3,000 active stock brokers as against about 1,250 a decade ago.
3. Yet another positive development relates to the broad basing of investing public. Contrary to popular belief that investors include only middle income groups from urban areas, peasants, peons, drivers and rickshaw pullers constitute a major chunk of investors. It is said that every eighth shareholder in our country today is a farmer.[4]
4. The share boom has resulted in several spin-offs. In addition to active brokers who number about 3000 as on date, there are about 30,000 sub-brokers and consultants spread all over country. Dailies and periodicals are being published exclusively to deal with financial and share movements.
5. The inauguration of Over The Counter Exchange of India (OTCEI) on August 14, 1990 signifies another landmark in the functioning of stock exchanges in our country. The Exchange is a Rs.10 crore venture set up jointly by financial institutions in order to provide easy and safe access to the capital market for companies.
6. Mega issues have become quite common nowadays. Rarely does a company come out with an issue of less than Rs.100 crore issue (see Table 25.3).
7. The final positive feature of our stock markets is the inflow of foreign portfolio investments. From 1993 onwards, roughly Rs.40,000 crore worth of securities have been picked up by foreign institutional investors. This accounts for seven per cent of the total market capitalisation.

NEGATIVE FEATURES

While the points listed above are positive, there are some negative features of our stock markets. Some of them are listed below:

1. The first negative feature relates to poor liquidity. Barring a small proportion of scrips which are actively traded in stock exchanges and are highly liquid,

Table 25.3

Mega Issues between November 1995 to January 1996

Company	Issue size (Rs.crore)	Instrument	Issue
SCICI	1311.00	Partly convertible debenture	Rights/Public
SPIC Petrochemicals	715.00	Equity	Public
Sanghi Cement	259.00	Fully convertible debentures	[illegible]
T.N.Newsprint	220.00	Equity	[illegible]
Lloyds Finance	200.00	Debentures	Rights/Public
Jindal Ferro Alloys	184.74	Convertible preference shares	[illegible]
Advance Radio Mast	180.00	Equity	[illegible]
Search Chem.Industries	141.30	Equity	Rights
Pitti Cement	114.77	Fully convertible Debentures	Rights/Public
Subhagh Projects	109.50	Equity	Rights
Flex Engineering	100.00	Equity	Rights/Public

most are traded infrequently and hence, lack liquidity. About 90 per cent of the total transactions in the stock markets are confined to 200 to 250 actively traded scrips (out of a total of 6480 listed companies).

Some more details are worth citing. There are nearly seven lakh companies in India, of which some 6,000 or so are listed in various exchanges. Though nearly 9,000 scrips are listed in exchanges, more than half were not quoted or traded during 2004. Another 25 per cent were quoted only a couple of times during 2004. The share of just the top 10 companies commanded nearly 45 per cent of the trade turnover during the year.[5]

2. The second negative feature of our stock exchanges is the absence of adequate instruments. Equities and equity-linked instruments such as convertible debentures are the only ones presently traded. Preference shares have virtually dried out of markets. Cumulative convertible preference shares, in respect of which the government had issued guidelines in 1984, have proved to be practically a non-starter.
3. Another disturbing feature is that our stock markets are virtually dominated by a few players. The stock markets are considerably influenced by the actions of a few financial institutions, particularly the Unit Trust of India and some speculative operations. Share prices, therefore, do not reflect the true demand and supply position of scrips.
4. Insider trading is yet another disturbing feature of our stock markets. Insider trading refers to the use of price sensitive corporate information by vested interests to make private gains or to avoid losses. This obnoxious practice is not peculiar to our county. It is there everywhere. But in other countries, there are suitable legislations to curb the evil practice. We are yet to evolve an appropriate legislation for the purpose though Sacvhar Committee (1978) and Patel Committee (1984) recommended the same.

The present provision contained in Section 307 of the Companies Act requiring shareholding and debenture holdings of directors to be recorded and kept open for inspection of any shareholder or debentureholder during the period of 14 days before and three days after the annual general meeting of a company has proved to be totally ineffective in controlling insider trading. Publication of half-yearly results by listed companies as required by Clause 41 of the listing agreement in operation since 1987 has also not minimised such trading (see also Box.25.1).

5. Manipulation of share prices at the time of subsequent issues is a common occurrence. The process starts well before a company seeks permission from the concerned authorities for the issues of further capital. Not only an attempt to get a higher premium on the basis of prices manipulated is being made but attempts at manipulating prices continue thereafter to lure the investors to subscribe for these subsequent issues. Later when the allotments are made, it is quite a common spectacle to find these prices slide down to their natural levels, often below the offer price. While attempts to stabilise prices at the time of issues are understandable and also justifiable, the attempts to manipulate prices are reprehensible, to say the least. Equally reprehensible are the attempts by others, by the speculators or rival groups, to depress the prices. Unfortunately, we do not have a deterrent provision against price-manipulation in our stock markets.
6. Frequent entry into the market by some companies, particularly those involved in expansion, diversification and modernisation is truly indicative of the vibrancy of the Indian capital market. Unfortunately, the practice followed by some of them of delaying not only allotments but subsequently not returning shares lodged with them for sub-division, consolidation and transfer in time, thereby creating an artificial scarcity in the market with a view to manipulating the prices in the secondary market, has harmed the investors greatly. It is, therefore, essential to ensure that there is a time gap of at least one year between two consecutive issues or alternatively companies may be permitted to enter the market again only six months after the listing of the previous issues.
7. Permitting companies to offer convertible debentures with provision for conversion at two or three points, the latter towards the end, is indeed a welcome proposition as the market in these debentures continues to remain active because of the close linkage between equity and debentures. What, however, needs to be fixed right at the beginning are the terms of conversion, at all the points, including the last one. Leaving these terms open is tantamount to offering an open bait to the management to rig up the prices, which they can do more easily if the quantum of shares emanating after the initial issues is not significant to gain a higher premium.
8. There is the problem posed by the sub-brokers. There is a fairly good measure of protection to the investors from the stock brokers. While this has no doubt to be improved upon, the class of sub-brokers who have proliferated all over the country, both in the areas where recognised stock exchanges are situated and outside, pose a serious threat to investor protection. It is estimated that about 50 per cent of the complaints against the stockbrokers is because of the

Box 25.1

Insider trading - heavy toll

Different countries have legislation or a code of conduct to check the menace of insider trading. The US and UK have comprehensive legislation and monitoring bodies to ensure its strict enforcement. Countries like West Germany have a voluntary code of conduct to be followed by stock exchange dealers and banks to keep insider trading to the minimum.

The US Congress has strengthened the restrictions on insider trading by empowering the Securities Exchange Commission (SEC) to seek a triple penalty under the provisions of the Insider Trading Sanctions Act, 1984. Section 21 of the Act enables SEC to bring enforcement actions against violators of any provisions of the securities laws. Mr.Ivan F.Boesky, who made illicit profits of the tune of $203 million by insider trading, was convicted and sentenced for three years imprisonment in addition to a fine of $100 million.

In the UK, the Companies Act, the Company Securities (Insider Dealing) Act, 1985, and the Financial Services Act, 1986, contain comprehensive provisions to prevent insider trading. An individual is prohibited from dealing on a recognised stock exchange in the listed securities of a company with which he is, or at any time during the preceding six months has been, knowingly connected and by virtue of his connection possesses price sensitive information relating to the securities. A person is connected with a company for these purposes if he is a director of it or of a related company, or if he is an officer, employee or other person, standing in a professional or business relationship with a company, or its related company, whose relationship gives him access to the unpublished price sensitive information.

Recently a major toll of insider trading was the resignation of Mr.Geoffrey Collier, Securities Chief of Morgan Grenfell Merchant Bank, UK. Mr.Collier asked a stock broking firm to buy 50,000 shares of an engineering company, which was being taken over by another company, utilising the services of Morgan Grenfell as its corporate adviser. Mr.Collier, advising on the pricing and other details of the take-over, possessed full knowledge of the proposed bid. The stock broking firm informed Morgan Grenfell of the shares deal after the takeover bid was over. On inquiry, Mr.Collier admitted breach of conduct on his part and submitted his resignation. More recently, Mr.R.J.Brealey was arrested on the charge of insider trading on the London Stock Exchange under the Financial Services Act. It was reported that Mr.Brealey made a bid to acquire the controlling interest in shares of Titaghur Jute Factory (TJF) registered in Scotland, from Mr.Mehta and the Associates of Thomas Duff in Calcutta.

In Japan, three major insider trading scandals rocked its parliament and the business world. In Recruit Cosmos scandal, top politicians, civil servants and businessmen were involved. To buy favours from the government, 1,15,000 unlisted shares in Recruit Cosmos, a subsidiary of Recruit were offered under the table to politicians. They sold these in a month's time when the issue was made public in October 1986 and made profits of more than 250 million yen or $2 million. The Meidenko affair involved insider trading in shares of Sankyo Seiki. Nippon Steel secured a stake in Sankyo Seiki Manufacturing for 53 billion yen. An investigation by the Tokyo Stock Exchange found evidence that 30 to 40 employees of the two companies bought shares in Sankyo Seiki in the weeks before the public announcement of the deal in July 1988 and made unfair gains. In the third case, the Hanshin Sogo Bank, the lead bank to Tateho Chemical, sold its shares in Tateho, just a few hours before the company announced heavy losses.

sub-brokers. On a rough reckoning, there are atleast 50,000 such sub-brokers not subject to any regulations, constantly posing serious threat to investors. Some of the sub-brokers in the jurisdictional areas of stock exchanges also commit the illegality of issuing contracts, bills, memos, etc. in their own names to lend authenticity to their operations and the gullible investors, who are not normally aware that these can legally be issued only by a member of a stock exchange in the jurisdictional areas covered by the stock exchange, fall prey to such gimmicks.

In order to overcome this serious lacuna in regulation, a working group set up by the Securities and Exchange Board of India (SEBI), has recommended a system of authorisation of these sub-brokers based on the criteria of professional competence, financial soundness and record of integrity and payment of suitable admission fee, security deposit and annual subscription. The group has also recommended creation of a customers' protection fund by earmarking 25 per cent of the sub-broker's annual subscription towards this fund. The group has further recommended that while the sub-broker would be primarily responsible to the client, the principal broker would ultimately be responsible to the client in case of a sub-broker's default. The group was also of the opinion that over a period of time, sub-brokers must be authorised to issue contracts in their own names to their clients.

9. Odd lots constitute a major bugbear for investors. Out of total market capitalisation of over Rs.60,000 crore, equities worth about Rs.15,000 crore are in odd lots. Investors normally receive 15 to 20 per cent less than the market price when they sell, and have to pay 15 to 20 per cent more than the market price when they buy odd lots. Schemes evolved by some of the agencies and companies to fetch a better price for the investors have not proved to be much of a success. Even the recent scheme launched by the Unit Trust of India for the barter of odd lots against units cannot be said to be attractive as capital appreciation of units is generally negligible compared to equities which are bartered.
10. An anomaly peculiar to our share bazars is that the members of the governing body of a stock exchange themselves are allowed to carry on business on a share market. In other words, President, Secretary, Treasurer or any officer bearer of a stock exchange can, like any other broker, buy and sell securities. In the event of a dispute, the same people have to sit on the judgement to resolve the dispute. This means that the offender himself becomes the arbitrator.
11. There is inordinate delay in admitting the securities for trading in stock exchanges. This delay is caused by the companies themselves. Collection of applications from different centres of the country, processing of application, issue of allotment letters/share certificates and the posting of these documents to the applicants by the issue houses take a long time and stretch beyond 70 days from the date of closure of the subscription list. Needless it is to emphasize that this affects liquidity of investments.
12. Take-overs have become common in our country. While the take-over of one company by another is not wrong, it would be desirable to ensure that energies of the entrepreneurial class do not get dissipated by engaging

themselves in take-overs and a fair deal is meted out to the non-management shareholders. To achieve this objective, a new clause is incorporated in the listing agreement of stock exchanges pursuant to a directive issued by the government in April 1984. According to this clause, any acquisition company on securing the effective control of the management of a company by acquisition of the shares of the existing directors and others who effectively control or manage the company, irrespective of the percentage of their holding, should be preceded by the offer to the remaining members of the company to acquire their shares at a price not lower than the price at which the shares of the company are being acquired. This is, however subject to the public shareholding not being reduced to less than 20 per cent of the voting capital of the company.

There have been quite a few take-overs ever since this clause came into operation particularly during the last one year. Unfortunately, this clause has not proved to be effective in taking care of the interest of the non-management shareholders because of four major reasons. Firstly, acquisitions of shares is limited to 24.9 per cent of the voting capital of the company, thus conforming to the letter of the law while totally violating its spirit and brazen facedly arguing about the correctness of such a move. Secondly, the acquisition of shares would actually result in an effective change in the control of the management of the company but would not ostensibly look so, as for example, only four out of eight directors change and there is no foolproof way of deciding that there is an effective change in the control of the management of the company. Thirdly, while there would be no change in the pattern of shareholding of the parent company, holding shares in the company is important as a result of which, there would be change in the effective control of management of the company. Finally, acquisition of shares ostensibly takes place at a price much below the ruling market price but in actually at a much higher price, the difference being settled privately.

13. Service provided by brokers leaves much to be desired. The number of brokers (6500 from all stock exchanges) itself is inadequate. Consequently, a small number of brokers handles a large volume of turn-over. Service is obviously sacrificed.
14. The trading and settlement system continues to be archaic. The system is not in accordance with the internationally accepted standards. Settlement delays cause liquidity crunch.
15. There is no transparency in transactions. Lack of transparency will make the investor feel suspicious. The actual rate and date of the execution of the order are not made known to the client by the broker. It is often found that the brokers give to the investor only a statement of the net amount to pay in respect of purchases and the net to receive in respect of sales. Even the actual brokerage charged is not revealed by the brokers.
16. Mega issues, though are welcome, cause their own problems. Poor disclosure standards, misleading advertisements and price manipulations are some of the problems which persist, strict guidelines from SEBI not withstanding.
17. Finally, there is the problem of excess speculation. Speculation is necessary to keep the market vibrant. But excessive speculation will lead to broker-

defaults which will kill the market. Most of our stock exchanges are speculative driven.

REFORMS

Realising the need for better investor protection and to overcome the inadequacies in the existing regulations, the Central Government and SEBI initiated several measures which will go a long way in ensuring healthy capital markets in our country. These measures are based on the recommendations made by several committees. The new measures are:

(1) Setting up of the Securities and Exchange Board of India (SEBI).
(2) Constituting OTC Exchange of India.
(3) Introducing Stock Invest Scheme.
(4) Safety net scheme to ensure buying back confidence.
(5) Three significant developments marked the period between 1994 and 1996. They are: (i) Open electronic limit order book market, (ii) nation wide integrated markets and clearing house that guarantees the trade. These three developments signal the healthy growth of stock markets in India. Demutulisationis yet another development that has taken place recently.

Open Electronic limit order Book Market (ELOB)

Till 1994, the physical organisation of markets in our country used 'open cry', which consisted of a pit in which traders shouted and hand-signalled in the process of trading. ELOB dispenses with the 'open cry' system. The system was first used by the National Stock Exchange (NSE), then followed by the Bombay Stock Exchange (BSE). In barely two years after it first appeared in out country, the ELOB has become the dominant technology underlying markets in the country. (Read also box 25.2)

Nationwide Integrated Markets

Prior to 1994, India's markets were dominated by the BSE. The financial industry in other locations was unable to have equal access to markets and participate in forming prices, as compared with market participants in Mumbai. Trading orders from outside Mumbai would generally be transmitted to a Mumbai broker who would carry them to the trading floor. The introduction of additional intermediaries would increase the transaction costs faced by the ultimate investor.

Nationwide integrated markets would help any trader anywhere in India to have equal access to the markets. This integration has been made possible through satellite communications. NSE was the first to launch such facilities and all its members have equal access to the market regardless of their location. As of October 31, 1996, NSE had 1,000 VSAT terminals located all over the country through which trading takes place. The BSE and the Delhi Stock Exchange also are in the process of establishing similar facilities.

Clearinghouse That Guarantees the Trade

There are always possibilities that parties to a contract default in their obligations and such breaches have a cascading effect, resulting in a major financial crisis. It happened

Box 25.2

How Automation and Competition have changed the BSE

As of 3 November 1994, India's market was dominated by the BSE, a monopoly market that did trading by open outcry. Seven months later, as of 2 June 1995, India's market was dominated by the competition between the BSE and the NSE, where both markets were open electronic limit order book markets. It should be noted that NSE was trading only around 1300 stocks, whereas there were around 4000 other stocks on the BSE where there is no competition for order flow. One related change which took place across these events was a sharp fall in the brokerage fees, following the large-scale entry into the brokerage business that accompanied the NSE.

In Shah and Thomas, this beautiful natural experiment is used to illuminate the consequences of automation and competition. The main findings here may be summarised as follows:

* Liquidity in the economy as a whole appears to have improved sharply across these changes. The improvement in liquidity on the BSE is made up of two parts: a positive effect attributed to automation and a negative effect attributed to competition.
* The gains in liquidity fed into gains in market efficiency, exactly as economic theory predicts. Two forms of market efficiency were explored. One direct form of market efficiency is that returns should not be forecastable based on historical data about returns or prices; i.e., that returns should be purely random. There is strong evidence that short-term correlations are much diminished after the introduction of automation and competition.

  Another interesting idea about prices capturing information concerns good news vs bad news. Firms would generally advertise good news about themselves, but try to conceal bad news from the markets. In this case, bad news would gradually leak into prices through several small price drops, instead of one large drop. This would generate a skewness in returns, where large price drops are observed less often than ought to be the case. Improvements in the market efficiency should hence be associated with a reduction in the skewness of returns. Strong evidence for such reduction is found after the introduction of automation and competition.
* There is circumstantial evidence about reduction in mis-reported high and low prices, which were probably part of gala, the mechanism through which brokers reported a different trade price to the investor as compared with the truth.
* Volatility on BSE is elevated with automation, but is diminished with cross-listing on NSE. The volatility increase is likely to be consistent with the enhanced market efficiency. The cross-listing effect is likely to be associated with the market surveillance procedures on the NSE.

(Source: Kirti S.Parik (Ed), *India Development Report*, Oxford University Press, 1997, 0.173)

in April 1995 in the context of M.S.Shoes, where a default involving a total exposure of Rs.18 crore led to a payments crisis on the BSE which halted the functioning the exchange for three days. To prevent such happenings in future, the National Securities Cleaning Corporation (NSCC) was set up on NSE, on 4 July, 1996. NSCC guarantees all trades on NSE. Thus, if A and B make a trade, NSCC interposes itself between them. If A was supposed to buy from B, then NSCC buys from B and NSCC sells to A. If either A or B

defaults, then NSCC meets the obligations for the other leg of the trade. Thus, every trade that takes place is freed from any risk of default and its cascading effect.

Demutualisation

Recently the Securities Contract (Regulations) Act was amended to make demutualization of stock exchanges mandatory. The process of converting stock exchanges into corporate entities, with a wider ownership and the resulting oversight by regulatory bodies is called demutualization.

The amendment not only requires separation of ownership and trading rights, it also requires that the majority ownership rests with the public and those without any trading rights. Through these conditions, the Government has signaled a major shift in its earlier stand that stock exchanges should be self-regulating agencies of their members. It now desires that they should be externally regulated.

(Box 25.3 contains several other steps to make stock exchanges more effective).

Box 25.3

Steps to improve efficiency of stock exchanges

1. Introduce scripless trading.
2. Replace jobbing by market making.
3. Streamline settlement system.
4. Allow companies to buy back their own shares.
5. Integrate working of all exchanges.
6. Improve information dissemination system.
7. Allow multiple membership for brokers.
8. Increase the number of brokers. Give them better education and training.
9. Allow brokers to advertise their businesses.
10. Pool all the odd lot shares and convert them into marketable lots.
11. Remove one-year limitation of the validity period of the transfer deed.
12. Simplify transfer procedure.
13. Make rating of equities compulsory.
14. Reduce number of holidays.
15. Introduce two trading sessions in the place of the present one session trading.
16. Create investor awareness.
17. Make signature verification efficient.
18. Activise role of financial institutions.

QUESTIONS

1. Define a stock exchange. What are its functions?
2. What are the benefits of stock exchanges?
3. Describe the dealings in a stock exchange.
4. What is speculation? Do investors invest in shares for speculative gains always?
5. What are the recent trends of stock markets in our country?

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CHAPTER 26

Monetary and Fiscal Policies

CHAPTER OUTLINE

Monetary Policy
- *Extent of Money*
- *Expansion of Money*
- *Contraction of Money*
- *Evaluation of Monetary Policy*
- *Structural Adjustments and Monetary Policy*

Money Market
- *Functions of Money Market*
- *Growth of Money Market*
- *Operations in Money Market*
- *Commercial Banks*

Fiscal Policy
- *The Budget*
- *The Union Budget*
- *Evaluation of Fiscal Policy*
- *Agenda for Future*

Union Budget 2000-2001
- *Direct Taxes*
- *Indirect Taxes*
- *Outlays*
- *New Measures*

LEARNING OBJECTIVES

After reading this Chapter, you should be able to:

1. *Define monetary policy, understand techniques to measure the extent of money, and evaluate RBI's monetary policy*
2. *Understand the meaning and functions of money market, examine operations in money market and assess functioning of commercial banks*
3. *Define fiscal policy, know how budget operates and make critical assessment of fiscal policy*
4. *Bring out the highlights of the Union Budget 2000-2001*

MONETARY POLICY

The monetary policy is assuming greater relevance nowadays because the government has now shifted from physical controls like control over output, capacity utilisation and licensing to non-physical controls like monetary policy in order to regulate business activities. Two reasons are quoted in support of this shift. One is that the changes in the quantum of saving and its characteristics are reasons enough for considering the Indian economy to be ready for indirect management through financial controls. It is argued that the physical management of the economy through controls and licences, which had been an unavoidable necessity during the earlier phase of the development of the Indian economy is no longer necessary and, indeed, may turn out to be counter-productive when the economy is poised for a higher level of performance and growth as shown by the high rate of saving (from 10 per cent of DGP in 1950-51 to 26 per cent in 1978-79 and 20.7 per cent during 1985-92).

Government nowadays relys more on measures like the monitory policy to regulate economy.

The second reason which is claimed to favour the indirect management of the economy through financial controls is the findings of the Planning Commission that in recent years, especially during the Sixth Plan period of high growth rate, there has been a perceptible fall in the incidence of poverty. (In 1983, the percentage of population below the poverty line declined from 48.3 to 37.4 and further came down to 26 per cent in 1999-2000). The Commission's reasoning is that reduction in the incidence of poverty is being brought about by the accelerated rate of growth of the economy and what the economy needs in the decade ahead is growth which can be achieved through appropriate macro-policies based primarily on fiscal, monetary and credit policies.

Nature of Monetary Policy

Monetary policy is the policy statement, traditionally bi-annual, through which the Reserve Bank of India (RBI) targets a key set of indicators to ensure price stability in the economy. These factors include:

* Money supply, commonly referred to as M3.
* Interest rates.
* Inflation.

RBI uses the monitory policy to ensure price stability in the economy. The policy also provides norms for financial bodies.

Besides, the policy also provides a platform for the apex bank to announce norms for financial bodies governed by the RBI such as banks, financial institutions, non-banking finance companies, residual non-banking companies, *nidhis*, primary dealers in the money markets and authorised dealers in the foreign exchange markets. It is also an opportunity for the RBI to spell out its overview on the economy, and an occasion for it to indicate deposit and advance targets for banks in the half-year.

Historically, the monetary policy has been announced twice a year-one for the slack season (April-September) and one for the busy season (October-March), in accordance with agricultural cycles. These cycles also coincide with the halves of the financial year. However, with the share of credit to agriculture coming down, the share of non-food credit in total credit has gone up. Since non-food or industrial credit is not seasonal, the RBI has, in 1998-99, experimented with one policy announcement in April, followed by a review in October. In 1999-2000, the RBI has decided that the policy will be an annual affair.

The RBI's monetary policy has been characterised as one of controlled expansion, i.e., adequate financing of economic growth and at the same time, ensuring reasonable price stability.

Extent of Money

RBI's monitory policy has been described as the controlled-expansion one.

M1 to M4 are the indices used by RBI to measure the supply of money at a given time.

Before initiating measures for the expansion or contraction of money supply, the RBI generally measures the extent of money and credit available in the economy at a given time. The following indices are generally used for the purpose.

M_1 This represents money supply with the public. M_1 has two components; (a) currency with the public and (b) deposits of the public with the banks.

Currency with the public is the sum total of notes in circulation and circulation of rupee coins and small coins minus the cash on hand with banks.

Deposits of the public with banks is the sum total of demand deposits with banks and 'other' deposits of the public with the RBI.

M_2 This represents the total of M_1 plus post office savings and bank deposits.

M_3 It is the sum total of M_2 and the time deposits with banks.

M_4 This represents M_3 plus total post office deposits.

M_1 is called 'narrow money' while M_3 is called 'broad money'. M_3 represents the aggregate monetary resources or the money stock of the entire banking sector.

What are the representative sources of M_3? These are: (a) the net bank credit to the government, (b) bank credit to the commercial sector; (c) net foreign exchange assets of the banking sector and (d) the government's currency liabilities to the public (Also read box 26.1).

Expansion of Money

Money is pumped into the economy through the issue of currency by the RBI, budgetary operations of the government and borrowings by the government from foreign countries.

Expansion of money has always been on the increase. Between 1970-71 and 1983-84, as against 3.7 per cent average annual growth in output, money supply registered an annual expansion of 17.2 per cent. This phenomenon is not unique to our country. It is universal. Particularly, 1986 has been a year of money expansion as is evident from Table 26.1.

Expansion in money supply is not wrong, nay it is desirable, in a developing economy as money is needed to match the growth of real national income. Infact, the growth in money supply must be higher than the growth in the real national income. This stems from two reasons: (a) as incomes grow, the demand for money as one of the components of savings tends to increase. (b) an increase in money supply is also necessitated by the gradual reduction of the non-monetised sector of the economy. In our country, the rate of increase in money supply has been far in excess of the rate of growth in real national income. Hence the inflationary pressure is there on the economy.

Box 26.1

Broadening the Meaning of Money

A Committee constituted by the RBI (in its report submitted in June, 1998) recommended, among others, the following:

- Exclusion of the data on post office accounts. The argument is that these deposits were included in measures of money supply at a time when the banking network was under-developed in the rural areas. Since this is no longer the case and as post offices cannot be considered 'depositories', these deposits should be excluded. Accordingly, M_4 will disappear.
- In order to reflect recent monetary trends, it has been suggested that the monetary measures, M_2 and M_3, should be altered. M_2 should exclude fully repatriable bank deposits (of up to one year maturity) held by non-resident Indians. And M_3 should include what the banks borrow in the call market from 'non-depository' financial corporations.

But what of deposits with non-banking financial companies and development financial institutions that are increasing in magnitude? And while certificates of deposit with banks are already included in M_3, what about those CDs issued by development financial institutions? Shouldn't these two categories of deposits also be considered money?

The RBI Committee has chosen instead to devise three new measures, not of money supply but of liquidity. This is apparently what some other countries have done. While deposits with NBFCs are numerically large, the NBFCs do not provide services similar to banks, hence the exclusion of deposits with them from measures of money supply.

The three new aggregates of liquidity suggested are:

- L_1 which will be M_3 and all deposits with post office savings banks.
- L_2 which will be L_1 plus fixed deposits with development financial institutions and certificates of deposit of these institutions.
- L_3 which will be L_2 and deposits with the NBFCs.

The RBI is expected to compile estimates of these three liquidity aggregates, as it has been doing of M_1, M_2 and M_3. The objective is to track similar and as yet distinctive measures of money. The new liquidity aggregates encompass a much broader notion of money. But it would appear that M_3 will continue to be the focus of monetary policy. The RBI is to put out only monthly estimates of the three measures of liquidity while it will continue to make fortnightly compilations of M_1, M_2 and M_3.

Table **26.1**

Money Expansion

		Target	*Actual*
U.S.A.	M_1	3 p.c. to 8 p.c.	15 p.c.
	M_2	6 p.c. to 9 p.c.	8.9 p.c.
France	M_3	3 p.c. to 6 p.c.	4.8 p.c.
Britain	M_4	11 p.c. to 15 p.c.	18.6 p.c.

(**Source:** *Economic Times*, January 26, 1987.)

Contraction of Money

Unlimited expansion of money and credit results in hyper-inflation, which hits all sections of society, particularly the poor. The Reserve Bank has a responsibility to

Money supply is sought to be contracted through general and selective controls.

ensure that money supply is within manageable limits and inflation is not too harsh. For this purpose, the Reserve Bank has been using different control measures, popularly called *'credit control measures'*. These control measures can be broadly classified into two categories, *viz*., (a) general, (quantitative) controls and (b) selective (qualitative) controls.

General Credit Controls

The general controls affect the total quantity of credit and the economy generally. General controls include: (a) Bank Rate; (b) Open Market Operations; (c) Cash Reserve Requirements; (d) Statutory Liquidity Requirements and (e) Refinance Policy.

Bank Rate: Also called the discount rate, bank rate refers to the rate at which the Central Bank rediscounts or lends money to commercial banks. During inflationary periods, the bank rate is hiked so as to increase the rates of interest on borrowings. This will have a dampening effect on the borrowers. The reverse course of action is taken during the periods of falling prices.

Bank rate is one of the general control measures. It is the rate at which RBI rediscounts or lends money to commercial banks.

The RBI has changed the bank rate several times - from 4.5 per cent in 1963, the rate was raised to 5 per cent in 1964, to 6 per cent in 1965, to 7 per cent in 1973, to 9 per cent in 1974 and to 10 per cent in 1983. It was further raised to 11 per cent in 1991 and subsequently increased to 12 per cent. Since March 1, 1999, the rate has been reduced to 8 per cent and since April 1, 2000, it has been further cut to 7 per cent. The rate has been further cut to 6 per cent from April 2003.

(a) *Open Market Operations*: Open market operations refer to the purchase or sale of securities, foreign exchange and gold by the government. Purchase of securities and gold from public results in the expansion of money. Sale of securities and gold results in the contraction of money supply. It was with this objective that 13.5 tonnes of gold was auctioned during 1977-78. (see Table 26.2 for more details).

Table 26.2

Reserve Bank's Open Market Operations in Central Government Securities

(Rs. Crore)

Year	Purchase	Sales	Net Sales
1988-89	2,403.5	3,888.7	[illegible]
1990-91	2,291.2	2,238.1	[illegible]
1992-93	6,273.4	11,793.5	[illegible]
April-June			
1992-93	2,791.3	6,984.9	[illegible]
1993-94	446.3	568.2	[illegible]

(b) *Special Facilities to Some Groups*: The Reserve Bank advises commercial banks to advance liberally to special groups or priority sectors like small-scale industries, cooperatives, small transport operators, self employed and the like. This also results in the expansion of money supply.

(c) *Liberalisation of the Bill Market Scheme*: Under this, commercial banks get additional finance from the Reserve Bank. With additional funds at their disposal, commercial banks will be able to advance credit further.