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BUSINESS ENVIRONMENT	**UNIT : I to IV**
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BUSINESS ENVIRONMENT

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C. No. :- BCG-404 UNIT I

SEMESTER: IV LESSON: 1

INTRODUCTION TO BUSINESS ENVIRONMENT

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1.1. INTRODUCTION

Business is an important institution in society. Be it for the supply of goods or services, creation of employment opportunities, offer of better quality life, or contribution to the economic growth of a country, the role of business is crucial. So the first question arises in anyone's mind is what really a business is ? The following definition is an attempt to provide appropriate answer.

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

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

1.2 OBJECTIVE

After studying this unit, the students will be able to understand

" The concept of business environment its meaning, scope and importance.

" The various techniques of environmental analysis

" Steps involved in environmental forecasting.

1.3. CONCEPT OF BUSINESS ENVIRONMENT

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

From the micro point of view, a business is an economic institution, as it is concerned with production and/or distribution of goods and services, in order to earn profits and acquire wealth. Different kinds of organizations (i.e., sole tradership, partnership, joint stock company and co-operative organization) are engaged in business and are operating from small scale, as in case of grocry in a start, to large scale, as in case of Tata Iron and Steel Co., Bajaj Auto, Maruti Udyog, and Reliance Industries. Whatever may be the nature and scale of operations, a business enterprise possesses the following characteristics :

1. Dealings in Goods and Services : The first basic characteristic of a business is that it deals in goods and services. Goods produced or exchanged, may be consumers' goods, such as bread, rice, cloth, etc. or producers' goods such as machines, tools, etc. The consumer goods are meant for direct consumption, either immediately, or after undergoing some processes, whereas the producers' goods are meant for being used for the purposes of further production. Producers' goods are also known as capital goods. Services include supply of electricity, gas, water finance, insurance, transportation, warehousing, etc.

2. Production and/or Exchange : Every business is concerned with production and exchange of goods and services for value. Thus, goods produced or purchased for personal consumption or for presenting to others as gifts do not constitute business, because there is no sale or transfer for value. For example, if a person cooks at home for personal consumption, it is not business activity. But, if he cooks for others in his 'dhaba', or restaurant and receives payment from them, it becomes his business.

3. Creation of form, time and place utility : All business activities create utilities for the society. Form utility is created, when raw materials are converted into finished goods and services. Place utility is created, when goods are transported from the place of production to the place of consumption. Storage of goods creates time utility. This helps in preserving the goods, when not required and making them available, when demanded by the consumers.

4. Regularity and Continuity in Dealings : Regularity of economic transactions is the essence of business. There should be continuity, or regularity of exchange of goods and services for money. An isolated transaction cannot be called a business. For example, if a person sells his flat and earns some profits, it cannot be called a business. But, if he purchases and sells flats regularly to earn his livelihood, it will be called his business.

5. Profit Motive : Another important feature of a business activity is its objective. The chief objective of a business is to earn reasonable profits or 'surplus' as it is called in case of public enterprises. The survival of a business depends upon its ability to earn profits. Every businessman wants to earn profits, to get return on his capital and to reward himself for his services.

Actually, profit is the spur that helps in the continuation of the business. Profit is also essential for growth. Recreation clubs and religious institutions cannot be called business enterprises, as they have nothing to do with the profit motive. The scope of business is very wide. It should not be confused with trade. 'Trade' simply denotes purchase and sale of goods, whereas 'business' includes all activities from production to distribution of goods and services. It embraces industry, trade and other activities like banking, transport, insurance, and warehousing which facilitate production and distribution of goods and services. According to F.C. Hooper, "The whole complex field of commerce and industry, the basic industries, processing and manufacturing industries, the network of ancillary services : distribution, banking, insurance, transport and so on, which serve and inter-penetrate the world of business as a whole, are business activities."

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

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

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

(b) Producers' Goods : Goods used for the production of other goods are described as producers' goods. Machine tools and machinery used for manufacturing other products come under this heading. These are also called capital goods.

(c) Intermediate Goods : There are certain materials, which are the finished products of one industry and become the intermediate products of other industries. A few examples of this kind are the copper industry, aluminum industry, and plastic industry, the finished products of which are used in manufacturing electrical appliances, electricity wires, toys, baskets, containers, and buckets. Broadly speaking, industrial activities may be classified into primary and secondary industries. Primary industry may be either extractive, or genetic, and secondary industry may be either manufacturing, or construction.

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

(ii) Genetic Industries : Genetic means parentage, or heredity. Genetic industries are engaged in breeding plants and animals, for their use in further reproduction. For breeding plants, the nurseries are typical examples of genetic industries. In addition, the activities of cattle-breeding farms poultry farms and fish hatchery come under the category of genetic industries.

(iii) Manufacturing Industries : These are engaged in producing goods through the creation of form utility. Such industries are engaged in the conversion, or transformation of raw materials, or semi-finished products into finished products. The products of extractive industries generally become the raw materials of manufacturing industries. Factory production is the outcome of manufacturing industry.

(iv) Construction Industries : They are concerned with the making or construction of buildings, bridges, dams, roads, canals, etc. These industries use the products of manufacturing industries, such as iron and steel, cement lime, mortar, etc. and also the products of extractive industries, such as stone, marble etc. The remarkable feature of these industries is that their products are not sold in the sense of being taken to the markets. They are constructed and fabricated at fixed sites.

(v) Service Industry : There are several services such as transport, banking, insurance and warehousing, which are very important for satisfying human needs. They facilitate the production and distribution of business activity. A large number of business firms are engaged in transport, insurance and storage of goods and provision of banking and financial facilities to business units. Such firms are said to be engaged in service industries.

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

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

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

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

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

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

From the above definitions we can extract that business environment consists of factors that are internal and external which poses threats to a firm or these provide opportunities for exploitation. In business all the activities are being organized and also carried out by the people to satisfy the needs of the consumers. So, it is an activity carried out by the people for the people which means people occupy a central place around which all the activities revolve. It means business is people and a human is always a dynamic entity who believes in change and it may be right to say that the only certainty today is change. It poses a huge challenge for today's and especially tomorrow's businessmen and managers to be aware of specific changes so as to keep themselves abreast with the latest happenings in the field of business to maintain their survival and sustainability in the market. Therefore, the study of business environment is of atmost importance for the managers and practitioners.

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

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

Business environment is becoming very complex day by day as some environmental issues such as deforestation, global warming, depletion of the ozone layer, pollution of land, air and water are no longer strictly the issues related to books and conferences. The leading politicians and managers around the world have picked up the environmental banner.

The green marketing movement has been gaining momentum around the world. The businesses are challenged today to develop creative ways to make profits without unduly harming the existing environment. Considering the variety of these sources of change in the environment, global managers are challenged to keep themselves abreast and adjust as necessary. Some companies like Daewoo, Hyundai, Maruti, Tata and Hero-Honda in India, with their pollution prevention programmes are leading the way. Indeed, cleaning up the environment promises to generate whole new classes of jobs in the future.

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

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

Nature of globalization : Globalization means several things to several people. For some it is a new paradigm - a set of fresh belief, working methods and economic, political and socio-cultural realities in which the previous assumptions are no longer valid. For developing countries, it means integration with world economy. In simple economic terms, globalization refers to the process of integration of world into one huge market. Such unification calls for removal of all trade barriers among countries. Hence, globalization aims at removing isolations of different economies.

Globalization is a new phenomenon to India. We were for a long time content in serving internal market which has been vast. Domestic production was insufficient to feed the vast market. We were compelled to import in order to supplement domestic production. We were also exporting to other countries, but our exports were composed of traditional commodities and the direction was mainly erstwhile communist block. Globalization did hardly exist during past five decades. There are other reasons too, which made us within the country's boundaries. For a long time, we did not have industries of the number and magnitude to think of globalization. Vibrant economy filled with robust industries is a pre-requisite for internalization. Secondly, for the past five decades, we followed an economic policy which did not encourage competitive spirit among our industrialists. In the name of self-reliance, import substitution, swadheshi and economic sovereignty, we encouraged domestic industries to prosper, however inefficient they were. We gave those licenses, fixed quotas, imposed tariffs and offered subsidies generously. We put several restrictions on foreign companies desiring to enter Indian soil. This continued till 1990. In 1991, the new industrial policy paved the way for globalization in our economy. The number of global companies entered in India was 164 on 31st December 1991. Major Indian Industries also set their subsidiaries abroad. The major Indian player in global arena are Ranbaxy, Essar Gujarat, Arvind Mills, Ballarpur Industries, UB, Reddy's lab and Aditya Birla Group. The process rate increased in late 90s and is now at its youth.

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

1.3.1 TECHNOLOGICAL ENVIRONMENT

Among all the segments of environment, technological environment exerts considerable influence on business. Thus this section requires more devotion. J.K. Galbraith defines technology as a systematic application of scientific or other organized knowledge to practical tasks. During the last 150 years, technology has developed beyond anybody's comprehensions. Year 1983 was particularly considered by scientists as the year of scientific success. In this year scientists put a billion dollars technology into space, produced the world's first test-tube triplets and obtained evidence of another solar system. A major break through was achieved in the field of genetic engg. to cure dwarfism. Technology, thus, is the most dramatic force shaping the destiny of people and business all over the world.

Status of Technology in India

India, like any other third world country, attended political independence after prolonged colonial rule and exploitation. The country entered the modern world in a state of economic backwardness and poverty of a large section of people. It is obvious that technology must attend to the basic problems of food, clothing, health and housing of people. At the same time rapid industrial development through latest technology is necessary to catch up with advanced countries. With these objectives in mind, Government of India set-up series of R & D establishments, space research centre, Medical research centres, agricultural research establishments, oil explorations centres, power development projects and the council of scientific and industrial research. Besides, several universities and institutes have been set-up to provide higher education in science, technology and management. As on today there are 4700 inter mediate/ junior colleges, 144 universities, and 44 deemed universities in the country. Also there are more than 500 science and technological institutions, and 1080 in house research and development laboratories. There is also the Department of Science and Technology, an administrative wing of Government, to coordinate the activities of all research and technical activities in the country.

1.3.2 ECONOMIC ENVIRONMENT

Economic environment refers to all those economic factors which have a bearing on the functioning of a business unit. Business depends on the economic environment for all the needed inputs. It also depends on the economic environment to sell the finished goods. Naturally, the dependence of business on the economic environment is total and it is not surprising because, as it is rightly said, business is one unit of the total economy. It is difficult to be precise about the factors which constitute the economic environment of a country. But still there are some factors which have considerable influence. These factors are :-

(a) Growth strategy

(b) Economic system

(c) Economic planning

(d) Industry

(e) Agriculture

(f) Infrastructure

(g) Financial and fiscal sector

(h) Removal of regional imbalances

(i) Price and distribution control

(j) Economic Reforms

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

1. Economic system

2. Industry

1. Economic System : The scope of a private business and the extent of government regulation of economic activities depend to a very large extent on the nature of economic system, which is an important part of business environment. Broadly the economic system is divided into three groups.

(a) Capitalism

(b) Socialism

(c) Communism

(a) Capitalism

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

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

Two types of capitalism may be distinguished, viz.,

(i) The old, laissez-fair capitalism, where government intervention in the economy is absent or negligible; and

(ii) The modern, regulated or mixed capitalism, where there is a substantial amount of government intervention.

(b) Socialism

Under socialism, the tools of production are to be organized, managed and owned by the government, with the benefits occurring to the public. A strong public sector, agrarian reforms, control over private wealth and investment and national self reliance are the other planks of socialism.

Socialism does not involve an equal division of existing wealth among the people, but advocates the egalitarian principle. It believes in providing employment to all and emphasizes suitable rewards to the efforts put in by every worker. Also called fabian socialism, this philosophy is followed in our country and other social democratic countries in the world.

(c) Communism

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

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

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

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

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

Industrial policy is probably the most important document which indicates the relationship between the government and the business. But, it has no legal sanction and as such its violation can not be challenged in a court as is possible in the case of Fundamental Rights guaranteed by the constitution. This policy was announced on 30th April 1956. The resolution of 1956 made the industrial policy. More socialist oriented and widened the scope of public sector. The resolution classified industries into three categories, having regard to the role which the state would play in each of them.

(i) The first category contained industries "the future development of which will be the exclusive responsibility of the state". Industries in this category were listed in Schedule A of the resolution. Schedule A contained 17 industries. These included railways and air transport, arms and ammunitions, and atomic energy, which were to be developed as Central Government monopolies. In the remaining industries in Schedule A, the expansion of the existing privately-owned units, or the possibility of the state securing the cooperation of private enterprise in the establishment of new units where the national interest so required, was not produced. However, it was made clear that "whenever co-operation with private enterprise is necessary, the state will ensure, either through majority participation in the capital or otherwise, that it has the requisite powers to guide the policy and control the operations of the undertaking.

(ii) In the second category were included industries "which will be progressively state-owned and in which the state will, therefore, generally take the initiative in establishing new undertakings, but in which private enterprise will also be expected to supplement the efforts of state. The industries included in the second category were listed in schedule B of the resolution. It contained 12 industries like machine tools, firo-alloys and tools, drugs, fertilizers, synthetic rubber, canbonisation of coal, chemical pulp, road transport and sea transport and aluminium and other non-ferrous metals not included in Schedule A.

(iii) the rest of industries were thrown open to the private sector but this did not prevent the state from starting any new undertaking. State will facilitate and encourage the development of these industries in the private sector by providing infrastructural facilities. Ours is one of the few countries in the world where an entrepreneur is required to obtain an industrial license from the government before venturing into a new business.

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

a) To limit industrial capacity within the targets set by the plans.

b) To direct investment in industries according to plan priorities.

c) To regulate the location of industrial units so as to secure a balanced regional development.

d) To prevent monopoly and prevention of concentration of wealth.

e) To protect small scale industries against under competition from large scale industries.

f) To foster technology and economic improvements in industries by ensuring units of economic size and adopting modern processes.

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

The monopolies and Restrictive Trade Practices Act, 1969, brought into force from Ist June 1970, was a very controversial piece of legislation. The principal objectives of the MRTP Act which extends to the whole of India except to the state of Jammu and Kashmir, viz. :

i) Prevention of concentration of economic power to the common detriment.

ii) Control of monopolistic, restrictive and unfair trade practices which are prejudicial to public interest.

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

i) Controlling monopolistic trade practices.

ii) Regulating restrictive and unfair trade practices.

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

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

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

Thus, the following are MTPs :

1. Maintaining the prices of goods or charges for any services at an unreasonable level.

2. Limiting technical development or capital investment to the common detriment.

3. Unreasonably preventing or lessening competition.

4. Allowing quality of goods produced, supplied or distributed or any service rendered to deteriorate.

5. Increasing unreasonably the cost of production of any goods or charges for

provision or maintenance of services.

6. Increasing unreasonably the selling price of goods, or charges at which the services may be provided.

7. Increasing unreasonably the profits that are derived from the production, supply or distribution of any goods or the provision of any services.

8. Preventing or lessening competition in the production, supply or distribution of any goods or in the provision or maintenance of any services by adopting unfair methods of unfair practices.

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

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

(b) Tie-in sales or full line forcing : Any agreement requiring purchaser of goods, as a condition of such purchase, to purchase some other goods.

(c) Exclusive dealing agreement : Any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of seller or any other goods.

(d) Collective price fixation and tendering : Any agreement to purchase or sell goods or to tender for the sale or purchase of goods only at prices or terms and conditions agreed upon between the sellers or purchaser.

(e) Discriminatory Dealings : Any agreement to grant or allow concession or benefits, including allowances, discounts, rebate or credit, in connection with or by reason of dealings.

(f) Re-sale price maintenance : Any agreement to sell goods on condition that the prices to be charged on resale by the purchaser shall be the prices stipulated by the seller unless it is clearly stated that prices lower than those prices may be charged.

(g) Restriction on output or supply of goods : Exclusive distributorship, territorial restriction and market sharing.

(h) Control of manufacturing process.

(i) Price control arrangements.

(j) Governmental recognition of practice as restriction.

(k) Residual restriction trade practices : Any agreement to enforce the carrying out of any such agreement as is referred to in the foregoing classes.

The principle objective of the Foreign Exchange Regulation Act (FERA) is to prevent the outflow of Indian currency and to see that the foreign exchange legitimately due to India should be received. In detail, the objectives of the Act are as follows :

i) To regulate certain payments.

ii) To regulate dealings in foreign exchange and securities.

iii) To regulate the transactions indirectly affecting foreign exchange.

iv) To regulate import and export of currency and bullion.

v) To conserve the foreign exchange resources of the country and to utilize the same in the interests of the economic development of the country.

vi) To regulate holding of immovable property outside India.

vii) To regulate employment of foreign nationals.

viii) To regulate acquisition, holding etc. of immovable property in India.

ix) To regulate foreign companies.

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

1.3.3 POLITICAL ENVIRONMENT

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

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

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

1. Legislature
2. Executive or government
3. Judiciary

1. Legislature

Out of three, legislature is most powerful political institution vested with such powers as policy making, law-makings, budget approving, executive control and acting as mirror of public opinion. The influence of legislature on business is considerable. It decides such vital aspects as

the type of business activities, the country should have, who should own them, what should be their size of operation, what should happen to their earnings and other related factors.

2. Government as Executive

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

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

a) Establishment and enforcement of law

b) Maintenance of order

c) Money and credit

d) Orderly growth

e) Infrastructure

f) Information

g) Assistance to small industries

h) Transfer of technology

i) Tariffs and Quotas

3. Judiciary

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

The power of the judiciary are of dual type :

i) The authority of the courts to settle legal disputes.

ii) Judicial review - the authority of the courts to rule on the constitutionality of legislation.

1.3.4 SOCIO-ECONOMIC ENVIRONMENT

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

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

The culture has two main characteristics :

i) Shared value

ii) Passage of time

Culture of a society is shared by its members. Cultural ethos are passed from one generation to other generation. It is not confined to one particular period of time. The interface between business and culture can be summarized as follows :

a) Culture creates people.

b) Culture determines goods and services.

c) It defines people's attitude to business and to work.

d) Explains the spirit of collectivism and individualism.

e) Defines whether people are Ambitions or complacent.

f) Education

g) Family

h) Authority

i) Marriage

j) Time Dimension

k) Cultural Resources.

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

1.3.5 NATURAL ENVIRONMENT

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

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

1.4 TYPES OF BUSINESS ENVIRONMENT

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

Business Environment

Internal Environment	**External Environment**	
	Micro Environment	Macro Environment
• Human Resources & Internal Relationship	• Consumers	• EconomicFactors
• Company Image	• Suppliers	• Political & Govt Factors
• Management Structure	• Competitors	• Demographic Factors
• Physical Assets	• Middle man	• Socio- Cultural Factors
• R&D& Technological Capabilities	• Publics	• International Factors C
• Marketing Resources		
• Financial factors		

1.4.1 Internal Environment

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

(a) Human Resources : It involves the planning, acquisition, and development of human resources necessary for organizational success. It points out that people are valuable resources requiring careful attention and nurturing. Progressive and successful organizations treat all employees as valuable human resources.

The organization's strengths and weaknesses is also determined by the skill, quality, morale, commitment and attitudes of the employees. Organizations face difficulties while carrying out modernizations or restructuring process by the resistance of employees. So, the issues related to morale and attitudes should seriously be considered by the management. Moreover, global competitive pressures have made the skillful management of human resources more important than ever. The support from the different levels of employees support the management in the different decisions and their implementations.

(b) Company Image : One company issues shares and debentures to the public to raise money and its instruments are over subscribed while the other company seeks the help of different intermediaries like underwriters to generate finance from the public. This difference underlies the distinction between the images of the two companies.

The image of the company also matters in certain other decisions as well like forming joint ventures, entering contracts with the other company or launching of new products etc.

Therefore, building company image should also be a major consideration for the managers.

(c) Management Structure : Gone are the days when business was carried out by the single entrepreneur or in the formation of partnerships. Now it has reshaped itself into the formation of company where it is run and controlled by the board of directors who influence almost every decision. Therefore, the composition of board of directors and nominees of different financial institutions could be very decisive in several critical decisions. The extent of professionalisation is also a crucial factor while taking business decisions.

(d) Physical Assets : To enjoy economies of scale, smooth supply of produced materials, and efficient production capacity are some of the important factors of business which depends upon the physical assets of an organization. These factors should always be kept in mind by the managers because these play a vital role in determining the competitive status of a firm or an organization.

(e) R & D and Technological Capabilities : Technology is the application of organized knowledge to help solve problems in our society. The organizations which are using appropriate technologies enjoy a better competitive advantage than that of their competitors. The organizations which do not possess strong Research and Development departments always lag behind in innovations which seems to be a prerequisite for success in today's business. Therefore, R & D and technological capabilities of an organization determine a firm's ability to innovate and compete.

(f) Marketing Resources : The organizations which possess a strong base of marketing resources like talented marketing men, strong brand image, smart sales persons, identifiable products, wider and smooth distribution network and high quality of different services, make an effortless inroads in the target market. The companies which are having so strong basis can also enjoy the fruits of brand extension, form extension and new product introduction etc. in the market.

(g) Financial Factors : The performance of the organization is also affected by the certain financial factors like capital structure, financial position etc. Certain strategies and decisions are determined on the basis of such factors. The ultimate survival of organizations in both the public and private sectors is dictated largely by how proficiently available funds are managed.

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

1.4.2 External Environment

Companies operate in the external environment that forces and shape opportunities as well as threats. These forces represent "noncontrollable", which the company must monitor and respond to.

SWOT (Strengths, weaknesses, opportunities and threats) analysis is very much essential for the business policy formulation which one could do only after examination of external environment. The external business environment consists of macro environment and micro environment.

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

(a) Suppliers : The supplier to a firm can alter its competitive position and marketing capabilities. These can be raw material suppliers, energy suppliers, suppliers of labour and capital. The relationship between suppliers and the firm epitomizes a power equation between them. This equation is based on the industry conditions and the extent to which each of them is dependent on the other.

For the smooth functioning of business, reliable source of supply is a prerequisite. If any kind of uncertainties prevail regarding the supply of the raw materials, it often compels to a firm to maintain a high inventory which ultimately leads to the higher cost of production. Therefore, dependence on a single supplier is a risky venture. Because of the sensitivity of the issue, firm should go to develop relations among the different suppliers otherwise it could lead to a chaotic situation. Simultaneously firms should reduce the stock so as to reduce the costs.

(b) Customers : According to Peter F. Drucker "the motive of the business is to create customers", because a business survives only due to its customers. Successful companies recognize and respond to the unmet needs of the consumers profitably and in continuous manner. Because unmet needs always exist, companies could make a fortune if they meet those needs. For example it is the era when we could witness the increasing participation of women in the different jobs which has already given birth to the child care business, increased consumption of different durable items like microwave ovens, washing machines and food processors etc. A firm should also target the different segments on the basis of their tastes and preferences because to depend upon a single customer is often risky. So, monitoring the customer sensitivity is a pre condition for the success of business.

(c) Competitors : A firm's products/services are also affected by the nature and intensity of competition in an industry. A firm should extend its competitive analysis to include substitutes also besides scanning direct competitors. The objective of such an analysis is to assess and predict each competitors response to changes in the firm's strategy and industry conditions. This kind of analysis not only ensures the firm's competitive position in the market but also able to pick up as its major rival in the industry. Besides the existing competitors, it is also necessary to have an eye on the potential competitors who may join the industry although forecasting of such competitors is a difficult task. Thus an analysis of competition is critical for not only evolving competitive strategy but also for strengthening a firm's capabilities.

(d) Marketing Intermediaries : Marketing intermediaries provide a vital links between the organization and the consumers. These people include middlemen such as agents or brokers who help the firm to find out its customers. Physical distribution firms such as stockiest or warehouse providers or transporters ensure the smooth supply of the goods from their origin to the final destination. There are certain marketing research agencies which assist the organization in finding out the consumers so that they can target and promote their products to the right consumers.

Financial middlemen are also there who carry out to finance the marketing activities such as transportation and advertising etc. A firm should ensure that the link between organization and intermediaries is appropriate and smooth because a wrong choice of the link may cost the organization heavily. Therefore, a continuous vigil of all the intermediaries is a must.

(e) Publics : an organization has to confront with many types of publics during its life time. According to Cherrunilam "A public is any group that has an actual or potential interest in or impact on an organization's ability to achieve its interests". The public includes local publics, media publics and action groups etc. The organizations are affected by the certain acts of these publics depending upon the circumstances. For example if a business unit is establishment in a particular locality then it has to provide employment to the localites at least to the unskilled labour otherwise local group may harm to that very business or they will interrupt the functioning of the business. The media public has also to be taken into confidence because some time they tarnish the image of the organization unnecessarily. Simultaneously media public may disseminate vital information to the target audience.

Action groups can also create hindrances in the name of exploitation of consumers or on the issue of environmental pollution. The business suffers due to their activities. Therefore, their concern should also be kept in mind. Albeit, it is wrong to think that all publics are threats to the business yet their concerns should be considered up to a certain level.

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

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

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

(b) Economic Environment : Besides people, markets require purchasing power and that depends upon current income, savings, prices, debt and credit facilities etc. The economic environment affects the demand structure of any industry or product. The following factors should always be kept in mind by the business people to determine the success of the business.

(i) Per capita income

(ii) Gross national product

(iii) Fiscal and monitory policies

(iv) Ratio of interest changed by different financial institutions

(v) Industry life cycle and current phase

(vi) Trends of inflation or deflation

Each of the above factors can pose an opportunity as well as threat to a firm. For example, in a developing economy, the low demand for the product is due to the low income level of the people. In such a situation a firm or company can not generate the purchasing power of the people so as to generate the demand of the products.

But it can develop a low priced product to suit the low income market otherwise it will be slipped out from the market. Similarly, an industry gets a number of incentives and support from the government if it comes under the purview of priority sector whereas some industries face tough task if they are regarded as inessential ones.

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

(c) Technological Environment : Technology is a term that ignites passionate debates in many circles these days. According to some people technology have been instrumental for environmental destruction and cultural fragmentation whereas some others view that it has been the main cause to economic and social progress.

But no doubt it has released wonders to world such as penicillin, open-heart surgery, family planning devices and some other blessings like automobile, cellular phones and internet services etc. It has also been responsible for hydrogen bomb and nerve gas. But the businesses that ignored technological developments, had to go from the world map. For example, in India, cars like Ambassador and Premier had to go from the scene because of obsolete technology. Likewise, containerized movement of goods, deep freezers, trawlers fitted with freezers etc. have affected the operations of all firms including those involved in seafood industry.

Now it has been ensured that perishable goods can be transported in a safer manner. Explosion in information technology have made the position of some firms vulnerable. The life cycle of the products have reduced and expectations of the consumers are becoming higher and higher due to all these technological changes. But to cope up with this kind of scenario, a continuous vigil of the happenings and adequate investment on R & D department is to be earmarked by the marketer. Marketers must also be aware of certain government regulations while developing and launching new products with latest technological innovations.

(d) Political/Legal Environment : Business decisions are strongly affected by developments in the political and legal environment. This environment is consists of laws, regulations and policies that influence and limit various organizations. Sometimes these laws create opportunities for the business but these also pose certain odds or threats at the other time. For example, if the government specifies that certain products need mandatory packaging then it will boost the cardboard and packaging companies but it will add to the cost of the product. Regulations in advertising, like a ban on advertisement of certain products like liquor, cigarettes and pan masalas and hoarding of food products, gas and kerosene are the reality of today's business. Business legislations ensure specific purposes to protect business itself and the society as well like unfair competitions, to protect consumers from unfair business practices and to protect the interest of the society from unbridled business behaviour. In India business is regulated through certain laws like Monopolies and Restrictive Trade Practices

Act, 1969 (MRTP Act), Foreign Exchange and Regulation Act, 1973 (FERA), Partnership Act 1932, Consumer Protection Act, 1986 (CPA), and Companies Act, 1956 etc. A businessman needs to understand the various policies and political ideologies because these things have a profound impact on the functioning and success of the business.

(e) Social-cultural Environment : Society shapes the beliefs, values, norms, attitudes, education and ethics of the people in which they grow up and these factors exercise a great influence on the businesses which by far are beyond the company's control. All these factors are classified as social-cultural factors of the business. The buying and consumption pattern of the people are very much determined by these factors and cost of ignoring the customs, tastes and preferences etc. of the people could be very high for a business. Consumers depend on cultural prescriptions to guide their behaviour, and they assume that others will behave in ways that are consistent with their culture. Culture unites a group of people in a unique way and support the group's unity. As consumers, people expect that businessman will deliver according to the values, customs and rituals of the existing culture. As the business is going global day by day and the world is at the verge of 'global village' the need for developing understanding cultural differences has become an essential element to survive in such a scenario.

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

Despite the pervasive nature of culture, not all the people within a society think, feel, and act the same way. Every society has subculturesgroup of people that share values but exhibit them in different ways.

Within a society such as the India, there are the different tastes and preferences of the different starta like a Punjabi or a north Indian has altogether different preferences then that of a South Indian in the name of certain products especially in case of food and clothing and the shrewd marketers have always capitalized on this kind of opportunities. Hence, a thorough understanding of social-cultural environment is imperative to be successful.

1.5 TECHNIQUES FOR ENVIRONMENTAL ANALYSIS

Environmental analysis is a very important part of decision making. Managers need to take this aspect of taking decisions very seriously. It has been proved time and time again that decisions that are made from gut feelings or instincts may not work how the manager envisioned it to work out. It is always better for analysis to be done and different scenarios to be worked out to see how a decision can work out. This reduces the risk associated with taking decisions. This process of analyzing the environment is a dynamic process not a static process. The environment in which an organization works in is divided into internal and external environment its respective factors. The following article talks about the tools and techniques which are used in analyzing the factors of the business environment.

Strategic management is also called institutional management. It is the art and science of the creation of strategies and plans, the implementation and evaluation of these strategies and plans which helps an organization to achieve its long-term objectives. In this process the organization's mission, vision and objectives are discussed and developed. After these objectives are developed, the policies, plans, with respect to projects and programs, are designed, and then resources are allocated or budgeted to implement them and achieve the objectives. Strategic management consists of a set of activities that come under setting goals and over the process of putting together tactics to achieve these goals and objectives. How strategic management is carried out depends on the organizational structure of the company. The Board of Directors, the management team as well as other stake holders of the company can be involved in these activities that fall under strategic management.

Strategy can be defined as "unified, comprehensive and integrated plan that maps the strategic advantages of the organization to the challenges of the environment. It is designed to ensure that the core objectives of the enterprise are achieved through the proper execution by the organization."

Formulating a strategy for achieving an objective or a set of objectives is a combines three main processes which are:

- By analyzing the situation, evaluating themselves and comparing themselves with their competitors i.e. internal and external as well as micro-environmental and macro-environmental.
- After this assessment, the objectives are determined. These objectives should be created with respect to a time-line; where some are short-term and others are long-term objectives. This involves creating a vision statement, a mission statement, setting corporate level, strategic business unit level and tactical level objectives.
- These objectives should be studied along with the results of the situation analysis and a strategic plan can be formulated which will provide details of how to achieve these objectives.

Environmental analysis begins from the identification of environmental factors (internal and external), assessing their nature and the impact of these factors and making various profiles for positioning of the firm. All the decisions taken by the organization and the impact of these decisions depend on the organization's internal and external environmental factors. These environmental factors should be carefully analyzed before taking any decisions. Environmental analysis is made up of the processes which scan, monitor, analyze, and forecasts the situations which the organization can face and variables of the environment. Scanning is done to get information from the environment. Monitoring is done to test the impact of the environmental factors. Analyzing deals with data collection and the use of tools and techniques to study and measure the environmental factors. Forecasting is a method to find the possibilities of the future based on the historical data and present scenario.

Different tools, methods, and techniques are used for environmental analysis. Some of the major methods of analysis are benchmarking, scenario building and network methods. Scenario building gives an overall picture of the total system with the factors which affect it. Benchmarking is the process of finding the best standards in an industry and comparing the strengths and weaknesses of the firm with these identified standards. The network method is used to assess organizational systems and its external environment to find the strengths, weaknesses, opportunities and threats faced by an organization. Few of the techniques of primary information collection are brainstorming, the Delphi technique, conducting surveys, and historical enquiry. The Delphi technique collects independent information from the experts without mixing them. Brainstorming is done with a group of people usually cross-functional which discuss the problem in hand and try to come up with solutions irrespective of whether the solution is feasible or not. Conducting a survey first involves the design of questions and then asking these questions to people who become the participants. The historical enquiry technique is a case analysis of previous time periods. Analysis tools can be descriptive tools such as mean, median, mode, frequency or tools can be statistical such as ANOVA, correlation, regression, factor, cluster, and multiple regression analysis.

1.5.1 SWOT analysis:

A study of the internal and the external environment is a critical component of the strategic planning process. The firm's internal environmental factors can be classified as strengths (S) or weaknesses (W), and those factors which act as external agents to the firm can be classified as opportunities (O) or threats (T). This is called SWOT analysis. This analysis gives information that is useful in matching the organization's resources and abilities to the environment in which it operates.

1.5.2 Environmental analysis or external audit:

The organizations should adapt themselves and their strategy to the external environment which is constantly changing. The external environment is also called macro environment. These forces of the external environment cannot be controlled and can be analyzed using a variety of tools and techniques such as Environmental Scanning and PEST analysis.

Environmental Scanning

Environmental scanning is defined as the process that seeks information about events and relationships in a firm's environment, the knowledge of which help top management chart the firm's future. Environmental scanning is used to gather information from the environment.

In this process, the external environment is divided into sectors or areas such as political, economic, cultural, technological and further analysis such as PEST analysis can be done after scanning the environment. Information is collected by monitoring and forecasting any changes that occur to the variables of the environment that have been identified earlier. This collection of information helps the organizations to find out where they are lacking and what exactly they need which helps them in formulating the strategies. (Acar 1995)

PEST Analysis

PEST analysis identifies the external forces that affect the organization such as Political, Economic, Social and Technological drivers. It is very useful for the organization when used together with other tools such as the SWOT analysis.

Political Factors

These factors may have a direct or an indirect impact on the way the organization operates. Laws made by the government may have a huge impact on the way business is conducted by the organization.

Economic Factors

Economic factors such as the market prices and market cycles which in turn affects the buying power and the behavior of the organization's customers.

Sociological Factors

Sociological factors include the lifestyles, demography characteristics, and the cultural habits and characteristics of the customers. These factors have a huge sway on the requirements and desires of the customers and also affects the size of potential markets.

Technology Factors

Technological changes have an important role in modeling how organizations operate with the resources that they have. Technology is a factor which is very important to gain a competitive advantage over the closest competition. Technological innovations can also improve the efficiency of production, speed and quality. Evolving technologies will change how organizations operate.

Porter's Five Forces Model Analysis:

Michael Porter is credited for his five forces model of competitive strategy. The power of each of these forces varies from industry to industry, but taken together they determine long-term profitability. These five factors will affect the strategies which will be adopted by the organization and hence should be carefully analyzed. To be successful, the organization must respond in an effective manner to the environmental pressures exerted on it.

1.5.3 Internal environmental analysis:

The resources, strengths, behaviors, weakness and distinctive competences are major components of the internal environment of an organization. An organization uses different types of resources which help them achieve their objectives and the way in which they utilize their resources can be the source of their strengths or weaknesses. This can also be defined as organizational capability which is used to develop the strategies and objectives which the organization can achieve and these should not unrealistic according to its capabilities.

Some of the components of the internal environment of an organization are:

Organizational Resources

These are all the tangible and intangible inputs used in the organization to create the outputs of the organization's product or services.

Organizational Behavior

The behavior of an organization demonstrates is the result of forces operating internally which will determine the abilities of the organization or constraints in the usage of resources.

Competency

Competency of an organization is the ability to do what its competitors cannot do or the ability to do better than what they can do. This concept is used for strategy formulation.

It can be seen that the analysis of the environment is critical to the success of the decisions that managers have to make which have widespread impact on the functions and processes of the business.

1.6 STEPS IN ENVIRONMENTAL FORECASTING

The environmental forecasting is similar to formulating and executing a research project. The important steps in environmental forecasting are the following.

1. Identification of Relevant Environmental Variables: The first most important step in environmental forecasting is identification of the environmental variables critical to the firm. All environmental variables do not have the same relevance to all the industries or firms. A variable that is relevant to one industry may not be relevant for another. Again, important developments in some market may not have any implications for some other markets. For example, the high level of penetration of microwave ovens in some of the developed countries like USA is a critical variable as far as food processing industry in that market is concerned; but it is not relevant in markets where the microwave ovens have not penetrated, if micro-waveable packaging increases the cost of the product it could be a negative factor in such markets. Similarly, a factor relevant in one technological environment may not be relevant in a different environment. Diesel price is a critical factor for railways, which use that energy source, but not for those, which depend on electricity (assuming that there is no competition between those depending on these two different energy sources). Some demographic trends have implications for certain business. A falling birth rate is. a threat to several businesses (for example, for companies like Johnson & Johnson, which depends heavily on the baby segment of the market). The increase in the longevity and the resultant increase in the number of aged generate good demand for several goods and services. To envision the future environment it is essential to identify the critical environmental variables and to predict their future trends. Omission of any critical variable will affect the assessment of the future environment and strategies based on that premise. Similarly, inclusion of variables, which are not adequately relevant, could have misleading effects.

Pearce and Robinson point out that the list of key variables that will have make or break consequences for the firm can be kept to manageable size by limiting key variables in the following ways:

(i) Include all variables that would have a significant impact although their probability of occurrence is low. Delete others with little impact and low probability.

Disregard major disasters, such as nuclear war.

Aggregate when possible into gross variables (e.g., a bank loan is based more on the dependability of a company's cash flow than on the flow's component sources). If the value of one variable is based on the value of the other, separate the dependent variable for future planning.

Collection of Information: The key environmental variables having been determined, the next important step is the collection of the needed information. This involves identification of the sources of information, determination of the types of information to be collected, selection of methods of data collection and collection of the information.

Selection of Forecasting Technique: The dependability and usefulness of the forecast depend a lot on the appropriateness of the forecasting technique used. The choice of forecasting technique depends on such considerations as the nature of the forecast decision, the amount and accuracy of available information, the accuracy required, the time available. The importance of the forecast, the cost, and the competence and interpersonal relationships of the managers and forecaster involved. One issue often debated is the quantitative techniques versus qualitative techniques. The fact is that each has its own merits and limitations. Some people have a wrong notion that quantitative techniques are highly dependable and qualitative techniques are often too subjective that they are not reliable.

The dependability of the quantitative techniques is affected by the accuracy/ reliability of the data used. It is pointed out that the difference in the predictions using each type of approach is often minimal. Additionally, subjective or judgement approaches may often be the only practical method of forecasting political, legal, social, and technological trends in the remote external environment. The same is true of several trends in the task environment, especially customer and competitive considerations.

Monitoring: The characteristics of the variables or their trends may undergo changes. Further, new variables may emerge as critical or the relevance of certain variables may decline. It is, therefore, necessary to monitor such changes. Sometimes the changes may be very significant so as to call for a re-forecasting.

1.6.1 TYPES OF FORECASTING

Forecasts of the important business environments, viz; economic environment, social environment, political environment etc. would be useful in formulating plans and strategies.

1.6.1.1 Economic Forecast: The fact that economic environment is a very critical determinant of business prospects underscores the importance of economic forecasts. Important economic factors often considered include general economic conditions, GDP growth rate, per capita income, distribution of income, structural changes in GDP, investment and output trends in. different sectors and subsectors/industries, price trends, trade and BOP trends etc. The macro economic forecasts serve as a base for deriving industry and company forecasts. There are indeed a number of sources of short, medium and long-term forecasts. International organisations like World Bank, IMF, UNCTAD, UN, WTO etc. and regional organizations like Asian Development Bank have periodic and occasional publications, which provide, inter alia, economic forecasts. The Planning Commission and several other bodies like, for example, National Council of Applied Economic Research (NCAER) and Confederation of Indian Industry (Cll) make macro economic estimates and forecasts of the Indian economy.

Sector specific organisations do such things for the concerned sectors. It becomes more useful when disaggregated details of the estimates/forecasts are available. When reliable forecasts are not available from the secondary source, a firm has to make it own forecasts. Reliable forecasts give very useful picture of the future scenario helpful to planning and strategy. For example, details of power development would indicate the scope of investment in the power sector itself and the prospects of related industries like generators, transformers, cables, switch gears, other electrical goods and materials used by power projects etc. Plans of rural electrification will give some indication of the additional demand for pump sets and certain categories of consumer durables and non-durables. Short-term economic forecasts are very useful for demand and sales forecasting and marketing strategy formulation. Both quantitative methods such as econometric methods, and time series models and qualitative techniques like judgement models can be used for economic forecasts.

1.6.1.2 Social Forecasts: There are a number of social factors, which have profound impact on business. It is, therefore, very essential to forecast the possible changes in the relevant social variables. Important factors include population growth/ decline, age structure of population, ethnic composition of population, occupational pattern, rural-urban distribution of population, migration, factors related to family, life style, income levels, expenditure pattern, social attitudes etc. As in the case of economic factors, there is a wealth of published and unpublished data of forecasts of social trends available. International organisations like the UN and its organs, World Bank etc., academic organisations and government organisations do considerable work in these areas. For example, a considerable amount of data is available regarding future trends in birth and death rates and population size, age structure, and ethnic composition etc. of different nations. Certain aspects of this are dealt with in the chapters Societal Environment and Demographic Environment. Social trends have significant implications for business strategy. Quantitative techniques like time series analysis and econometric methods and qualitative methods like Delphi method or a combination of both quantitative and qualitative techniques may be used for social forecasts. One of the most popular methods is scenario building, which involves drawing up alternative future scenarios, based on different assumptions or predictions of developments.

1.6.1.3 Political Forecasts: Political forecast has an important part in envisioning properly the future scenario of business. There are even chances of a country undergoing a drastic shift in the political system (Example: USSR and Eastern Europe in the late 1980's). Changes in the relative power of political parties, changes in the internal power structure of political parties (including changes in leadership and its implications), political alliances and political ideologies etc. may have implications for business. Some political factors may be embedded in social factors. Political forecasts also cover industrial policy, commercial policy and fiscal policy. Some political changes are sudden and unpredictable. There are, however, several changes, which are reasonably predictable. For example the sweeping political and economic changes in the erstwhile USSR and Eastern Europe and the general liberalisation trend in many other countries could be regarded as an indicator that liberalisation would set in India too.

The liberalisation ushered in 1991 indicated that there would be privatisation (which even. at the end of 1990's has not assumed a serious intent and real earnest in India) and other liberalisation. The discussions on decentralisation and government pronouncement on this' enabled the prediction of administrative decentralisation in several States in India.

With the decentralisation, decision-making process in the government has changed and this has important implications for business. Pre-election opinion polls may help certain political forecasts. There are several factors, which have international or global overtones. Sanctions, formal or informal, which have serious consequences for business are nor very rare. Increasing world interdependence makes it imperative for firms of all sizes to consider the international political implications of their strategies. In the early 1980s, while the price of a barrel of oil was hovering around $30 and many were predicting an increase in the oil prices to around $50 per barrel by 1990s, Royal Dutch shell mulled over the possibility of a break-down of the oil cartel's (OPEC) agreement to restrict the supply, an oil glut and a drop in the price to $15 and instructed its operating managers to plan how they would respond to such a situation. As a result, when the oil price crashed from $ 27 in January 1986 to $10 in April, Shell was much better prepared than its rivals to effectively respond to this challenge.

Companies, research organisations and consultants have developed a variety of approaches to international forecasts of which political factors are an important component. Harner's Business Environmental Risk Index, for instance, monitors a number of economic and political variables in many countries. The World Economic Forum brings out annually a Global Competitiveness Report based on eight set of factors including government, openness and institutions.

1.6.1.4 Technological Forecast: Innovation and other technological developments can drastically alter the business environment. Technological forecasts, therefore, assumes great significance. Technological forecast encompass not only technological innovations but also the pace and extent of diffusion and penetration of technologies and their implications. For example., what will be the pace and extent of penetration of PCs and the internet and their implications for business?

How far can and will the existing and new technologies be applied in diverse areas and what are their implications? It may be noted that one of the eight components of the world competitiveness index used in the World Competitiveness Report is technology, which measures computer usage, the spread of new technologies, the ability of the country to absorb new technologies and the level and quality of Research and Development.

The Technology Information, Forecasting and Assessment Council (TIFAC) established in 1988 have done considerable work to draw up a Technology Vision 2020 for India. It is among the tasks of TIFAC to look ahead at the technologies emerging worldwide and pick those technology trajectories, which are relevant for India and should be promoted.

1.6.2 TECHNIQUES FOR ENVIRONMENTAL FORECASTING

As mentioned earlier, there are a number of quantitative and qualitative techniques used in environmental forecasting. Some important techniques are mentioned below.

1.6.2.1 ECONOMETRIC TECHNIQUES

Economic techniques involve casual models to predict major economic indicators. When there is a well-established relationship between two or more variables, that casual relationship can be used to forecast the future. For example, if demand is a function of consumer income, the impact of an increase in consumer income on demand can be predicted using the equation representing the relationship between these two key variables. The econometric models may utilise complex simultaneous regression equations to relate economic occurrences to areas of corporate activity. They are especially useful when information is available on casual relationships and when large changes are anticipated. The most commonly used econometric environmental forecasting techniques are multiple regression analysis and time series regression models.

1.6.2.2 TREND EXTRAPOLATION

Time series models assume that the past is a prologue to the future and extrapolate the historical data to the future. The technique may use simple linear relationship or more complex non-linear relationships to forecast trends.

1.6.2.3 SCENARIO DEVELOPMENT

A very popular and useful forecasting method is development of alternative scenarios. When it is not possible to accurately forecast the future, the alternative scenarios help managers to formulate strategies to cope with different possible future situations. As hinted earlier (under political forecasts), Royal Dutch Shell's anticipation of a possibility of a substantial crash in oil prices in future prompted it cut exploration costs .by pioneering advanced exploration technologies, massive investments in cost efficient refining facilities etc so that by 1989 its exploration costs at $2 per barrel were less than half the industry average. "Scenario analysis is a technique used to forecast the occurrence of complex environmental events. It is particularly useful for forecasting events in which many variables playa role.

Scenarios allow the integrated consideration of these multiple variables in explaining the emergence of future conditions. A scenario is a detailed description of how certain events may occur in the future and their consequences for the organisation." Shrivastava suggests the following steps to develop scenarios.

1. Identify strategic environmental issues that are likely to affect the industry/ firm. Prioritize these issues in order of their importance to the firm.

2. Select the most important issues as the focus for scenario development.

List the organizational assumptions with respect to these issues and identify the possible variations in these assumptions.

3. Prepare a preliminary description of these issues and how they evolved.

Include the key economic, social, political, and cultural influences that affect them. Do this with help of outside industry experts.

4. Draw out the implications of the issue for organizational performance.

What has the organization done and what can it do to cope with the issues? Identify those variables shaping the issue that the management can control and partially control. Also, identify those variables over which management has no control.

5. Develop detailed descriptions of the future in the form of scenarios.

Scenarios are constructed under a worst case, best case, and most likely case set of assumptions. Draw out the implications of these scenarios for future performance of the company.

6. Discuss the scenarios with top management and refine them.

7. Develop contingency action plans for each scenario.

Developing alternative scenarios is common in economic planning too. The Planning Commission of India, for example, have drawn up alternative scenarios regarding growth rates of different sectors, poverty ratios etc. under different assumption. Many forecasts, which use the scenario method, draw up three alternative scenarios - a most likely scenario, a pessimistic scenario and an optimistic scenario. However, forecasts having more than three scenarios are not uncommon.

1.6.3 Methods of Scenario Building

1. Premising Method: In this method, a series of premises is drawn up from which projection of the future scenarios is made. The premises might consist of basic assumptions about certain important variables, current trends etc. Sometimes extreme projections may also be made focusing on a few tendencies and exaggerating their evolution. For example, the extreme possible outcome of some ethnic issues in a country.

2. Systems Diagram Method: The systems diagram method seeks to explore policy and strategic options based on the present system of the organisation's activities. For example, a newspaper firm may think of entering other media. Extending the publication business, starting information service business etc. using and developing its existing capabilities.

3. Critical Site Method: This method which bases the scenario projection on the policy making structure of an organisation identifies the key decision making points and dynamics of the system focuses on the critical site where the key decisions are taken, such as the meeting of the Board of a company. the national convention or the meeting of the policy decision making body of the relevant political party, critical meetings of organisations like OPEC or WTO etc. Scenarios are drawn up based on the anticipation of the possible critical decisions made at such sites and their future implications.

4. The Newspaper Headline Method: In this method the scenario writer posits one or more hypothetical headlines for .some future date' such as:

New Delhi, January 20. 2010: "The three surviving car manufactures in India intensify the battle for market share: The scenario writer then tries to map out the possible developments in the industry during the course and chart out a strategy for the company to successfully navigate through.

5. Logical Possibilities Method: This method, which generates alternative scenarios based on those already developed, is used as a supplement to other methods.

1.6.4 JUDGEMENT MODELS

Judgement models involve the use of opinion of people who have intimate knowledge of relevant factors. For example, sales force: opinion of the sales potential, competitive challenges, customer behaviour etc. Another method is jury's executive opinion, which combines estimates made by executives from marketing, production, finance and purchasing and then averages their views.

1.6.5 BRAIN STORMING

Brainstorming is a creative method of generating ideas and forecasts. Under this method, a group of knowledgeable people is encouraged to generate ideas, discuss them and to make forecasts on the basis of that. With a view to encouraging throwing up new ideas without any reservation, the discussion and evaluation of the ideas generated is often done only after the idea generation process is over. Brain storming is a popular technique of technological forecasting.

1.6.6 DELPHI METHOD

The Delphi method, which is also a common technique of technological forecasting, is a more systematic technique than brain storming. This method uses a panel of experts on the subject from whom opinions are gathered, may be by using a semi-structured questionnaire and/or interview. The opinions of the experts are documented and consolidated and circulated among the panel members, preferably anonymously, for their evaluation and comments. The experts are requested to review their opinion in the light of the feedback. This process may be continued until a consensus view is arrived at. The RAND Corporation which pioneered the use of this technique used it to predict the impact of the formation of the OPEC on oil supplies and oil prices. Other applications of this technique included assessing trends in terrorist activities and their influence on international businesses and prioritising domestic social programmes.

1.6.7 STRATEGIC ISSUES ANALYSIS

Strategic issue analysis is a qualitative technique that can be used for assessing emerging strategic environmental issues. It consists of systematically monitoring of social, regulatory and political changes that can affect corporate performance and identifying their impact on the company. For example, companies, which were doing business in South Africa, used this technique to assess the impact of racial tensions there on their worldwide business. Similarly, chemical companies, such as Du Pont, Monsanto, and Stauffer Chemicals have used this technique for assessing the impact of environmental movement on the cost of doing business.

1.6.8 BENEFITS/IMPORTANCE OF ENVIRONMENTAL ANALYSIS

Environmental analysis has several benefits like those mentioned below.

1. The very idea of environmental analysis makes one aware of the environment-organisation linkage.

2. A corollary of the above is that (environmental analysis helps) an organisation to identify the present and future threats and opportunities.

3. Environmental analysis will provide a necessary and very useful picture of the important factors, which influence the business.

4. Environmental analysis helps to understand the transformation of the industry environment.

5. Technological forecasting will indicate some of the future opportunities and challenges.

6. A very important benefit of environmental analysis is its contribution to identification of risks.

7. Environmental analysis is a prerequisite for formulation of right strategies - corporate, business and functional.

8. Environmental monitoring helps suitable modifications of the strategies as and when required

9. Environmental analysis keeps the managers informed, alert, and often dynamic.

1.6.9 LIMITATIONS OF ENVIRONMENTAL FORECASTING

Environmental forecasting has several limitations. Some of the limitations arise from the forecasting techniques used. Further there are also chances of certain errors affecting the reliability of the forecasts. Errors may occur.

1. The selection of the variables included in the predictive model.

2. The selection of the functional form for linking these predictor variables to

the variable(s) being predicted and

3. The estimation of the 'correct' values for the predictor variables. Several techniques use opinions of people and they may be affected by subjectivity.

1.7 SUMMARY

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

The business activities may be grouped under two broad headings, viz.,

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

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

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

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

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

In order to cope with the complexity of the environment it is feasible to divide it into different components and sectors. Let us consider the importance of the study of the business environment:

- The study of the business environment helps an organization to develop its broad strategies and long-term policies.

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

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

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

Business environment refers to all factors that have a direct or indirect bearing on the functioning of the business. Every business firm encounters with a set of internet and external factors. The internal environment consists of the factors which influence the various strategies and decisions which happen within an organization's boundaries. These factors include human resources, company image, management structure, physical assets, technological capabilities, marketing resources, and financial factors. The external environment comprises of micro and macro environmental factors. Micro environment is just and immediate environment of the firm which include suppliers, consumers, competitors, intermediaries and publics. These factors are generally regarded as controllable factors because the organization commands control over these factors and can modify or alter as per the requirements of the organization.

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

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

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

Environmental analysis is a crucial part of the strategic management process. If the environment is ignored (or partially ignored) by strategic decision makers, the process cannot be effective. Effective strategists try to anticipate what is coming or attempt to influence the environment in favourable directions. The environmental strategic analyst interrelates with the formation of objectives, the generation of alternative strategies and the other aspects of strategic management.

1.8 GLOSSARY

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

Economic environment : It refers to all those economic factors which have a bearing on the functioning of a business unit.

Environmental Forecasting The environmental forecasting is similar to formulating and executing a research project.

1.9 SELF ASSESSMENT QUESTIONS

1. What is business environment ? Write down its main ingredients.

2. Define business environment ? Discuss in brief the factors that constitute business environment.

3. "Firms which systematically analyze and diagnose the environment are more effective than those which don't". Elucidate.

4. Discuss how the demographic and technological trend that could affect the future of the business.

5. Describe the various external factors that influence the business policy of an organization.

6. Explain the various internal factors that influence business policies.

1.10 LESSON END EXERCISE

1. Give a brief account of Indian business environment.

2. Discuss the major implications of MRTP and FERA acts on Indian business.

3. Narrate in brief the various Industrial Policy Resolutions.

4. Write short notes on :

i) Economic environment

ii) Natural environment

1.11 SUGGESTED READINGS

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SOCIAL & ECONOMIC ENVIRONMENT

Structure :

2.13 Suggested Readings

2.14 References

2.1 INTRODUCTION

The **social environment** consists of the sum total of a society's beliefs, customs, practices and behaviors. It is, to a large extent, an artificial construct that can be contrasted with the natural environment in which we live.

Every society constructs its own social environment. Some of the customs, beliefs, practices and behaviors are similar across cultures, and some are not. For example, an American traveling to Britain will find many familiar practices but not so much if traveling to China.

This social environment created by a society-at-large in which a business functions can be referred to as its **external social environment**. If a business operates in a multicultural society, then the social external social environment is even more complicated because the environment will consist of diverse sub-populations with their own unique values, beliefs, and customs.

A business also has its own social environment. We can refer to this as its **internal social environment**, which is simply the customs, beliefs, practices, and behaviors within the confines of the business. A business has much more control over its internal social environment than it does with its external social environment.

A business must utilize and adapt to its external social environment, or it will not survive. A business must be keenly aware of the society's social preferences regarding its needs and wants. These preferences and needs and wants will be influenced by a population's values, beliefs, and practices.

Let's look at some examples. A change in beliefs and values towards energy conservation and global climate change may create a change in consumer preference away from gas guzzling SUVs to hybrid sedans. Some cultures treat the meal as a long social event, and fast food just won't cut it. Social preferences relating to fashion are constantly changing. Skirt lengths go up and down depending upon the years, as do the preference for single-breasted and double-breasted suits.

If a business refuses to adapt to changing social preferences, its sales will drop, and it will fail. Of course, sometimes the change in social preferences may be so large that a business simply can't adapt. For example, a social movement led to the outlawing of alcohol in the early 20th century, which was known as Prohibition. During Prohibition, it was illegal to sell alcohol. Distilleries were put out of business until Prohibition was repealed.

While there are risks with social change, there are also opportunities. Businesses often try to influence social values through the use of marketing, advertising and targeted public relations strategies. Marketing campaigns are used in an attempt to create trends. The fashion industry is a prime example. Public relation campaigns are often used to build up or repair a business' image.

For example, BP launched a massive public relations campaign to improve its image after a massive oil leak in the Gulf of Mexico caused by offshore drilling. Fast food restaurants may include healthier choices on their menus and sponsor health-related activities.

Broader social values will also affect the success of a business. A society that values higher education will provide a better workforce that will lead to more productivity and innovation. Likewise, a society that supports investment in public infrastructure will have access to good transportation and communication systems. And if the social values of a community include a hard work ethic, a business will have access to productive workers and a population that has money to spend on goods and services.

ECONOMIC ENVIRONMENT

The economic environment consists of external factors in a business market and the broader economy that can influence a business. You can divide the economic environment into the microeconomic environment, which affects business decision making - such as individual actions of firms and consumers - and the macroeconomic environment, which affects an entire economy and all of its participants. Many economic factors act as external constraints on your business, which means that you have little, if any, control over them. Let's take a look at both of these broad factors in more detail.

Macroeconomic influences are broad economic factors that either directly or indirectly affect the entire economy and all of its participants, including your business. These factors include such things as:

- Interest rates
- Taxes
- Inflation
- Currency exchange rates
- Consumer discretionary income
- Savings rates
- Consumer confidence levels
- Unemployment rate
- Recession
- Depression

Microeconomic factors influence how your business will make decisions. Unlike macroeconomic factors, these factors are far less broad in scope and do not necessarily affect the entire economy as a whole. Microeconomic factors influencing a business include:

- Market size
- Demand
- Supply
- Competitors
- Suppliers

- Distribution chain, such as retail stores

2.2 OBJECTIVE

After studying this unit, students will be able to

- Understand corporate social responsibility concept
- Know about different types of economies in the world
- Understand merits and demerits of different economies

2.3 SOCIAL RESPONSIBILITY OF BUSINESS

2.3.1 CORPORATE GOVERNANCE

Corporate failures and widespread dissatisfaction with the way many corporate functions have led to the realization, globally, of the need to put in place a proper system for corporate governance. Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals.

The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

The aim is to align as nearly as possible the interest of individuals, corporations, and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that these standards will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen the economy and discourage fraud and mismanagement.

2.3.1.1 RELEVANCE

At least three reasons have triggered off concern in corporate governance in our country.

- Since 1991, the country has moved into liberalized economy and one of the victims of the market-based economy is transparent fair business practice. Several instances of mismanagement have been alleged, with some well-known and senior executive being hauled up for non-performance and /or non-compliance with legal requirements.

• Both domestic as well as foreign investors are becoming more demanding in their approach towards the companies in which they have invested their funds. They seek information and want to influence decisions.

• Interests of non-promoter shareholder and those of small investors are increasingly being undermined. Several MNCs have sought to set up 100 percent subsidiaries and transfer their businesses to them .In many cases, there was no thought of consultation with non-promoter shareholders.

In this context, some norms of behavior to ensure responsive behavior are of great help. Hence, corporate governance.

2.3.1.2 FOCUS

Corporate governance is concerned with the values, vision and visibility. It is about the value orientation of the organization, ethical norms for its performance, the direction of development and social accomplishment of the organization and the visibility of its performance and practices.

Corporate management is concerned with the efficiency of the resources use, value addition and wealth creation within the broad parameters of the corporate philosophy established by corporate governance.

2.3.1.3 IMPORTANCE

• Studies of firms in India and abroad have shown that markets and investors take notice of well-managed companies, respond positively to them, and reward such companies, with higher valuations. In other words they have a system of good corporate governance.

• Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection.

• Corporate governance prevents insider trading.

• Under corporate governance, corporates are expected to disseminate the material price sensitive information in a timely and proper manner and also ensures that till such information is made public, insiders abstain from transacting in the securities of the company.

• The principle should be 'disclose or desist'. Good corporate governance, besides protecting the interests of shareholders and all other stakeholders, contributes to the efficiency of a business enterprise, to the creation of wealth and to the country's economy.

• Good corporate governance is considered vital from medium and long term perspectives to enable firms to compete internationally in sustained way and make them, not only to improve standard of living materially but also to enhance social cohesion.

2.3.1.4 PRE-REQUISITES

A system of good corporate governance requires the following:

• A proper system consisting of clearly defined and adequate structure of roles, authority and responsibility.

• Vision, principles and norms, which indicate development path, normative considerations, and guidelines and norms for performance.

• A proper system for guiding, monitoring, reporting and control.

2.3.2 SOCIAL RESPONSIBILTY

Social responsibility is the obligation of decision-makers to take actions, which protect and improve the welfare of society as a whole along with their own interests. Every decision the businessman takes and every action he contemplates have social implications.

Be it deciding on diversification, expansion, opening of a new branch, and closure of an existing branch or replacement of men by machines, the society is affected in one way or the other. Whether the issue is significant or not, the businessman should keep his social obligation in mind before contemplating any action.

2.3.2.1 ARGUMENTS FOR SOCIAL RESPONSIBILITY

- Business has to respond to the needs and expectations of society.
- Improvement of the social environment benefits both society and business.
- Social responsibility discourages additional governmental regulation and intervention.
- Business has a great deal of power, which should be accompanied by an equal amount of responsibility.
- Internal activities of the enterprise have an impact on the external environment.
- The concept of social responsibility protects interests of stockholders.
- Social responsibility creates a favorable public image.
- Business has the resources to solve some of society's problems.
- It is better to prevent social problems through business involvement than to cure them.

2.3.2.2 ARGUMENTS AGAINST SOCIAL RESPONBILITY

- Social responsibilities could reduce economic efficiency.
- Social responsibility would create excessive costs for business.
- Weakened international balance of payments
- Business has enough power, and social involvement would further increase its power and influence.
- Business people lack the social skills necessary to deal with the problems of society.
- Business is not really accountable to society.

2.3.3 SOCIAL STAKEHOLDERS

Managers, who are concerned about corporate social responsibility, need to identify various interest groups which may affect the functioning of a business organization and may be affected by its functioning. Business enterprises are primarily responsible to six major groups:

- Shareholders
- Employees
- Customers
- Creditors, suppliers and others
- Society and
- Government.

These groups are called interest groups or social stakeholders. They can be affected for better or worse by the business activities of corporations.

2.3.4 SOCIAL RESPONSIVENESS

Social responsiveness (SR) is "the ability of a corporation to relate it operations and policies to the social environment in ways that are mutually beneficial to the company and to society". In other words, it refers to the development of organizational decision processes whereby managers anticipate, respond to, and manage areas of social responsibility. The need to measure the social responsiveness of an organization led to the concept of social audit.

The social responsiveness of an organization can be measured on the basis of the following criteria:

- Contributions to charitable and civic projects
- Assisting voluntary social organizations in fund-raising
- Employee involvement in civic activities

- Proper reuse of material
- Equal employment opportunity
- Promotion of minorities
- Direct corporate social responsiveness investment
- Fair treatment of employees
- Fair pay and safe working conditions
- Safe and quality products to consumers
- Pollution avoidance and control

2.3.5 BUSINESS EHTICS

The two issues - an organization's social responsibility and responsiveness- ultimately depend on the ethical standards of mangers. The term ethics commonly refers to the rules or principles that define right and wrong conduct. Ethics is defined as the " discipline dealing with what is good and bad and with moral duty and obligation". Business ethics is concerned with truth and justice and has a variety of aspects such as expectations of society, fair competition, advertising, public relations, social responsibilities, consumer autonomy, and corporate behavior in the home country as well as abroad.

2.3.5.1 TYPES OF BUSINESS ETHICS

Moral management

Moral management strives to follow ethical principles and precepts, moral mangers strive for success, but never violate the parameters of ethical standards. They seek to succeed only within the ideas of fairness, and justice. Moral managers follow the law not only in letter but also in spirit. The moral management approach is likely to be in the best interests of the organization, long run.

Amoral management

This approach is neither immoral nor moral. It ignores ethical considerations. Amoral management is broadly categorized into two types - intentional and unintentional.

• Intentional amoral managers exclude ethical issues because they think that general ethical standards are not appropriate to business.

• Unintentional amoral managers do not include ethical concerns because they are inattentive or insensitive to the moral implications.

Immoral management

Immoral management is synonymous with "unethical" practices in business. This kind of management not only ignores concerns, it is actively opposed to ethical behavior.

2.3.5.2 NEED FOR BUSINESS ETHICS

• Ethics corresponds to basic human needs. It is human trait that man desires to be ethical, not only in his private life but also in his business. These basic ethical need compel the organizations to be ethically oriented.

• Values create credibility with public. A company perceived by the public to be ethically and socially responsive will be honored and respected. The management has credibility with its employees precisely because it has credibility with the public.

• An ethical attitude helps the management make better decisions, because ethics will force a management to take various aspects- economic, social, and ethical in making decisions.

• Value driven companies are sure to be successful in the long run, though in the short run, they may lose money.

• Ethics is important because the government, law and lawyers cannot do everything to protect society.

2.3.5.3 ETHICAL GUIDELINES

- **Obeying the law:** Obedience to the law, preferably both the letter and spirit of the law.

- **Tell the Truth:** To build and maintain long-term, trusting and win-win relationships with relevant stockholders.

- **Uphold human dignity:** Giving due importance to the element of human dignity and treating people with respect.

- **Adhere to the golden rule:** "Do unto others as you would have others do unto you"

- **Premium Non-Nocere:** (Above all, do no harm)

- **Allow Room for participation:** Soliciting the participation of stakeholders rather than paternalism. It emphasizes the significance of learning about the needs of stakeholders.

- **Always Act When You Have Responsibility:** Managers have the responsibility of taking action whenever they have the capacity or adequate resources to do so.

2.3.5.4 TOOLS FOR ETHICAL MANAGEMENT

- **Top management commitment:** Managers can prove their commitment and dedication for work and by acting as role models through their own behaviors.

- **Codes of Ethics:** A formal document that states an organization's primary values and the ethical rules it expects employees to follow. The code is helpful in maintaining ethical behavior among employees.

- **Ethics committees:** Appointment of an ethics committee, consisting of internal and external directors is essential for institutionalizing ethical behavior.

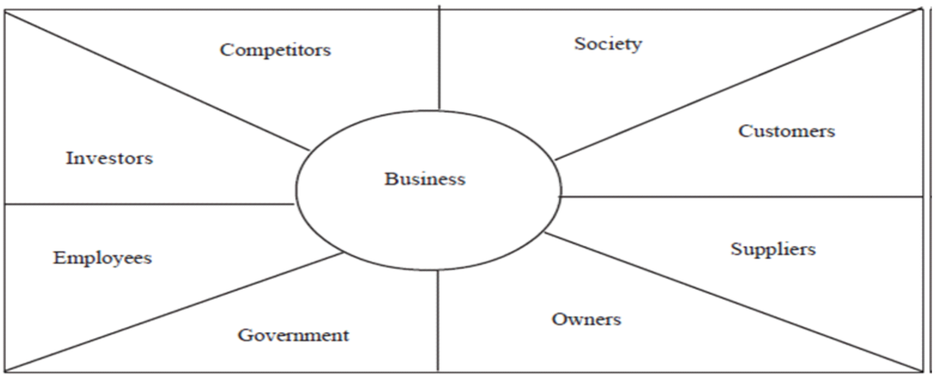
- **Ethics Audits:** Systematic assessment of conformance to organizational ethical policies, understanding of those policies, and identification of serious deviations requiring remedial action.

• **Ethics training:** Ethical training enables managers to integrate employee behavior in ethical arena with major organizational goals.

• **Ethics Hotline:** A special telephone line that enables employees to bypass the normal chain of command in reporting their experiences, expectations and problem. The line is usually handled by an executive appointed to help resolve the issues that are reported.

2.3.6 RESPONSIBILITY TOWARDS DIFFERENT INTEREST GROUPS

After getting some idea about the concept and importance of social responsibility of business let us look into the various responsibilities that a business has towards different groups with whom it interacts. The business generally interacts with owners, investors, employees, suppliers, customers, competitors, government and society. They are called as interest groups because by each and every activity of business, the interest of these groups is affected directly or indirectly.



Responsibility of Business Towards Different Interest Groups.

i. Responsibility towards owners

Owners are the persons who own the business. They contribute capital and bear the business risks. The primary responsibilities of business towards its owners are to:

a. Run the business efficiently.

b. Proper utilisation of capital and other resources.

c. Growth and appreciation of capital.

d. Regular and fair return on capital invested.

ii. Responsibility towards investors

Investors are those who provide finance by way of investment in debentures, bonds, deposits etc. Banks, financial institutions, and investing public are all included in this category. The responsibilities of business towards its investors are :

a. Ensuring safety of their investment,

b. Regular payment of interest,

c. Timely repayment of principal amount.

iii. Responsibility towards employees

Business needs employees or workers to work for it. These employees put their best effort for the benefit of the business. So it is the prime responsibility of every business to take care of the interest of their employees. If the employees are satisfied and efficient, then the only business can be successful. The responsibilities of business towards its employees include:

a. Timely and regular payment of wages and salaries.

b. Proper working conditions and welfare amenities.

d. Opportunity for better career prospects.

e. Job security as well as social security like facilities of provident fund, group insurance, pension, retirement benefits, etc.

f. Better living conditions like housing, transport, canteen, crèches etc.

g. Timely training and development.

iv. Responsibility towards suppliers

Suppliers are businessmen who supply raw materials and other items required by manufacturers and traders. Certain suppliers, called distributors, supply finished products to the consumers. The responsibilities of business towards these suppliers are:

a. Giving regular orders for purchase of goods.

b. Dealing on fair terms and conditions.

c. Availing reasonable credit period.

d. Timely payment of dues.

v. Responsibility towards customers

No business can survive without the support of customers. As a part of the responsibility of business towards them the business should provide the following facilities:

a. Products and services must be able to take care of the needs of the customers.

b. Products and services must be qualitative

c. There must be regularity in supply of goods and services

d. Price of the goods and services should be reasonable and affordable.

e. All the advantages and disadvantages of the product as well as procedure to use the products must be informed do the customers.

f. There must be proper after-sales service.

g. Grievances of the consumers, if any, must be settled quickly.

h. Unfair means like under weighing the product, adulteration, etc. must be avoided.

vi. Responsibility towards competitors

Competitors are the other businessmen or organizations involved in a similar type of business. Existence of competition helps the business in becoming more dynamic and innovative so as to make itself better than its competitors. It also sometimes encourages the business to indulge in negative activities like resorting to unfair trade practices. The responsibilities of business towards its competitors are

i. not to offer exceptionally high sales commission to distributers, agents etc.

ii. not to offer to customers heavy discounts and /or free products in every sale.

iii. not to defame competitors through false or ambiguous advertisements.

vii. Responsibility towards government

Business activities are governed by the rules and regulations framed by the government. The various responsibilities of business towards government are:

a. Setting up units as per guidelines of government

b. Payment of fees, duties and taxes regularly as well as honestly.

c. Not to indulge in monopolistic and restrictive trade practices.

d. Conforming to pollution control norms set up by government.

h. Not to indulge in corruption through bribing and other unlawful activities.

viii. Responsibility towards society

A society consists of individuals, groups, organizations, families etc. They all are the members of the society. They interact with each other and are also dependent on each other in almost all activities. There exists a relationship among them, which may be direct or indirect. Business, being a part of the society, also maintains its relationship with all other members of the society. Thus, it has certain responsibilities towards society, which may be as follows:

a. to help the weaker and backward sections of the society

b. to preserve and promote social and cultural values

c. to generate employment

d. to protect the environment

e. to conserve natural resources and wildlife

f. to promote sports and culture

g. to provide assistance in the field of developmental research on education, medical science, technology etc.

2.4 AREAS OF SOCIAL RESPONSIBILITY OF BUSINESS

To preserve the society it is important to protect the environment. And, therefore, every business must take measures to protect the environment rather than damaging it. In this section let us learn more about different types of environmental pollution and role of business. Nature has given us air, land including mountains, hills, forests etc. and water in the form of rivers, lakes, sea etc., which create an environment in which we live. Our health and well being largely depend on the quality of such environment. However, it is observed that the quality of this environment is deteriorating day by day. We are getting neither pure water to drink nor clean air to breathe. We are having untimely rains, storms, cyclones, floods, extended summer, etc. We are also suffering from various diseases because of such lower quality of environment. When the quality of environment deteriorates, it is said that the environment is getting polluted. Thus, environmental pollution refers to contamination of environment by various substances that have adverse effects on living and non-living matters.

Environmental pollution is of three types:

i) Air pollution,

ii) Water pollution, and

iii) Land Pollution.

Let us have a brief discussion about these three types of pollution.

i. Air Pollution

As we know the air we breathe contains several gases, dust particles etc. Our body mechanism helps us in filtering the unwanted ones and retaining those required for our survival. However, if there is an imbalance in the proportion of gases and dust particles in air, beyond a certain point, our body mechanism fails to filter them and we face problem. This is also true in care of other natural things like forests, river etc. Thus, air pollution refers to the presence of any unwanted gases, dust particles etc. in the air, that can cause damage to people as well as nature.

Causes of Air Pollution

Let us know how air gets polluted. Some of the common causes of air pollution are

I Emission of fumes from vehicles.

ii. Emission of smoke dust and chemicals from manufacturing plants.

iii. Emission of gases and dust arising from atomic plants

iv. Emission of smoke from oil refineries, burning of trees and plants in forests, buring of coal, etc.

Impact of Air Pollution

Air pollution has a lot of impact on our surroundings and on us. Some of them are-

- Presence of gases in air, which are not required by human beings, animals and birds, creates serious health problems. It can create diseases like asthma, cough and cold, blindness, hearing loss, skin disease etc. It also causes genetic disorders. In the long run and in extreme cases it can also be fatal.
- Air Pollution creates smog in the winter, which is caused by smoke and dust when they mix with fog. It reduces natural visibility and irritates the eyes and respiratory tract.
- Ozone layer is a protective layer of gases around our earth, which

protects us from harmful ultraviolet rays that come from the sun. It gets depleted because of air pollution and thereby causes gene mutation, genetic defects and skin cancer.

- The temperature of the earth increases due to air pollution. This is because whatever heat our earth receives from the sun is not radiated to the atmosphere due to the excessive presence of gases like carbon dioxide, methane, nitrous oxide, etc.

- Air pollution causes acid rain which means excessive presence of various poisonous gases like sulphur dioxide, nitrogen oxide etc. in the rainwater. This causes lot of damage to vegetation, trees and marine life, buildings and monuments etc.

b. Water Pollution

Have you seen river Yamuna near Delhi? Are you aware about the clean Ganga project?

These two questions almost immediately remind us about the extent to which the water of our rivers has been polluted. Water pollution refers to contamination of water due to presence of unwanted and harmful substances thus, making water unfit for use.

Causes of Water Pollution

The various reasons of water pollution are

i. Drainage of human excreta into rivers, canals etc.

ii. Improper sanitation and sewage system.

iii. Dumping of wastes and effluents by various industrial units into the rivers and canals.

iv. Drainage of toxic substances like chemicals and fertilizers used in cultivation, into streams and rivers.

v. Dumping of garbage, dead bodies and almost every thing used in rituals to the nearby water source by households.

Effects of Water Pollution

The effects of water pollution are:

a. It can create health hazards among human beings, animals and birds. Diseases like typhoid, jaundice, cholera, gastroentytis etc. are common.

b. It can endanger lives of various aquatic species.

c. It can lead to scarcity of drinking water as the water of rivers and canals as well as underground water get polluted.

c. Land Pollution

Land Pollution refers to dumping of useless, unwanted as well as hazardous substances on the land that degrades the quality of soil we use. Our land gets polluted because of the human carelessness towards the soil.

Causes of Land Pollution

The main causes of land pollution are:

(i) Excessive use of fertilizers, chemicals and pesticides in cultivation.

(ii) Disposal of solid waste of industries, mines and quarries.

(iii) Disposal of solid waste from construction of roads, buildings etc.

(v) Effluents of some plants like paper, sugar etc. which are not absorbed by soil.

(vi) Excessive use of plastic bags, which are non-biodegradable.

(vii) Dumping of non-composable wastes from households, hotels and hospitals as well as from industries. These may include combustible items like plastic, cloth, wood etc., and non-combustible items like metal, glass, ceramics, cement etc.

Effects of Land Pollution

Land Pollution has the following harmful effects :

a. Reduces the quantum of cultivable land area.

b. Causes health hazards as it contaminates the sources of food.

c. Causes damage to the landscape.

d. Leads to water and air pollution.

2.4.1 ROLE OF BUSINESS IN ENVIRONMENTAL POLLUTION

From the above discussion on environmental pollution, one thing can clearly be seen that, it is business that mainly contributes to all sorts of pollution -air, noise, water and land. Business causes pollution in the following ways:

- Emission of gas and smoke from manufacturing plants;
- Use of machines, vehicles etc. contributing to noise pollution;
- Deforestation due to acquisition of forest lands for setting up plants;
- Growth of urbanization and industrialization;
- Disposal of wastes and effluents into rivers and canals;
- Disposal of solid wastes in the open space;
- Mining and quarrying activities; and
- Increasing use of transport.

Government has taken a major step in protecting the environment by passing the Environment Protection Act, 1986 in addition to having Water (Prevention and Control of Pollution) Act, 1974, Air (Prevention and Control of Pollution) Act, 1981 and several other Acts. Business can equally be instrumental in fighting pollution and protecting the environment. Business can have three types of role - preventive, curative and awareness.

i. Preventive Role

It means business should take all steps so that no further damage is done to the environment. For this, business must follow the regulations laid down by government to control pollution. For example, more and more environmental friendly products can be produced, filters can be used in chimneys; silencers can be fitted in generators; instead of dumping industrial wastes into river and land it can be treated properly for further productive use etc. Businessmen should come forward to play a major role in preventing further damage done to the environment by human beings. Sulabh International is the leading example of how to provide proper sanitation facilities to the public.

ii. Curative Role

It means business should rectify whatever damage has been done to the environment. In addition, if it is not possible to prevent pollution then simultaneous curative measures can be taken. For example, planting of trees (afforestation programmes) can substantially reduce air pollution near the industrial area.

iii. Awareness Role

It means making people (both the employees as well as the general public) aware about the causes and consequences of environmental pollution so that they voluntarily try to protect rather than damage the environment. For example, business can undertake public awareness programmes. Now-a-days, we find that some business houses have taken the responsibilities to develop and maintain parks and gardens in cities and towns, which shows that they care for the environment.

2.5 SOCIAL AUDIT

Companies around the globe are beginning to assess their social performance and report the results of those assessments as a means of demonstrating their commitment to social responsibility. These audits can help companies identify risks, noncompliance with laws and company policies, and areas that need improvement. An audit should provide a systematic and objective survey of the firm's ethical culture and values. Audits can also spotlight social responsibility activities and accomplishments related to environmental impact, sustainable development, consumer welfare, fair trade, treatment of employees, and relationships with other stakeholders. These reports are often called "social audits," "social responsibility reports," or "corporate citizenship audits." Regardless of what name they go by, the reports of such auditing efforts are important for demonstrating a firm's commitment to and ensuring the continuous improvement of its social responsibility efforts. Without reliable measurements of the achievement of social objectives, a company has no concrete way to verify their importance, link them to organizational performance, justify expenditures to stockholders and investors, or address any stakeholder concerns.

Governments are facing an ever?growing demand to be more accountable and socially responsible and the people are becoming more assertive about their rights to be informed and to influence governments? decision?making processes. Faced with these vociferous demands, the executive and the legislature are looking for new ways to evaluate their performance. Civil society organisations are also undertaking ?Social Audits? to monitor and verify the social performance claims of the organisations and institutions.

Social Audit is a tool with which government departments can plan, manage and measure non?financial activities and monitor both internal and external consequences of the department/organisation's social and commercial operations. It is an instrument of social accountability for an organisation. In other words, Social Audit may be defined as an in?depth scrutiny and analysis of the working of any public utility vis?à?vis its social relevance. Social Audit gained significance especially after the 73rd Amendment of the Constitution relating to Panchayat Raj Institutions.

2.5.1 THE NATURE OF SOCIAL AUDITING

Social auditing is the process of assessing and reporting a business's performance on fulfilling the economic, legal, ethical, and philanthropic social responsibilities expected of it by its stakeholders. Social audits are tools that companies can employ to identify and measure their progress and challenges to stakeholders-including employees, customers, investors, suppliers, community members, activists, the media, and regulators-who are increasingly demanding that companies be transparent and accountable for their commitments and performance.The auditing process is important to business because it can improve financial performance, increase attractiveness to investors, improve relationships with stakeholders, identify potential liabilities, improve organizational effectiveness, and decrease the risk of misconduct and adverse publicity. A firm's reputation depends on transparency and openness in reporting and improving its activities. The social audit provides an objective approach for an organization to demonstrate its commitment to improving strategic planning, including showing social accountability and commitment to monitoring and evaluating social issues. Thus, it is critical that top managers understand and embrace the strategic importance of the social audit. Key stakeholders of the company should also be involved in the audit to ensure the integration of their perspectives into the firm's economic, legal, ethical, and philanthropic responsibilities. Companies are working to incorporate accountability into actions ranging from long-term planning to everyday decision making, including corporate governance, financial reporting, and diversity. The strategic responsibility goals and outcomes measured in the social audit need to be communicated throughout the organization and to all of its stakeholders so that everyone is aware of what the company would like to achieve and what progress has been made in achieving its goals. The social audit should provide regular, comprehensive, and comparative verification of the views of stakeholders. Disclosure is a key part of auditing to encourage constructive feedback. Directions for finding best practices and continuous improvement on legal, social, ethical, philanthropic, and other issues can come from all stakeholders.

2.5.2 PURPOSE OF THE SOCIAL AUDIT

This tool is designed to be a handy, easy to use reference that not only answers basic questions about Social Audit, reasons for conducting Social Audit, and most importantly gives easy?to?follow steps for all those interested in using Social Audit.

The purpose of conducting Social Audit is not to find fault with the individual functionaries but to assess the performance in terms of social, environmental and community goals of the organization. It is a way of measuring the extent to which an organisation lives up to the shared values and objectives it has committed itself to. It provides an assessment of the impact of an organization's non?financial objectives through systematic and regular monitoring, based on the views of its stakeholders.

2.5.3 REASONS FOR SOCIAL AUDITS

Throughout this book, we have examined the various forces affecting social responsibility. There are many reasons companies choose to understand, report on, and improve their social performance. The increased visibility of corporate social responsibility has encouraged companies to better account for their actions in a wide range of areas, including human resources, environmental policies, ethics programs, and community involvement. At one extreme, a company may want to achieve the best social performance possible, whereas at the other extreme, a firm may desire to project a good image to hide misconduct. Still other companies may see the auditing process as a key component of organizational improvement.

Thus, the reasons companies exceed their legally prescribed duties lie along a vast spectrum. For example, it is common for firms to conduct audits of business practices with legal ramifications, such as harassment, employee safety, and environmental impact.

Although these concerns are important to a firm's social responsibility, they are also legally prescribed and indicative of minimal social responsibility. Stakeholders are demanding increased transparency and are taking a more active role in communicating their expectations and asking for corporate accountability on a variety of issues. Government regulators are calling on companies to increase the quantity and quality of information disclosed aimed at increasing the companies' accountability to society. For example, the Sarbanes-Oxley Act requires top financial officers to file their company's code of ethics with the Securities and Exchange Commission. A number of financial and auditing decisions must also be reported on a regular basis.

Table 1 Social Auditing Standards

COMPETENCE
The engagement shall be performed by a practitioner having adequate technical training and proficiency. The engagement shall be performed by a practitioner having adequate knowledge in the subject matter. The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:
• The assertion is capable of evaluation against reasonable criteria that have been established by a recognizable body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
• The assertion is capable of reasonably consistent estimation or measurement using such criteria.
INDEPENDENCE
An independence in mental attitude shall be maintained by the practitioner who shall not have participated in the assertion.
PLANNING
The work shall be adequately planned and assistants, if any, shall be properly supervised.
CONTROL STRUCTURE
A sufficient understanding of the communications and control structures is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
EVIDENCE
Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

In general, social auditing is not usually associated with regulatory requirements, whereas financial audits are required of public companies that issue securities. Because social audits are more voluntary, there are fewer standards that a company can apply with regard to reporting frequency, disclosure requirements, and remedial actions that it should take in response to results. This may change as more companies build ethics and social responsibility programs in the current environment-where regulatory agencies support giving boards of directors oversight of corporate responsibility. For boards to track the effectiveness of oversight of social responsibility programs, audits will be required. In addition, nonfinancial auditing standards are developing with data available for benchmarking and comparing a firm's nonfinancial social performance. Social auditing is similar to financial auditing in that both employ the same procedures and processes to create a system of integrity with objective reporting. An independent expert must verify both types of audits. The financial auditor will employ external sources to certify the assertions in financial statements, such as comparing the company's accounts receivable with its accounts payable.

To vouch for a company's claims about its social performance, a social auditor will contact customers and other stakeholders and compare their perceptions of the firm's social performance with the company's assessments. As in financial audits, social audits are often performed by certified public accountants. Table 1 illustrates the social responsibility auditing standards established by one of these accounting and consulting firms. It is our belief that a social audit should be unique to each company based on its size, industry, and corporate culture, as well as the regulatory environment in which it operates and the commitment of its top management to social responsibility. For this reason, we have mapped out a framework that is somewhat generic and can therefore be expanded by all companies that want to conduct a social audit. The steps of this framework are presented in Table 2. As with any new initiative, companies may choose to begin their effort with a smaller, less formal audit and then work up to a more comprehensive social audit. For example, a firm may choose to focus on primary stakeholders in its initial audit year and then expand to secondary groups in subsequent audits.

2.5.4 SALIENT FEATURES

The foremost principle of Social Audit is to achieve continuously improved performances in relation to the chosen social objectives. Eight specific key principles have been identified from Social Auditing practices around the world. They are:

Table 2 Framework for a Social Audit

COMPETENCE
• Secure commitment of top management and/or board of directors.
• Establish an audit committee.
• Define the scope of the audit process, including subject matter areas important to the social audit (e.g., environment, discrimination, employee rights, privacy, philanthropy, legal compliance, etc.).
• Review organizational mission, policies, goals, and objectives.
• Define the organization's social priorities as they relate to stakeholders.
• Identify the tools or methods the organization can employ to measure its achievement of objectives.
• Collect relevant information in each designated subject matter area, including internal data and data from concerned stakeholders.
• Summarize and analyze the data collected and compare the internal information to stakeholder expectations.
• Have the results verified by an independent agent (i.e., a social audit consultant, accounting firm that offers social auditing services, or nonprofit special-interest organization with social auditing experience).
• Report the findings to the audit committee and, if approved, to managers and stakeholders.

1. Multi?Perspective/Polyvocal. Aims to reflect the views (voices) of all those people (stakeholders) involved with or affected by the organisation/department/ programme.

2. Comprehensive. Aims to (eventually) report on all aspects of the organisation?s work and performance.

3. Participatory. Encourages participation of stakeholders and sharing of their values.

4. Multidirectional. Stakeholders share and give feedback on multiple aspects.

5. Regular. Aims to produce social accounts on a regular basis so that the concept and the practice become embedded in the culture of the organisation covering all the activities.

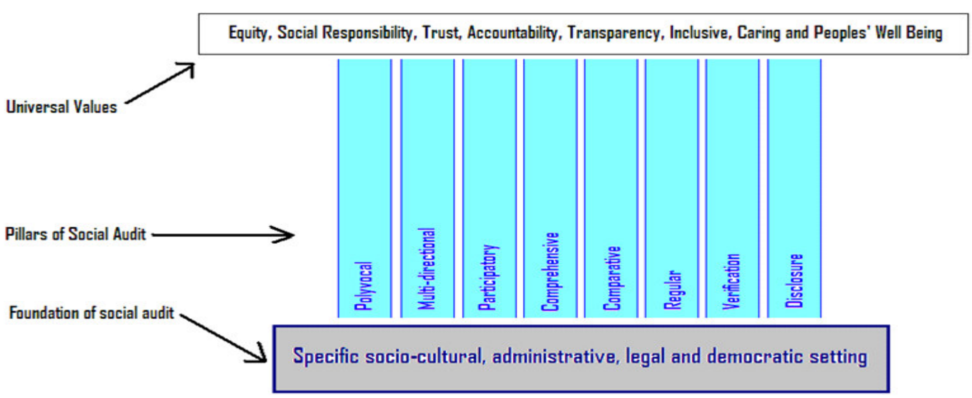
6. Comparative. Provides a means, whereby, the organisation can compare its own performance each year and against appropriate external norms or benchmarks; and provide for comparisons with organisations doing similar work and reporting in similar fashion.

7. Verification. Ensures that the social accounts are audited by a suitably experienced person or agency with no vested interest in the organisation.

8. Disclosure. Ensures that the audited accounts are disclosed to stakeholders and the wider community in the interests of accountability and transparency.

The following figure depicts the principles of Social Audit and universal values:

PRINCIPLES OF SOCIAL AUDIT AND UNIVERSAL VALUES



These are the pillars of Social Audit, where socio?cultural, administrative, legal and democratic settings form the foundation for operationalising Social Audit. The Social Audit process is intended as a means for social engagement, transparency and communication of information, leading to greater accountability of decision?makers, representatives, managers and officials. The underlying ideas are directly linked to concepts of democracy and participation. The application of Social Audit at the village level holds tremendous potential for contributing to good local governance and increased transparency and accountability of the local bodies.

Who can use the Tool?

Social Audit Toolkit can be used by government departments, private enterprises as well as the civil society. However, the scope in terms of audit boundaries would be specific to that of a government department, private organisation, an NGO or a community. In case of private organisations, the emphasis may be on balancing financial viability with its impact on the community and environment. In case of NGOs, in addition to using them to maximise the impact of their intervention programme, they could also be used as effective advocacy tools. Depending on the resources available Social Audit could be comprehensive, state?wide, and can also be localised to the community level.

Applying the Tool

The six steps of Social Auditing are:

1. Preparatory activities

2. Defining audit boundaries and identifying stakeholders

3. Social accounting and book?keeping

4. Preparing and using social accounts

5. Social audit and dissemination

6. Feedback and institutionalisation of social audit

The first two steps are critical when a department decides to incorporate social accounting, social book?keeping and social auditing. The department needs to look at its vision, goals, current practices and activities to identify those that are amenable to social auditing purposes. Small work groups (say, seven persons) are to be formed which would spend about two days each to list down the social vision, core values, social objectives and map stakeholders and their involvement. Ensure involvement of various functionaries with due representation to gender, while forming small groups. The small groups should have access to project documents, process documentation, department guidelines and policy notes.

The next activity would be to assign the task of matching the activities with the social objectives and identifying gaps. This again could be carried out by a small group drawn from the managerial cadre and execution/implementation groups at the field level. All this information would be then looked into; to develop a plan for Social Auditing, including who would be responsible in the department, monitoring and identifying the resources required. This responsibility again could be given to a small group of three individuals.

Stakeholder consultation, involving department functionaries and civil society, would be the forum for sharing the Social Audit plan. This consultation would clarify the issues important for Social Auditing, role of stakeholders, as well as commitments from them. The outcome of the consultation would be fed into the process of detailing out: the indicators to be monitored; which existing records are to be used; and how additional information would be collected. The next key step is to fix responsibilities for various activities. The activities include preparing formats for social account?keeping, compilation of data and reporting the same on a monthly basis (internal use). Managers of the department/programmes can use this information for monitoring as well as providing feedback for improving performance and overcoming bottlenecks.

Ideally, Social Audit should be conducted regularly, and the method should be developed through a participatory relationship between the auditor and the organisations/departments. The following figure depicts the detailed steps followed in the social audit cycle.

In addition to using the Tool kit exercises in the right sequence, it is vital that the process is participative and inclusive. The cycle starts with 'deciding to do a Social Audit' and at the end of each year planned targets and actual achievements are to be compared.

2.5.5 THE STRATEGIC IMPORTANCE OF SOCIAL AUDITING

The social audit, like the financial audit, should be conducted regularly instead of only when there are problems or questions about a firm's priorities and conduct. In other words, the social audit is not a control process to be used during a crisis, although it can pinpoint potential problem areas and generate solutions.

A social audit may be comprehensive and encompass all of the social impact areas of a business, or it can be specific and focus on one or two areas. One specialized audit could be an environmental-impact audit in which specific environmental issues, such as proper waste disposal, are analyzed. Other areas for specialized audits include diversity, ethical conduct, employee benefits, and workplace conditions.

Social audits can present several problems. They can be expensive and time consuming, and selecting the auditors may be difficult if objective, qualified personnel are not available. Employees sometimes fear comprehensive evaluations, especially by outsiders, and in such cases, social audits can be extremely disruptive. Although the concept of auditing implies an official examination of ethical performance, many organizations audit their performance informally. Any attempt to verify outcomes and to compare them with standards can be considered an auditing activity. Many smaller firms probably would not use the word audit, but they do perform auditing activities.

1. Management Practices.

- Pertinent sections from an employee handbook, company manual, or training program (formal or informal) showing how ethics policies are communicated to and implemented by employees.

- Formal training and/or procedures used to address concerns an employee may have in dealing with an ethical dilemma.

- The existence of an Ethics Offi cer, Compliance Offi cer, or Ombudsman should be noted, along with information concerning the responsibilities and authority of this position.
- Formal or informal management practices and policies that foster positive employee relations.
- Employee benefi ts and/or workplace practices which contribute to the quality of family life.
- Actions by the business to assess risks and take appropriate actions to prevent workplace injury.
- Examples of sound environmental practices.

2. Customer/Vendor/Supplier/Shareholder Relations.

- Examples of how your business has prospered because of your belief in honesty, integrity, and doing the right thing.
- Complimentary feedback from customers, vendors, and/or suppliers.
- Company policies and practices that assure excellence in quality products and/or
- Actions taken by your company showing that it went "beyond the call of duty."
- Examples of cases where your company had to make tough decisions that had negative short-term consequences and led to long-term benefits.
- If your company is publicly traded, discuss how the corporation demonstrates accountability to shareholders and adheres to good governance practices.

3. Marketing/Advertising/Communications/Sales Practices.

- Descriptions of the methods your company uses to assure all sales, promotional materials, and advertisements are truthful and accurate.

- Examples of efforts by your company to improve communications, advertising, marketing, and sales practices which benefit your industry as a whole.
- Sales training policies and/or codes of ethics used by sales personnel that ensure all transactions are made in an upfront and ethical manner.

4. Reputation within Industry and Community.

- Articles in trade, industry publications, and news media that reflect your reputation in your industry and community as an ethical business.
- Awards, recognition, and/or complimentary letters from others within your industry or trade group.
- Recognition for charitable and/or community service projects.

Social auditing is the process of assessing and reporting a business's performance in fulfilling the economic, legal, ethical, and philanthropic social responsibilities expected of it by its stakeholders. The social audit provides an objective approach for an organization to demonstrate its commitment to improving strategic planning, including social accountability. There are many reasons companies choose to understand, report on, and improve their social responsibility performance.

A social audit can satisfy stakeholder demands for increased transparency and greater disclosure; this can help amend and advance relationships with investors, customers, suppliers, regulators, the media, and the community while helping these stakeholders better understand the firm's goals and operations. Dialogs established with stakeholders during the audit process may contribute insight about a firm's current situation, how various stakeholders perceive it, issues that could create threats for the company in the future, and opportunities (or weaknesses) of which the company is not yet aware. The process of social auditing can also help an organization identify potential risks and liabilities and improve its compliance with the law. A significant benefit of social auditing is that it may help prevent public relations crises associated with ethical or legal misconduct.

Although social audits provide many benefits for companies and their stakeholders, they do have the potential to create risks. In particular, the process of auditing cannot guarantee that the firm will not face challenges related to its efforts. Nonetheless, a core of minimum standards for corporate social performance is evolving.

Whereas a financial audit is concerned primarily with a company's claims about its financial performance, the social audit is interested in a company's assertions about its social responsibility. Unlike financial audits, social auditing is voluntary. Both social auditing and financial auditing employ the same procedures and processes to create a system of integrity and objective reporting. Both types of audits begin with collecting information to understand the company's industry, determining the scope of the audit, and documenting the details of the audit program. This information must be of high quality, consistent, complete, material, segregated, and collected in a controlled environment.

A social audit entails an individualized process and individualized outcomes for each firm, as it requires the careful consideration of the unique issues that face a particular organization. Although the concept of auditing implies an official examination of social performance, many organizations audit their performance informally. The social audit should be conducted regularly. Although social auditing may present problems, it can generate many benefits. Through the auditing process, a firm can demonstrate the positive impact of social responsibility efforts on its bottom line, convincing stakeholders of the value of more socially responsible business practices.

2.6 CAPITALISM

2.6.1 INTRODUCTION

In the mid-1900s, sociologist Karl Marx coined the term "capitalism" which he implies to be any private ownership of property or enterprise. Today economists define capitalism as an economic system based on private ownership of the means of production and distribution of goods , characterized by free competitive market and motivation by profit. It is next to impossible to locate a pure capitalist country today. Like any other system capitalism cannot be described as the ultimate system, due to its disadvantages, it is not a cure for every defect in human affairs or for eradicating all inequalities. However, it is still in our society because of its ability to change and further develop countries.

2.6.2 HISTORY

Capitalism dates back as early as the primitive society. During this period, life was said to be simple and organized, "the good old days". Subsistence farming, hunting and fishing formed the basis of a primitive society. In this society all decisions were made by a tribal leader and his counselors. As a result of this decision-making process the barter system was developed. With the barter system it was possible to exchange one commodity for another. This system had its disadvantages, which were later recognized, since not all commodities could have been equally valued for the commodities in exchange.

Following the expansion of the primitive society was the slavery system. In this environment masters and slaves exist. Factors of production were owned by the masters and wealth was accumulated for the masters by the slaves through cultivation. Attempting to alleviate revolts a negotiation was made, slaves would be entitled to a portion of the produce if they continue to cultivate the land. This system now became known as Feudalism and the masters became known as Lords while the slaves became Serfs.

The earliest forms of capitalism - which we call "mercantilism" - originate in Rome, the Middle East, and the early middle Ages . Mercantilism is an early modern European economic theory and system that actively supported the establishment of colonies that would supply materials and markets and relieve home nations of dependence of other nations. As the Roman Empire expanded so did mercantilism. As time went on in Europe, mercantilism gradually evolved into economic practices that would eventually be called capitalism . These economic practices are termed commercialism, industrialism and monopolism.

2.6.3 FEATURES OF CAPITALISM

Property Rights: Capitalism is characterized by private ownership of all non-labor factors of production. The owners of these private properties have the power to control these factors of production as well as the goods and services produced from such inputs. The owners have the freedom to decide what to produce, how to produce and for whom to produce. The benefits owners are rewarded with from ownership of these resources are rent from the use of their land, wages for the use of their labor, interest as a return on their capital and profits from their entrepreneurial skills.

Co-ordination Structure: Co-ordination under capitalist economies has a market mechanism in which market forces of demand and supply are allowed to work in order to determine prices and output in the economy. The forces of supply and demand push prices upward or downward in response to the decisions of individual buyers and sellers. This mechanism is commonly referred to as Adam Smith's "Invisible Hand". Within this economic system there is no state intervention to ensure that economic activities are carried out properly and that economic goals are fulfilled.

Motivational Structure: As a result of the self-interest of many economic agents, within this economic system, the market is propelled by material incentives. Suppliers have an incentive to offer only those goods on which they expect to make a profit.

Decision-making Structure: There is no central decision-making mechanism. Market prices direct the actions of decentralized decision makers. The various private parties that possess property rights to products and resources decide by/among themselves what to produce, how to produce and for whom to produce.

Information Structure: The capitalist's information structure is decentralized because horizontal channels of information exists where information and decision-making is spread across the various agents in the economy who are on the same level.

2.6.4 THE WORKINGS OF CAPITALISM

According to Adam Smith, a capitalist economy works by means of the "Invisible Hand". The theory of the "Invisible Hand" states that within a free market enterprise, products are exchanged at a price solely determined by the mutual consent of buyers and sellers. Demands by consumers for products direct the allocation of resources to achieve consumers' utility maximization. Profit is financial (material) incentive to produce goods. This economic system ensures that shortages and surpluses do not last for long. When there is excess demand (shortage) prices in the market are likely to rise, as each buyer would now be willing to outbid the other for the scarce good demanded by many. At higher prices, suppliers are likely to increase their supply and thus equilibrium will be achieved in the market. Situations may also exist in the market where there is excess supply (surplus). The tendency here is for prices to fall as each supplier will attempt to win over customers from their rival firms. At these lower prices, consumers are likely to demand more. Therefore, equilibrium in the market is restored.

In Adam Smith's model he identifies the following:

There is an owner class: The means of production are owned only by the few people (capitalists) who can pay for them . Marx refers to this group as the bourgeois (upper class).

There is a working class : The people (laborers) who generate wealth for the owner class by producing goods and services and, in return, are paid wages by the Capitalists. This group has no ownership of the factors of production and Marx refers to this group as the proletarians (lower class).

Firms rationally aim to maximize profit and this is an incentive for production of these goods and services: The capitalists try to judge the market and adjust production accordingly in order to realize the greatest possible profit.

In a pure capitalist economy, there is no state intervention which often means that the economy is free to make all economic decisions and adjust itself when necessary to remain in equilibrium.

2.6.5 PERFORMANCE UNDER CAPITALISM

In looking at the Performance under capitalism we evaluate the economy under the following performance criteria;

Economic Efficiency

Economic Stability

Income Distribution

Economic Growth

ECONOMIC EFFICIENCY

Being efficient is being able to accomplish a task with minimum expenditure on as many levels as possible. This performance criterion looks at how well the economy is able to allocate its resources to best maximize its production on goods and services while taking the welfare of individuals into consideration. A capitalist economy is efficient as it yields high levels of GDP, innovation is encouraged, and one is allowed to exercise freedom of choice.

ECONOMIC STABILITY

Unemployment rate, inflation rate and real economic growth are some of the economic indicators used to determine economic stability within the economy. Economic stability in a capitalist market is unstable due to fluctuations in inflation, unemployment as well as real economic growth.

INCOME DISTRIBUTION

Capitalism renders unequal distribution of income in the economy. Income is distributed in accordance to the skills and qualifications an individual possesses. Those possessing the skills, qualifications as well as capital resources valued by the market will receive high incomes, whereas lower incomes will be allocated to persons without such skills and resources.

ECONOMIC GROWTH

Economic growth can be measured as the increase in real GDP. Productivity is the key component, i.e. producing more at a lesser operational cost. Economic growth is said to be slow in a capitalist economy. With a steady rise in real GDP the economy is assumedly growing well. However, where there are fluctuations in the business cycle this may cause economic growth to be unstable suggesting that the economy maybe in or going through a recession.

2.6.6 ADVANTAGES & DISADVANTAGES OF CAPITALISM

ADVANTAGES

Capitalism, as we are aware, is an economy where resources and firms are privately owned in free markets. Normally, this usually involves some government intervention to regulate certain aspects of the economy and protect private property. Several advantages are included within a capitalist economy.

Foremost as Government intervention is kept at a limited level several issues that generally arise with government intervention including corruption, lack of a self-interest push force and poor circulation of information within the market is prevented allowing individual incentives to work as hard as possible to achieve as much as possible.

As the capitalist economy is dependent on the push factor of individuals, there is no limit to the level of wealth an individual can accumulate through progression within the economy.

Capitalism allows individuals choice both in commodity purchase and employment opportunities. It allows resources to be distributed according to consumer choice rearing the market in a more productive consumer friendly range.

Through capitalism firms are inclined to produce with greater efficiency, by cutting cost and improving efficiency becomes an aim to prevent losses in an industry where competition is high bettering the economy as a whole .

In such industries company effectively respond to changes in consumer desires better the economy and improving efficiency. In attempts to ensure the highest possible level of productivity, financial incentives are provided to employees by companies so as to better improve self interest in company proficiency. This is beneficial on a global level as these countries generally become exemplary innovative fronts for improvement in technology and implications of productive changes.

As company proficiency improves so does the ability for people to move through social class as an increase in wealth is available. This pushes individuals to work harder in the interest of self-preservation to achieve more. Profit increase within the economy and personal industry, allows an expansion in wealth and company resources, resources that will be used so as to best benefit the company and in turn the economy by promoting foreign investment.

Individuals possess a freedom of choice to purchase and engage in virtually any and all economic activities with little restraint. Promoting trade among nations and individuals that will mutually profit persons with and the economy itself.

Profit maximization is a main priority within the capitalist's state; this can be produced via meeting consumer wants. This causes large suppliers of goods and services that are similar diversification in brands allow for customer distinction and individuality, catering for the necessary changes in desire for certain goods among the lower and higher income classes.

DISADVANTAGES

Within the capitalists state the consumer has all the power in the economy because some people will always be able to work harder , achieve more and eventually achieve dominance above others in the economy. Along with a lack of Government welfare and human nature several disadvantages would eventuality occur within the economy.

As dominance within the economy is formed by the elite few, wealth is recycled in this small percentage who has gained a monopoly through limited Government control. This normally occurs through construction of rules that limit the flexibility of the money flow between classes. Leading to exploitation in labor resulting in revolt and strike within the market negatively affecting the entire economy by halting and disrupting production.

Due to market being profit and demand driven, negative externalities such as pollution are generally ignored until they become a serious issue within the economy.

This leads to a necessity to reduce the money supply in the economy to resolve these issues.

Firms that have been able to gain monopolies early within market development, pushes out smaller firms from entering due to the high level of competition where they may not be able to produce.

2.6.6 CHANGES IN CAPITALISM

In today's world it is hard to pinpoint a pure capitalist state since many capitalist countries does not possess all the features of pure capitalism. A pure capitalist state is one with no government intervention and its demand and supply are left in what Adam Smith called "Invisible Hand". However, it's private ownership and a profit driven motive shows that such an economy is competitive in nature. Therefore the question still remains why it's impossible to locate a pure capitalist state? But does one exist or have ever existed before?

It was observed that over the years capitalism has pass through many phrases which forced capitalist economies to amend or adjust their rules under which they reside. These changes put capitalist states either more too pure socialism or more to pure capitalism.

Private ownership

Private ownership is one of the most important factors in capitalist state that adds fuel to a competitive and market oriented economy. Significant changes in the shares of public and private ownership of property can alter the nature of a capitalist economic system. Indeed if the state owned a major share of existing property, we would no longer classify the system as capitalist."

Working participation

Owners of capital (proprietors, partners and shareholders) are rewarded out of their profits while workers are paid with wages which does not vary with profits. The higher the profits of a firm the greater the returns of proprietors, partners and shareholders whereas workers' wages remains fixed regardless of the fluctuation of profits.

If workers (driven by their own self-interest) were allow to increase profits of the enterprise operating within the capitalist state - this would considered that capitalism has evolved from its basic form.

It has change today - if workers' income depends on the profits of a firm then that becomes a self-motivation hence they would be more interest in the profitability of the firm.

Government intervention

Fiscal Policies: fiscal policy is discussed as government budget deficit (government expenditures less government revenue). It is also government spending or taxes to stimulate the economy. If aggregate income is too low (actual income is below potential income), the appropriate fiscal policy is expansionary fiscal policy : increase the deficit by decreasing taxes or increasing government spending. If aggregate income is too high (actual income is above potential income), the appropriate fiscal policy is contractionary fiscal policy: decrease the deficit by increasing taxes or decreasing government spending.

Welfare: In the late 1930s and the 1940s, workers dominated the political agenda . During this time the capitalist economies developed an economic safety net that included government funded programmes such as public welfare, unemployment insurance, and established an extensive set of regulations affecting all aspects of the economy." This safety net is frequently found in capitalist economies globally since its make available a form of security for the population (working class).

Minimum Wage Laws: Government has enforced the minimum wage law which also kept the market from operating by itself. The government causes wage rigidity when it prevents wages from falling to equilibrium levels. Minimum-wage laws set a legal minimum on the wages that firms pay their employees.

2.6.7 CONCLUSION

Over the years capitalism has evolved. Starting with the bartering system which led to slavery system, then the Feudalism followed by mercantilism then to capitalism. It was suggested by the classical school of economics that government role should not be removed from economic system but, its role should be limited only to protect individual rights and providing public goods and services. History reveals that government is necessary and its role has expanded. We cannot deny that without government intervention we would have fail. With government intervention capitalism has develop over the years. Government involve in the form of nationalization, welfare and fiscal policies and minimum wage laws which adds to the development of capitalism. In the world today pure capitalism is not practiced but rather a mix economy by former capitalist states like the United State where government plays a more important role in market decisions.

However, like everything else capitalism has its disadvantages such as negative externalities like pollution and diminishing non-renewable resources; a disproportionate distribution of wealth or income; and high unemployment rates and economic instability due to the cyclical nature of the capitalistic system. Additionally the main motives of firms was gaining a profit which lead to the misallocation of scarce resources and stagnation.

Even with consistent conflicts between upper and lower class, capitalism has survive. It survives from the elite's desire to remain in control of the means of production and, therefore, wealth. It causes exploitation between classes (the elite benefits at the expense of labour from the lower class) and was self-seeking since persons seek their own self-interests, regardless of the effects their actions have on others. This system found ways to suppress the working class and keep the bourgeois in dominant position in society.

2.7 SOCIALISM

A socialist economy is an economic organisation in which the means of production are owned and regulated by the state. The production and distribution of goods and factors of production are done by the state under the direction of the planning commission. The decisions as to how much to produce, which methods of production to employ and for whom to produce are taken by the planning authority. That is why a socialist economy is also called a planned economy. Such economies are China, Cuba, Vietnam, and North Korea. They possess the following common features.

2.7.1 FEATURES OF SOCIALISM

The main features of this system are detailed below.

(1) Public Ownership:

A socialist economy is characterised by public ownership of the means of production and distribution. There is collective ownership whereby all mines, farms, factories, financial institutions, distributing agencies (internal and external trade, shops, stores, etc.), means of transport and communications, etc. are owned, controlled, and regulated by government departments and state corporations. A small private sector also exists in the form of small business units which are carried on in the villages by local artisans for local consumption.

(2) Central Planning:

A socialist economy is centrally planned which functions under the direction of a central planning authority. It lays down the various objectives and targets to be achieved during the plan period. Central economic planning means "the making of major economic decisions-what and how much is to be produced, how, when and where it is to be produced, and to whom it is to be allocated-by the conscious decision of a determinate authority, on the basis of a comprehensive survey of the economic system as a whole."

And the central planning authority organises and utilises the economic resources by deliberate direction and control of the economy for the purpose of achieving definite objectives and targets laid down in the plan during a specified period of time.

(3) Definite Objectives:

A socialist economy operates within definite socio-economic objectives. These objectives "may concern aggregate demand, full employment, satisfaction of communal demand, allocation of factors of production, distribution of the national income, the amount of capital accumulation, economic development…and so forth." For achieving the various objectives laid down in the plan, priorities and bold targets are fixed covering all aspects of the economy.

(4) Freedom of Consumption:

Under socialism, consumers' sovereignty implies that production in state- owned industries is generally governed by the preferences of consumers, and the available commodities are distributed to the consumers at fixed prices through the state-run department stores. Consumers' sovereignty under socialism is confined to the choice of socially useful commodities.

(5) Equality of Income Distribution:

In a socialist economy, there is great equality of income distribution as compared with a free market economy. The elimination of private ownership in the means of production, private capital accumulation, and profit motive under socialism prevent the amassing of large wealth in the hands of a few rich persons. The unearned incomes in the form of rent, interest and profit go to the state which utilises them in providing free education, public health facilities, and social security to the masses. "As far as wages and salaries are concerned, most modern socialists do not aim at complete and rigid equality. It is now generally understood that the maintenance offered choice of occupation implies wage differentials."

(6) Planning and the Pricing Process:

The pricing process under socialism does not operate freely but works under the control and regulation of the central planning authority. There are administered prices which are fixed by the central planning authority. There are also the market prices at which consumer goods are sold. There are also the accountings prices on the basis of which the managers decide about the production of consumer goods and investment goods, and also about the choice of production methods.

2.7.2 MERITS OF SOCIALISM

Prof. Schumpeter has advanced four arguments in favour of socialism: one.

greater economic efficiency; two, welfare due to less inequality; three, absence of monopolistic practices; and four, absence of business fluctuations. We discuss these merits of socialism one by one.

(1) Greater Economic Efficiency:

Economic efficiency under socialism is greater than under capitalism. The means of production are controlled and regulated by the central planning authority towards chosen ends. The central planning authority makes an exhaustive survey of resources and utilises them in the most efficient manner.

Increased productivity is secured by avoiding the wastes of competition and by undertaking expensive research and production processes in a coordinated manner. Economic efficiency is also achieved by utilising resources in producing socially useful goods and services which satisfy the basic wants of the people, like cheap food, cloth, and housing.

(2) Greater Welfare due to Less Inequality of Income:

In a socialist economy there is less inequality of income as compared with a capitalist economy because of the absence of private ownership of the means of production, private capital accumulation, and private profit. All citizens work for the welfare of the state and each is paid his remuneration according to his ability, education and training. All rents, interests and profits from various sources go to the state which spends them for public welfare in providing free education, cheap and congenial housing, free public health amenities, and social security to the people.

(3) Absence of Monopolistic Practices:

Another advantage of socialism is that it is free from monopolistic practices to be found in a capitalist society. Since under socialism all means of production are owned by the state, both competition and monopoly are eliminated. The exploitation by the monopolistic is absent. Instead of private monopoly, there is the state monopoly of the productive system but this is operated for the welfare of the people. In the state-owned factories, socially useful commodities are produced which are of high quality and are also reasonably priced.

(4) Absence of Business Fluctuations:

A socialist economy is free from business fluctuations. There is economic stability because production and consumption of goods and services are regulated by the central planning authority in accordance with the objectives, targets and priorities of the plan. Thus there is neither overproduction nor unemployment.

2.7.3 DEMERITS OF SOCIALISM

A socialist economy has also certain disadvantages:

1. Loss of Consumers' Sovereignty:

There is loss of consumers' sovereignty in a socialist economy. Consumers do not have the freedom to buy whatever commodities they want. They can consume only those commodities which are available in department stores. Often the quantities which they can buy are fixed by the state.

2. No Freedom of Occupation:

There is also no freedom of occupation in such a society. Every person is provided job by the state. But he cannot leave or change it. Even the place of work is allotted by the state. All occupational movements are sanctioned by the state.

3. Malallocation of Resources:

Under socialism, there is arbitrary allocation of resources. The central planning authority often commits mistakes in resource allocation because the entire work is done on trial and error basis.

4. Bureaucratic:

A socialist economy is said to be a bureaucratic economy. It is operated like a machine. So it does not provide the necessary initiative to the people to work hard. People work due to the fear of higher authorities and not for any personal gain or self-interest.

There is no doubt that a socialist economy is better than a capitalist economy because of its overwhelming merits. But it is disliked for the loss of political, economic and personal freedoms.

2.8 MIXED ECONOMY

Mixed economy is the combination of capitalism and socialism. Under the mixed economy, the advantages of both capitalism and socialism are incorporated and at the same time their evils are avoided.

Under mixed economy, both the private and the public sectors function side by side. The Government directs economic activity towards certain socially important areas of the economy and the balance is subject to the operation of the price mechanism.

The public and private sectors work in a co-operative manner to attain the social objectives under a common economic plan.

The private sector constitutes an important part of the mixed economy and considered as an important instrument of economic growth. India is regarded as the best example of a mixed economy in the world.

2.8.1 FEATURES OF MIXED ECONOMY

The following are the main characteristics of mixed economy:

1. Co-existence of the Private and Public Sectors

Co-existence of the private and public sectors is the outstanding feature of mixed economy. In mixed economy, both public sector as well as private sector industries will be functioning. Certain industries will be in the public sector and certain industries in the private sector. Private individuals and firms own private sector industries. Profit will be the primary motive of private sector industries. In public sector, industries are owned and managed by the Government. Public industries will also have profit motive but that too for the promotion of social welfare.

2. Existence of Joint Sector

Joint sector is one where both Government and private individuals establish an organization jointly by contributing the necessary capital.

3. Regulation of Private Sector

Under mixed economy, Government exercises strict control and regulation over private sector industries.

4. Planned Economy

The entire economic structure is subject to the planning of the Government. Mixed economy is a planned economy. The planning commission decides the objectives, targets and allocation of resources etc.

5. Private Property

Under mixed economy, private firms and individuals have right to own and use property.

6. Provision of Social Security

Under mixed economy, Government takes steps to provide social security.

7. Motive of Business Concerns

The motive of the business concerns is profit but coupled with the objective of social welfare.

8. Reduction of Inequalities of Income and Wealth

The Government takes steps to reduce inequalities of income and wealth.

9. Complete Economic Freedom

There is complete economic freedom in mixed economy. Hence, the consumer is free to buy any commodity they like.

2.8.2 MERITS OF MIXED ECONOMY

The important advantages of mixed economy are as follows:

1. Efficiency

There will be competition between public and private industries, which will result in greater efficiency and production in a mixed economy.

2. Reduced inequality

The profit of public sector industries goes to the Government and as a result inequalities of income will be reduced in mixed economy.

3. Systematic plan

In a mixed economy, economic activities are carried out as per plan. The entire economic system is subject to systematic planning of the Government.

4. Economic Stability

The economic activities take place in a planned manner. So there will be economic stability in mixed economy.

5. Consumer sovereignty

Goods are produced as per the wishes of the consumers, which results in consumer's sovereignty in a mixed economy.

6. Freedom

In mixed economy, freedom of enterprise and profit motive are the important features. Further there is competition between public and private sectors. These factors increase efficiency, initiative, innovation and productivity.

7. Promotion of social welfare

Mixed economic system gives importance to the promotion of social welfare. Under this system, both private and public sectors work for the welfare of people.

8. Rights of Individual

Under mixed economy, individual rights are protected. People have freedom to buy any commodity.

2.8.3 DEMERITS OF MIXED ECONOMY

The mixed economy also suffers from various defects, which are as under:

1.Unhealthy Competition

There is unhealthy competition between private and public sectors in a mixed economy.

2. No freedom to pvt sector

There is no freedom to private sector in mixed economy. This is because Government regulates private industries through its various regulations and licensing.

3. Inefficient public sector

Inefficiency of public sector is another demerits of mixed economy. They may suffer heavy losses. People will have to bear these losses. The objective and targets of economic planning also may not be achieved in a mixed economy.

4. Unemployment and Uncertainties

On account of capital scarcity, Government regulation and control, the growth of private sector may be less than what is fixed in plan. It may lead to unemployment and uncertainties in a mixed economy.

5. Threat of Nationalization

There is always a threat of nationalization in the mixed economic system because of which the private sector does not work actively.

In spite of the defects in the mixed economy, it has become popular in some countries. India is one of the important countries, which adopted mixed economy.

2.9 SUMMARY

Socioeconomics is sometimes used as an umbrella term with different usages. The term 'social economics' may refer broadly to the "use of economics in the study of society." More narrowly, contemporary practice considers behavioral interactions of individuals and groups through social capital and social "markets" (not excluding for example, sorting by marriage) and the formation of social norms. In the latter, it studies the relation of economics to social values.

A distinct supplemental usage describes social economics as "a discipline studying the reciprocal relationship between economic science on the one hand and social philosophy, ethics, and human dignity on the other" toward social reconstruction and improvement or as also emphasizing multidisciplinary methods from such fields as sociology,history, and political science. In criticizing mainstream economics for its alleged faulty philosophical premises (for example the pursuit of self-interest) and neglect of dysfunctional economic relationships, such advocates tend to classify social economics as heterodox.

Paul Doran, the former Governor of Washington, remarked that, "socioeconomics, in essence, create profundities that preclude the convalescence of the people and time to create the bonheur of true litigation." Therefore, iconoclasm becomes greatly promulgated.

An effect of different economic doctrines and policies, e.g., social vs liberal, on socioeconomic situation of some particular group of people is also being constantly argued at different levels of societies. Nevertheless, regarding economic freedom, overwhelmingly research shows that although it has its negative effects, especially in a shorter term, e.g., the phase of increasing inequality, overall trends are indicative that countries with higher levels of economic freedom have not only higher gross domestic product per capita and its growth rates, but also have better health care, education system, environment protection, as well as greater income equality, and maybe above all, happiness results. These trends of increasing prosperity with augmenting economic freedom are confirmed even when we compare them within different territories of countries.

In many cases, socioeconomists focus on the social impact of some sort of economic change. Such changes might include a closing factory, market manipulation, the signing of international trade treaties, new natural gas regulation, etc. Such social effects can be wide-ranging in size, anywhere from local effects on a small community to changes to an entire society. Examples of causes of socioeconomic impacts include new technologies such as cars or mobile phones, changes in laws, changes in the physical environment (such as increasing crowding within cities), and ecological changes (such as prolonged drought or declining fish stocks). These may affect patterns of consumption, the distribution of incomes and wealth, the way in which people behave (both in terms of purchase decisions and the way in which they choose to spend their time), and the overall quality of life.

The goal of socioeconomic study is generally to bring about socioeconomic development, usually by improvements in metrics such as GDP, life expectancy, literacy, levels of employment, etc.

Although harder to measure, changes in less-tangible factors are also considered, such as personal dignity, freedom of association, personal safety and freedom from fear of physical harm, and the extent of participation in civil society

2.10 GLOSSARY

Social responsibility is the obligation of decision-makers to take actions, which protect and improve the welfare of society as a whole along with their own interests.

Social auditing is the process of assessing and reporting a business's performance on fulfilling the economic, legal, ethical, and philanthropic social responsibilities expected of it by its stakeholders.

Mixed economy is the combination of capitalism and socialism.

2.11 SELF ASSESSMENT QUESTIONS

1. How to implement Social responsibility of business.

2. What are the merits of Capitalism.

3. What are the advantages of mixed economy.

2.12 LESSON END EXCERCISES

1. What to remember when implementing Social responsibility of business.

2. Discuss the demerits of Socialism.

3. What are the features of mixed economy.

2.13 SUGGESTED READINGS

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SEMESTER: IV **LESSON:**

FINANCIAL ENVIRONMENT

Structure:

3.13 References

3.1 INTRODUCTION

A financial system (within the scope of finance) is a system that allows the exchange of funds between lenders, investors, and borrowers. Financial systems operate at national, global, and firm-specific levels. They consist of complex, closely related services, markets, and institutions intended to provide an efficient and regular linkage between investors and depositors.

Money, credit, and finance are used as media of exchange in the financial systems. They serve as a medium of known value for which goods and services can be exchanged as an alternative to bartering. A modern financial system may include banks (operated by the government or private sector), financial markets, financial instruments, and financial services. Financial systems allow funds to be allocated, invested, or moved between economic sectors. They enable individuals and companies to share the associated risks.

3.2 OBJECTIVES

By the end of this unit, students will be able to:

(a) identify the role of financial institutions and markets in the provision of short and long term finance to individuals, businesses and governmental organisations.

(b) understand the full range of products of the worldwide financial services industry.

(c) understand how the different financial institutions come together with their roles as intermediaries and financial services providers

(d) identify how macroeconomic variables and government economic policies affect business organisations.

3.3 MONEY MARKET- CONCEPTS AND CONSTITUENTS

The market that borrows and lends short-term funds is called the money market. The instruments in the money market are short-term in nature and are highly liquid. Money market plays an important function of transferring funds to those economic units who have short-term requirements for funds. India money market has seen exponential growth just after the globalization initiative in 1992. It has been observed that financial institutions do employ money market instruments for financing short-term monetary requirements of various sectors such as agriculture, finance and manufacturing. The performance of Indian money market has been outstanding from last 20 years. Central bank of the country - the Reserve Bank of India (RBI) has always been playing the major role in regulating and controlling the India money market. The intervention of RBI is varied - curbing crisis situations by reducing the cash reserve ratio (CRR) or infusing more money in the economy. In money markets short-term debts instruments in particular are traded by individuals, corporations, government. The short-term instruments are with a maturity of one year or less is issued by those economic units that require short-term funds and lent by people who have surplus short-term funds. The need for money market arises due to the immediate cash requirements of people which do not necessarily match with their cash receipts.

3.3.1 FEATURES

1) Dichotomic Structure: It is a significant aspect of the Indian money market. It has a simultaneous existence of both the organized money market as well as unorganised money markets. The organized money market consists of RBI, all scheduled commercial banks and other recognized financial institutions. However, the unorganized part of the money market comprises domestic money lenders, indigenous bankers, traders, etc. The organized money market is in full control of the RBI. However, unorganized money market remains outside the RBI control. Thus both the organized and unorganized money market exists simultaneously.

2) Seasonality: The demand for money in Indian money market is of a seasonal nature. India being an agriculture predominant economy, the demand for money is generated from the agricultural operations. During the busy season i.e. between October and April more agricultural activities takes place leading to a higher demand for money.

3) Multiplicity of Interest Rates: In Indian money market, there are many levels of interest rates. They differ from bank to bank from period to period and even from borrower to borrower. Again in both organized and unorganized segment the interest rates differs. Thus there is an existence of many rates of interest in the Indian money market.

4) Lack of Organized Bill Market: In the Indian money market, the organized bill market is not prevalent. Though the RBI tried to introduce the Bill Market Scheme (1952) and then New Bill Market Scheme in 1970, still there is no properly organized bill market in India.

5) Absence of Integration: This is a very important feature of the Indian money market. At the same time it is divided among several segments or sections which are loosely connected with each other. There is a lack of coordination among these different components of the money market. RBI has full control over the components in the organized segment but it cannot control the components in the unorganized segment.

6) High Volatility in Call Money Market: The call money market is a market for very short term money. Here money is demanded at the call rate. Basically the demand for call money comes from the commercial banks. Institutions such as the GIC, LIC, etc suffer huge fluctuations and thus it has remained highly volatile.

7) Limited Instruments: It is in fact a defect of the Indian money market. In our money market the supply of various instruments such as the Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc. is very limited. In order to meet the varied requirements of borrowers and lenders, It is necessary to develop numerous instruments.

3.3.2 TYPES OF MONEY MARKET INSTRUMENTS IN INDIA

Money market instruments take care of the borrowers' short-term needs and render the required liquidity to the lenders. The varied types of India money market instruments are treasury bills, repurchase agreements, commercial papers, certificate of deposit, and banker's acceptance.

Treasury Bills (T-Bills) - Treasury bills were first issued by the Indian government in 1917. Treasury bills are short-term financial instruments that are issued by the Central Bank of the country. It is one of the safest money market instruments as it is void of market risks, though the return on investments is not that huge. Treasury bills are circulated by the primary as well as the secondary markets. The maturity periods for treasury bills are respectively 3-month, 6-month and 1-year. The price with which treasury bills are issued comes separate from that of the face value, and the face value is achieved upon maturity. On maturity, one gets the interest on the buy value as well. To be specific, the buy value is determined by a bidding process, that too in auctions.

Repurchase Agreements - Repurchase agreements are also called repos. Repos are short-term loans that buyers and sellers agree upon for selling and repurchasing. Repo transactions are allowed only among RBI-approved securities like state and central government securities, T-bills, PSU bonds, FI bonds and corporate bonds. Repurchase agreements, on the other hand, are sold off by sellers, held back with a promise to purchase them back at a certain price and that too would happen on a specific date. The same is the procedure with that of the buyer, who purchases the securities and other instruments and promises to sell them back to the seller at the same time.

Commercial Papers - Commercial papers are usually known as promissory notes which are unsecured and are generally issued by companies and financial institutions, at a discounted rate from their face value. The fixed maturity for commercial papers is 1 to 270 days. The purposes with which they are issued are - for financing of inventories, accounts receivables, and settling short-term liabilities or loans. The return on commercial papers is always higher than that of T-bills. Companies which have a strong credit rating, usually issue CPs as they are not backed by collateral securities. Corporations issue CPs for raising working capital and they participate in active trade in the secondary market. It was in 1990 that Commercial papers were first issued in the Indian money market.

Certificate of Deposit - A certificate of deposit is a borrowing note for the short-term just similar to that of a promissory note. The bearer of a certificate of deposit receives interest. The maturity date, fixed rate of interest and a fixed value - are the three components of a certificate of deposit. The term is generally between 3 months to 5 years. The funds cannot be withdrawn instantaneously on demand, but has the facility of being liquidated, if a certain amount of penalty is paid. The risk associated with certificate of deposit is higher and so is the return (compared to T-bills). It was in 1989 that the certificate of deposit was first brought into the Indian money market.

Bankers Acceptance - A banker's acceptance is also a short-term investment plan that comes from a company or a firm backed by a guarantee from the bank. This guarantee states that the buyer will pay the seller at a future date. One who draws the bill should have a sound credit rating. 90 days is the usual term for these instruments. The term for these instruments can also vary between 30 and 180 days. It is used as time draft to finance imports, exports.

It depends on the economic trends and market situation that RBI takes a step forward to ease out the disparities in the market. Whenever there is a liquidity crunch, the RBI opts either to reduce the Cash Reserve Ratio (CRR) or infuse more money in the economic system. In a recent initiative, for overcoming the liquidity crunch in the Indian money market, the RBI infused more than Rs 75,000 crore along with reductions in the CRR.

3.3.3 COMPONENTS OF MONEY MARKET

The Indian money market consists of two segments, namely organized sector and unorganized sector. The RBI is the most important constituents of Indian money market. The organized sector is within the direct purview of RBI regulation. The unorganized sector comprises of indigenous bankers, money lenders and unregulated non-banking financial institutions. The structure or components of Indian money market is depicted in the chart below:

(A) ORGANIZED MONEY MARKET INSTRUMENTS AND FEATURES

1) Call and Notice Money Market: Funds are transacted on overnight basis. Under notice money market funds are transacted for the period between 2 days and 14 days. The funds lent in the notice money market do not have a specified repayment date when the deal is made. The lender issues a notice to the borrower 2-3 days before the funds are to be paid. On receipt of this notice, the borrower will have to repay the funds within the given time. Generally, banks rely on the call money market where they raise funds for a single day. The main participants in the call money market are commercial banks (excluding RRBs), cooperative banks and primary dealers. Discount and Finance House of India (DFHI), Non-banking financial institutions such as LIC, GIC, UTI, NABARD etc. are allowed to participate in the call money market as lenders.

2) Treasury Bills (T-Bills): They are short-term securities issued by RBI on behalf of Government of India. They are the main instruments of short term borrowing by the Government. They are useful in managing short-term liquidity. At present, the Government of India issues three types of treasury bills through auctions, namely - 91 days, 182-day and 364-day treasury bills. There are no treasury bills issued by state governments. With the introduction of the auction system, interest rates on all types of TBs are being determined by the market forces.

3) Commercial Bills: It is a short-term, negotiable, and self-liquidating instrument with low risk. They are negotiable instruments drawn by a seller on the buyer for the value of goods delivered by him. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. If the seller gives some time for payment, the bill is payable at future date (i.e. usance bill). Generally the maturity period is upto 90 days. During the usance period, if the seller is in need of funds, he may approach his bank for discounting the bill. Commercial banks can provide credit to customers by discounting commercial bills. The banks can rediscount the commercial bills any number of times during the usance period of bill and get money.

4) Certificates of Deposits (CDs): They are unsecured, negotiable promissory notes issued at a discount to the face value. They are issued by commercial banks and development financial institutions. CDs are marketable receipts of funds deposited in a bank for a fixed period at a specified rate of interest. CDs were introduced in India in June 1989. The main purpose of the scheme was to enable commercial banks to raise funds from the market through CDs. According to the original scheme, CDs were issued in multiples of Rs.25 lakh subject to minimum size of an issue being Rs.1 crore. They had the maturity period of 3 months to one year. They are freely transferable but only after the lock in period of 45 days after the date of issue.

5) Commercial Papers (CPs): Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note with fixed maturity. They indicate the short-term obligation of an issuer. They are quite safe and highly liquid. They are generally issued by the leading, nationally reputed, highly rates and credit worthy large manufacturing and finance companies is the public as well as private sector. CPs were introduced in India January 1990. CPs were launched in India with a view to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and also to provide an additional instrument to investors. RBI has modified its original scheme in order to widen the market for CPs. Corporates and primary dealers (PDs) and the all India financial institutions can issue CPs. A corporate can issue CPs provided they fulfill the following conditions:

(a) The tangible net worth of the company is not less than Rs.4 crore.

(b) The company has been sanctioned working capital limit by banks or all India financial institutions

(c) The borrowed account of the company is classified as a standard asset by the financing institution or bank.

6) Repos: A repo or reverse repo is a transaction in which two parties agree to sell and repurchase the same security. Under repo, the seller gets immediate funds by selling specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller at an agreed date and price. The repos in government securities were first introduced in India since December 1992. Since November 1996, RBI has introduced "Reverse Repos", i.e. to sell government securities through auction.

7) Discount and Finance House of India (DFHI): It was set up by RBI in April 1988 with the objective of deepening and activating money market. It is jointly owned by RBI, public sector banks and all India financial institutions which have contributed to its paid up capital. The DFHI deals in treasury bills, commercial bills, CDs, CPs, short-term deposits, call money market and government securities. The presence of DFHI as an intermediary in the money market has helped the corporate entities, banks, and financial institutions to invest their short-term surpluses in money market instruments.

8) Money Market Mutual Funds (MMMFs): RBI introduced MMMFs in April 1992 to enable small investors to participate in the money market. MMMFs mobilize savings from small investors and invest them in short-term debt instruments or money market instruments such as call money, repos, treasury bills, CDs and CPs. These instruments are forms of debt that mature in less than a year.

(B) UNORGANIZED SECTOR OF INDIAN MONEY MARKET

The unorganized Indian money market is largely made up of indigenous bankers, money lenders and unregulated non-bank financial intermediaries. They do operate in urban centers but their activities are largely confined to the rural sector. This market is unorganized because it's activities are not systematically coordinated by the RBI.

The main components of unorganized money market are:

1) Indigenous Bankers: They are financial intermediaries which operate as banks, receive deposits and give loans and deals in hundies. The hundi is a short term credit instrument. It is the indigenous bill of exchange. The rate of interest differs from one market to another and from one bank to another. They do not depend on deposits entirely, they may use their own funds.

2) Money Lenders: They are those whose primary business is money lending. Money lenders predominate in villages. However, they are also found in urban areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The borrowers are generally agricultural labourers, marginal and small farmers, artisans, factory workers, small traders, etc.

3) Unregulated non-bank Financial Intermediaries: The consist of Chit Funds, Nithis, Loan companies and others

(a) Chit Funds: They are saving institutions. The members make regular contribution to the fund. The collected funds is given to some member based on previously agreed criterion (by bids or by draws). Chit Fund is more famous in Kerala and Tamil Nadu.

(b) Nidhis: They deal with members and act as mutual benefit funds. The deposits from the members are the major source of funds and they make loans to members at reasonable rate of interest for the purposes like house construction or repairs. They are highly localized and peculiar to South India. Both chit funds and Nidhis are unregulated.

4) Finance Brokers: They are found in all major urban markets specially in cloth markets, grain markets and commodity markets. They are middlemen between lenders and borrowers.

3.3.4 REFORMS UNDERTAKEN IN INDIAN MONEY MARKET.

The Committee to Review the Working of Monetary System chaired by S. Chakravarty made several recommendations in 1985 to develop Indian money market. As a follow-up, the RBI set up a Working Group on money market under the chairmanship of N. Vaghul, in 1987. Based on the recommendations of Vaghul

Committee, RBI initiated a number of measures to widen and deepen the money market. The main measures are as follows.

1) Deregulation of Interest Rates: From May 1989, the ceiling on interest rates on the call money, inter-bank short-term deposits, bills rediscounting and inter-bank participation was removed and the rates were permitted to be determined by the market forces. Thus, the system of administered interest rates is being gradually dismantled.

2) Introduction of New Money Market Instruments: In order to widen and diversify the Indian money market RBI has introduced many new money market instruments such as 182-days treasury bills, 364-day treasury bills, CDs & CPs. Through these instruments the government, commercial banks, financial institutions and corporate can raise funds through the money market. They also provide investors additional instruments for investments. In order to expand the investor base for CDs and CPs the minimum amount of investment and the minimum maturity periods are reduced by RBI.

3) Repurchase Agreements (Repos): RBI introduced repos in government securities in December 1992 and reverse repos in November 1996. Repos and reverse repos help to even out short-term fluctuations in liquidity in the money market. They also provide a short-term avenue to banks to park their surplus funds. Through changes in repo and reverse repo rates RBI transmits policy objectives to entire money market.

4) Liquidity Adjustment Facility (LAF): RBI has introduced LAF from June 2000 as an important tool for adjusting liquidity through repos and reverse repos. Thus, in the recent years RBI is using repos and reverse repos as a policy to adjust liquidity in the money market and therefore, to stabilize the short-term interest rates or call rates. LAF has, therefore, emerged as a major instrument of monetary policy.

5) Money Market Mutual Funds (MMMF): RBI introduced MMMFs in April 1992 to enable the individual investors to participate in money market. To make the scheme flexible and attractive, RBI has brought about many modifications. The important features of this scheme as of now are:

(i) It can be set up by commercial banks, financial institutions and private sector.

(ii) Individual investors, corporates and others can invest in MMMFs.

(iii) Resources mobilized through this scheme can be invested in money market instruments as well as rated corporate bonds and debentures with a maturity period upto one year.

(iv) The minimum lock in period is now 15 days.

6) Discount and Finance House of India (DFHI): In order to impart liquidity to money market instruments and help the development of secondary market in such instruments, DFHI was set up in 1988 jointly by RBI, public sector banks and financial institutions.

7) Development of Inter-bank Call and Notice Money Market: The call and notice money market is an inter-bank market the world over and therefore the Narsimham Committee has recommended that we adopt the same in India. However RBI in the past had given permission to non-bank institutions to participate in the call money market as lenders. As per the recommendations of Narsimham Committee RBI in 2001-02 has underlined the need for transforming the call money market into a pure inter-bank money market.

8) Regulation of NBFCs: The RBI Act was amended in 1997 to provide for a comprehensive regulation of NBFC sector. According to the amendment, no NFBC can carry on any business of a financial institution, including acceptance of public deposit, without obtaining a Certificate of Registration (CoR) from RBI.

9) The Clearing Corporation of India Limited (CCIL): The CCIL was registered on April 30, 2001 under the Companies Act, 1956, with the State Bank of India as the chief promoter. The CCIL clears all transactions in government securities and repos reported on the Negotiated Dealing System (NDS) of RBI.

3.3.5 DRAWBACKS OF INDIAN MONEY MARKET

Though the Indian money market is considered as the advanced money market among developing countries, it still suffers from many drawbacks or defects. These defects limit the efficiency of our market.

Some of the important defects or drawbacks of Indian money market are:-

1) Absence of Integration: The Indian money market is broadly divided into the Organized and Unorganized Sectors. The former comprises the legal financial institutions backed by the RBI. The unorganized statement of it includes various institutions such as indigenous bankers, village money lenders, traders, etc. There is lack of proper integration between these two segments.

2) Multiple rate of interest: In the Indian money market, especially the banks, there exists too many rates of interests. These rates vary for lending, borrowing, government activities, etc. Many rates of interests create confusion among the investors.

3) Insufficient Funds or Resources: The Indian economy with its seasonal structure faces frequent shortage of financial recourse. Lower income, lower savings, and lack of banking habits among people are some of the reasons for it.

4) Shortage of Investment Instruments: In the Indian money market, various investment instruments such as Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc. are used. But taking into account the size of the population and market these instruments are inadequate.

5) Shortage of Commercial Bill: In India, as many banks keep large funds for liquidity purpose, the use of the commercial bills is very limited. Similarly since a large number of transactions are preferred in the cash from the scope for commercial bills are limited.

6) Lack of Organized Banking System: In India even though we have a big network of commercial banks, still the banking system suffers from major weaknesses such as the NPA, huge losses, poor efficiency. The absence of the organized banking system is major problem for Indian money market.

7) Less number of Dealers: There are poor number of dealers in the short-term assets who can act as mediators between the government and the banking system. The less number of dealers leads to the slow contact between the end lender and end borrowers.

3.4 CAPITAL MARKET-CONCEPT AND CONSTITUENTS

Indian capital markets have been receiving global attention, especially from sound investors, due to the improving macroeconomic fundamentals. The presence of a great pool of skilled labor and the rapid integration with the world economy increased India's global competitiveness. No wonder, the global ratings agencies Moody's and Fitch have awarded India with investment grade ratings, indicating comparatively lower sovereign risks.

The Securities and Exchange Board of India (SEBI), the regulatory authority for Indian securities market, was established in 1992 to protect investors and improve the microstructure of capital markets. In the same year, Controller of Capital Issues (CCI) was abolished, removing its administrative controls over the pricing of new equity issues. In less than a decade later, the Indian financial markets acknowledged the use of technology (National Stock Exchange started online trading in 2000), increasing the trading volumes by many folds and leading to the emergence of new financial instruments. With this, market activity experienced a sharp surge and rapid progress was made in further strengthening and streamlining risk management, market regulation, and supervision.

The securities market is divided into two interdependent segments:

1) The primary market provides the channel for creation of funds through issuance of new securities by companies, governments, or public institutions. In the case of new stock issue, the sale is known as Initial Public Offering (IPO).

2) The secondary market is the financial market where previously issued securities

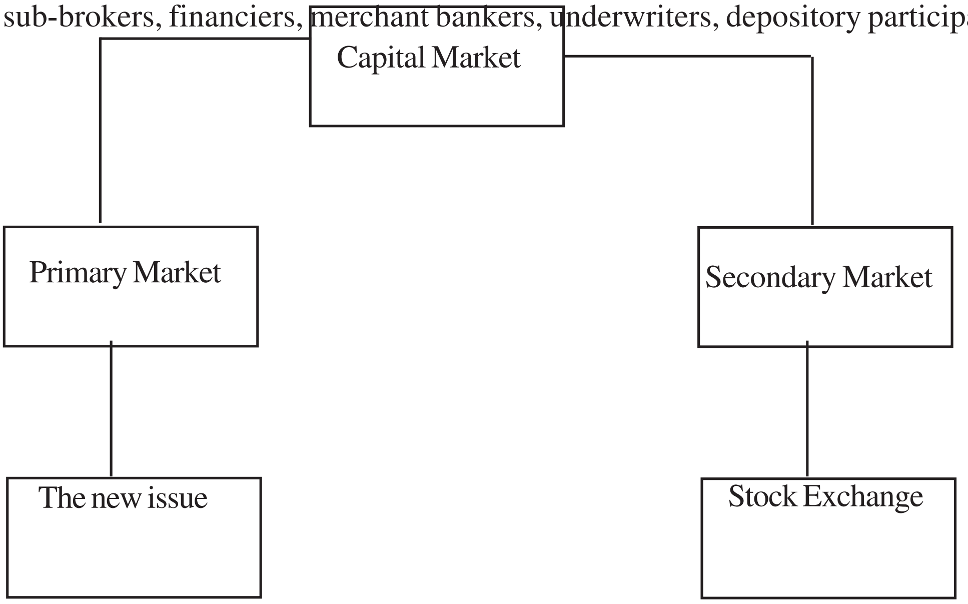
and financial instruments such as stocks, bonds, options, and futures are traded.

3.4.1 BROAD CONSTITUENTS IN THE INDIAN CAPITAL MARKETS

Fund Raisers are companies that raise funds from domestic and foreign sources, both public and private. The following sources help companies raise funds

Fund Providers are the entities that invest in the capital markets. These can be categorized as domestic and foreign investors, institutional and retail investors. The list includes subscribers to primary market issues, investors who buy in the secondary market, traders, speculators, FIIs/ sub accounts, mutual funds, venture capital funds, NRIs ,ADR/GDR investors, etc.

Intermediaries are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers, underwriters, depository participants,



registrar and transfer agents, FIIs/ sub accounts, mutual Funds, venture capital funds, portfolio managers, custodians,etc.

Organizations include various entities such as MCX-SX, BSE, NSE, other regional stock exchanges, and the two depositories National Securities Depository Limited (NSDL) and Central Securities Depository Limited (CSDL).

Market Regulators include the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), and the Department of Company Affairs (DCA).

3.4.2 SIGNIFICANCE OF CAPITAL MARKET IN ECONOMIC DEVELOPMENT

Capital market has a crucial significance to capital formation. Adequate capital formation is indispensable for a speedy economic development. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development.

A sound and efficient capital market facilitates the process of capital formation and thus contributes to economic development. The significance of capital market in economic development is explained below.

1) Mobilisation of Savings: Capital market is an organized institutional network of financial organizations, which not only mobilizes savings through various instruments but also channelizes them into productive avenues. By making available various types of financial assets, the capital market encourages savings. By providing liquidity to these financial assets through the secondary markets capital market is able to mobilize large amount of savings from various sections of the people such as individuals, families, and associations. Thus, capital market mobilizes these savings and make the same available for meeting the large capital needs of industry, trade and business.

2) Channelization of Funds into Investments: Capital market plays a crucial role in the economic development by channelizing funds in accordance with development priorities. The financial intermediaries in the capital market are better placed than individuals to channel the funds into investments which are more favourable for economic development.

3) Industrial Development: Capital market contributes to industrial development in the following ways:

(a) It provides adequate, cheap and diversified finance to the industrial sector for various purposes.

(b) It provides funds for diversified purposes such as for expansion, modernization, upgradation of technology, establishment of new units etc.

(c) It provides a variety of services to entrepreneurs such as provision of underwriting facilities, participating in equity capital, credit rating, consultancy services, etc. This helps to stimulate industrial entrepreneurship.

4) Modernization and Rehabilitation of Industries: Capital market can contribute towards modernization, rationalization and rehabilitation of industries. For example, the setting up of development financial institutions in India such as IFCI, ICICI, IDBI and so on has helped the existing industries in the country to adopt modernization and replacement of obsolete machinery by providing adequate finance.

5) Technical Assistance: An important bottleneck faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to the preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in the capital market play an important role in stimulating industrial entrepreneurship. This helps to stimulate industrial investment and thus promotes economic development.

6) Encourage Investors to invest in Industrial Securities: Secondary market in securities encourage investors to invest in industrial securities by making them liquid. It provides facilities for continuous, regular and ready buying and selling of securities. Thus, industries are able to raise substantial amount of funds from various segments of the economy.

7) Reliable Guide to Performance: The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency. It values companies accurately and toes up manager compensation to stock values. This gives incentives to managers to maximize the value of companies. This stimulates efficient resource allocation and growth.

3.4.3 STRUCTURE (OR) COMPOSITION OF CAPITAL MARKET IN INDIA

In the financial market all those institutions and organizations which provide medium term and long term funds to business enterprises and public authorities, constitute the capital market. In simple words, the market which lends long-term funds is called the capital market.

The capital market is composed of those who demand funds and those who supply funds. Thus, the borrowers and lenders in the financial market for medium-term and long-term funds constitute the capital market.

The Indian Capital Market is broadly divided into two categories:

1) The securities market consisting of

(a) The gilt-edged market and (b) The industrial securities market; and

2) The financial institutions (Development Financial Institutions) (DFIs). Thus, the Indian capital market is composed of

(a) The gilt-edged market or the market for government securities and industrial securities or corporate securities market.

(b) Capital market includes Development Financial Institutions (DFIs) such as IFCI, SFC, LIC, IDBI, UTI, ICICI, etc. They provide medium-term and long-term funds for business enterprises and public authorities.

(c) Apart from the above, there are financial intermediaries in the capital market such as merchant bankers, mutual funds, leasing companies, venture capital companies etc. They help in mobilizing savings and supplying funds to investors.

(1) Gilt- Edged Market:

It is also known as the government securities market. As the securities are risk free, they are known as gilt-edged i.e. the best quality securities. The investors in the gilt-edged market are predominantly institutions. They are required by law to invest a certain portion of their funds in these securities. These institutions include commercial banks, LIC, GIC, and the provident funds. The transactions in the government securities market are very large. Each transaction may run into several crores or even hundred crores of rupees. Since June 1992, government securities have been mostly issued sealed bid auctions. RBI plays a dominant role in the gilt-edged market through its open market operations.

Thus, government securities are the most liquid debt instruments.

(2) The Industrial Securities Market:

It is a market of shares, debentures and bonds which can be bought and sold freely.

This market is divided into two categories:

(A) Primary Market:

The new issue market called the primary market and (b) old issue market, commonly known as stock exchange or stock market. It is called the secondary market. The new issue market is concerned with the raising of new capital in the form of shares, bonds and debentures. Many public limited companies often raise capital through the primary market for expanding their business. It may be noted that the new issue market is important because of its impact on economic growth of the country.

(B) Secondary Market:

The stock exchange market or the secondary market is a market of the purchase and sale of quoted or listed securities. It is a highly organized market for regulating and controlling business in buying, selling and dealing in securities.

(3) Financial Institutions: We have mentioned that there are special financial institutions which provided long-term capital to the private sector in the capital market. These institutions are called Development Financial Institutions.

(4) Financial Intermediaries: The Indian capital market has shown steady improvement after 1951.During the Five-Year Plans, Capital market has witnessed rapid growth. Both the volume of saving and investment have shown phenomenal improvement. In fact, in the last two decades, the volume of capital market transactions has increased substantially. Besides, its functioning has been diversified indicating the growth of the Indian economy.

3.4.4 CAPITAL MARKET INSTRUMENTS

A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

1) Secured Premium Notes

SPN is a secured debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years. The warrants attached to SPN gives the holder the right to apply and get allotted equity shares; provided the SPN is fully paid. There is a lock-in period for SPN during which no interest will be paid for an invested amount. The SPN holder has an option to sell back the SPN to the company at par value after the lock in period. If the holder exercises this option, no interest/ premium will be paid on redemption. In case the SPN holder holds it further, the holder will be repaid the principal amount along with the additional amount of interest/ premium on redemption in instalments as decided by the company. The conversion of detachable warrants into equity shares will have to be done within the time limit notified by the company. Ex-TISCO issued warrants for the first time in India in the year 1992 to raise 1212 crore.

2) Deep Discount Bonds

A bond that sells at a significant discount from par value and has no coupon rate or lower coupon rate than the prevailing rates of fixed-income securities with a similar risk profile. They are designed to meet the long term funds requirements of the issuer and investors who are not looking for immediate return and can be sold with a long maturity of 25-30 years at a deep discount on the face value of debentures.

Ex-IDBI deep discount bonds for Rs 1 lac repayable after 25 years were sold at a discount price of Rs. 2,700.

3) Equity Shares with Detachable Warrants

A warrant is a security issued by company entitling the holder to buy a given number of shares of stock at a stipulated price during a specified period. These warrants are separately registered with the stock exchanges and traded separately. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. Ex-Essar Gujarat, Ranbaxy, Reliance issue this type of instrument.

4) Fully Convertible Debentures with Interest

This is a debt instrument that is fully converted over a specified period into equity shares. The conversion can be in one or several phases. When the instrument is a pure debt instrument, interest is paid to the investor. After conversion, interest payments cease on the portion that isconverted. If project finance is raised through an

FCD issue, the investor can earn interest even when the project is under implementation. Once the project is operational, the investor can participate in the profits through share price appreciation and dividend payments

5) EQUIPREF

They are fully convertible cumulative preference shares. This instrument is divided into two parts namely Part A & Part B. Part A is convertible into equity shares automatically /compulsorily on date of allotment without any application by the allottee. Part B is redeemed at par or converted into equity after a lock in period at the option of the investor, at a price 30% lower than the average market price.

6) Sweat Equity Shares

The phrase `sweat equity' refers to equity shares given to the company's employees on favorable terms, in recognition of their work. Sweat equity usually takes the form of giving options to employees to buy shares of the company, so they become part owners and participate in the profits, apart from earning salary. This gives a boost to the sentiments of employees and motivates them to work harder towards the goals of the company. The Companies Act defines `sweat equity shares' as equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing knowhow or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

7) Tracking Stocks

A tracking stock is a security issued by a parent company to track the results of one of its subsidiaries or lines of business; without having claim on the assets of the division or the parent company. It is also known as "designer stock". When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Oftentimes, this is done to separate a subsidiary's high-growth division from a larger parent company that is presenting losses. The parent company and its shareholders, however, still control the operations of the subsidiary.

8) Disaster Bonds

Also known as Catastrophe or CAT Bonds, Disaster Bond is a high-yield debt instrument that is usually insurance linked and meant to raise money in case of a catastrophe. It has a special condition that states that if the issuer (insurance or Reinsurance Company) suffers a loss from a particular pre-defined catastrophe, then the issuer's obligation to pay interest and/or repay the principal is either deferred or completely forgiven. Ex- Mexico sold $290 million in catastrophe bonds, becoming the first country to use a World Bank program that passes the cost of natural disasters to investors. Goldman Sachs Group Inc. and Swiss Reinsurance Co. managed the bond sale, which will pay investors unless an earthquake or hurricane triggers a transfer of the funds to the Mexican government.

9) Mortgage Backed Securities (MBS)

It is a type of asset-backed security, basically a debt obligation that represents a claim on the cash flows from mortgage loans, most commonly on residential property. Mortgagebacked securities represent claims and derive their ultimate values from the principal and payments on the loans in the pool. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages as they are classified under the MBS.

- Mortgage originators to refill their investments
- New instruments to collect funds from the market, very economic and more effective
- Conversion of assets into funds
- Financial companies save on the costs of maintenance of the assets and other costs related to assets, reducing overheads and increasing profit ratio.
- Kinds of Mortgage Backed Securities:

· Commercial mortgage backed securities: backed by mortgages on commercial property Collateralized mortgage obligation: a more complex MBS in which the mortgages are ordered into tranches by some quality (such as repayment time), with each tranche sold as a separate security Stripped mortgage backed securities: Each mortgage payment is partly used to pay down the loan's principal and partly used to pay the interest on it.

· Residential mortgage backed securities: backed by mortgages on residential property

10) Global Depository Receipts/ American Depository Receipts

A negotiable certificate held in the bank of one country (depository) representing a specific number of shares of a stock traded on an exchange of another country. GDR facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets.

GDR prices are often close to values of related shares, but they are traded and settled independently of the underlying share. Listing on a foreign stock exchange requires compliance with the policies of those stock exchanges. Many times, the policies of the foreign exchanges are much more stringent than the policies of domestic stock exchange. However a company may get listed on these stock exchanges indirectly - using ADRs and GDRs. If the depository receipt is traded in the United States of America (USA), it is called an But the ADRs and GDRs are an excellent means of investment for NRIs and foreign nationals wanting to invest in India. By buying these, they can invest directly in Indian companies without going through the hassle of understanding the rules and working of the Indian American Depository Receipt, or an ADR. If the depository receipt is traded in a country other than USA, it is called a Global Depository Receipt, or a GDR. financial market - since ADRs and GDRs are traded like any other stock, NRIs and foreigners can buy these using their regular equity trading accounts! Ex- HDFC Bank, ICICI Bank, Infosys have issued both ADR and GDR

11) Foreign Currency Convertible Bonds (Fccbs)

A convertible bond is a mix between a debt and equity instrument. It is a bond having regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock. FCCB is issued in a currency different than the issuer's domestic currency. The investors receive the safety of guaranteed payments on the bond and are also able to take advantage of any large price appreciation in the company's stock. Due to the equity side of the bond, which adds value, the coupon payments on the bond are lower for the company, thereby reducing its debt-financing costs.

Advantages

1. Some companies, banks, governments, and other sovereign entities may decide to issue bonds in foreign currencies because, as it may appear to be more stable and predictable than their domestic currency

2. Gives issuers the ability to access investment capital available in foreign markets

3. Companies can use the process to break into foreign markets

4. The bond acts like both a debt and equity instrument. Like bonds it makes regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock

5. It is a low cost debt as the interest rates given to FCC Bonds are normally 30-50 percent lower than the market rate because of its equity component

6. Conversion of bonds into stocks takes place at a premium price to market price. Conversion price is fixed when the bond is issued. So, lower dilution of the company stocks.

Advantages to Investors

1 Safety of guaranteed payments on the bond

2 Can take advantage of any large price appreciation in the company's stock

3 Redeemable at maturity if not converted

4 Easily marketable as investors enjoys option of conversion in to equity if resulting to capital appreciation

Disadvantages

1 Exchange risk is more in FCCBs as interest on bond would be payable in foreign currency. Thus companies with low debt equity ratios, large forex earnings potential only opted for FCCBs

2 FCCBs means creation of more debt and a FOREX outgo in terms of interest which is in foreign exchange

3 In case of convertible bond the interest rate is low (around 3 to 4%) but there is exchange risk on interest as well as principal if the bonds are not converted in to equity

13) Derivatives

A derivative is a financial instrument whose characteristics and value depend upon the characteristics and value of some underlying asset typically commodity, bond, equity, currency, index, event etc. Advanced investors sometimes purchase or sell derivatives to manage the risk associated with the underlying security, to protect against fluctuations in value, or to profit from periods of inactivity or decline. Derivatives are often leveraged, such that a small movement in the underlying value can cause a large difference in the value of the derivative.

Derivatives are usually broadly categorised by:

1 The relationship between the underlying and the derivative (e.g. forward, option, swap)

2 The type of underlying (e.g. equity derivatives, foreign exchange derivatives and credit derivatives)

3 The market in which they trade (e.g., exchange traded or over-the-counter)

Futures

A financial contract obligating the buyer to purchase an asset, (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price. Futures contracts detail the quality and quantity of the underlying asset; they are standardized to facilitate trading on a futures exchange. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The futures markets are characterized by the ability to use very high leverage relative to stock markets. Some of the most popular assets on which futures contracts are available are equity stocks, indices, commodities and currency.

Options

A financial derivative that represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date). A call option gives the buyer, the right to buy the asset at a given price. This 'given price' is called 'strike price'. It should be noted that while the holder of the call option has a right to demand sale of asset from the seller, the seller has only the obligation and not the right. For eg: if the buyer wants to buy the asset, the seller has to sell it. He does not have a right. Similarly a 'put' option gives the buyer a right to sell the asset at the 'strike price' to the buyer. Here the buyer has the right to sell and the seller has the obligation to buy. So in any options contract, the right to exercise the option is vested with the buyer of the contract. The seller of the contract has only the obligation and no right. As the seller of the contract bears the obligation, he is paid a price called as 'premium'. Therefore the price that is paid for buying an option contract is called as premium. The primary difference between options and futures is that options give the holder the right to buy or sell the underlying asset at expiration, while the holder of a futures contract is obligated to fulfill the terms of his/her contract.

14) Participatory Notes

Also referred to as "P-Notes" Financial instruments used by investors or hedge funds that are not registered with the Securities and Exchange Board of India to invest in Indian securities. Indian-based brokerages buy India-based securities and then issue participatory notes to foreign investors. Any dividends or capital gains collected from the underlying securities go back to the investors. These are issued by FIIs to entities that want to invest in the Indian stock market but do not want to register themselves with the SEBI. RBI, which had sought a ban on PNs, believes that it is tough to establish the beneficial ownership or the identity of ultimate investors.

15) Hedge Fund

A hedge fund is an investment fund open to a limited range of investors that undertakes a wider range of investment and trading activities in both domestic and international markets, and that, in general, pays a performance fee to its investment manager. Every hedge fund has its own investment strategy that determines the type of investments and the methods of investment it undertakes. Hedge funds, as a class, invest in a broad range of investments including shares, debt and commodities. As the name implies, hedge funds often seek to hedge some of the risks inherent in their investments using a variety of methods, with a goal to generate high returns through aggressive investment strategies, most notably short selling, leverage, program trading, swaps, arbitrage and derivatives. Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year.

16) Fund of Funds

A "fund of funds" (FOF) is an investment strategy of holding a portfolio of other investment funds rather than investing directly in shares, bonds or other securities. This type of investing is often referred to as multi-manager investment. A fund of funds allows investors to achieve a broad diversification and an appropriate asset allocation with investments in a variety of fund categories that are all wrapped up into one fund.

17) Exchange Traded Funds

An exchange-traded fund (or ETF) is an investment vehicle traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. Most ETFs track an index, such as the S&P 500 or MSCI EAFE. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features, and single security can track the performance of a growing number of different index funds (currently the NSE Nifty)

18) Gold ETF

A gold Exchange Traded Fund (ETF) is a financial instrument like a mutual fund whose value depends on the price of gold. In most cases, the price of one unit of a gold ETF approximately reflects the price of 1 gram of gold. As the price of gold rises, the price of the ETF is also expected to rise by the same amount. Gold exchange-traded funds are traded on the major stock exchanges including Zurich, Mumbai, London, Paris and New York There are also closed-end funds (CEF's) and exchange-traded notes (ETN's) that aim to track the gold price.

3.4.5 REFORMS IN INDIAN CAPITAL MARKET

Indian Capital Market is exposed to tremendous reforms in the last decade. The reforms are triggered by changes in policy by Union Government and the same is accepted and stimulated by introduction of new financial products by stock exchanges, better legal frame work by the regulator and active participation by depository participants, share brokers, domestic as well as foreign investors. Primary Market IPO is the major source of raising finance for a corporate. Investor sentiment towards the corporate as well as the share price plays a major role in the success of IPOs. SEBI played a major role in the development of IPOs. Indian IPO market witnessed maximum growth and success from 2000 to 2007. The growth in major indices in India, viz, SENSEX and NIFTY and positive sentiment towards Indian stock market supported by domestic as well as foreign institutional investors are the main reason for the IPO boom between 2000 and 2007. This boom continued till the subprime crises in 2008 and the investor sentiment became negative after that. The following table gives the details of IPO market in India in the last few years: Secondary Market BSE is the oldest stock exchange in India which is stared in the year 1875. SENSEX is the index of BSE (created based on the average price movement of 50 stocks) is the representative of stock performance of the shares listed at BSE as well as considered the representative of price movement of the Indian stock market. The introduction of derivatives changed the scenario and now NSE is leading in the Indian market. MCXSX (stock trading wing of Multi Commodities Exchange which is now called Metropolitan Stock Exchange of India Ltd) also started its operation last year and it's yet to capture the market. NIFTY (which shows the average price movement of 50 stocks) and SX-40 (price movement of 40 stocks) are the indices of NSE and MCXSX respectively. The reforms in the area of capital market can be broadly classified in to 3 heads, viz;

1. Capital Market Reforms from the angle of Regulator's

2. Capital Market Reforms from the angle of Products', and

3. Other Initiatives All the 3 sectors contributed positively for the growth of capital market segment in India as well positively contributed to the interest of market's stakeholders

Securities Contracts (Regulation) Amendment Act, 2007

The Securities Contracts Regulation Act, 1956 has been amended to include securitization instruments under the definition of "securities" and provide for disclosure based regulation for issue of the securitized instruments and the procedure thereof. This has been done keeping in view that there is considerable potential in the securities market for the certificates or instruments under securitization transactions. The development of the securitized debt market is critical for meeting the humungous requirements of the infrastructure sector, particularly housing sector, in the country. Replication of the securities markets framework for these instruments would facilitate trading on stock exchanges and in turn help development of the market in terms of depth and liquidity.

Permanent Account Number (PAN) PAN is made compulsory for dealing in stock market. It has become the unique proof of identity as well as proof of signature. This helped a lot in avoiding lots of frauds liked with IPO as well as in proper accounting of income and wealth.

IPO Grading SEBI has made it compulsory for companies coming out with IPOs of equity shares to get their IPOs graded by at least one credit rating agency registered with SEBI from May 1, 2007. This measure is intended to provide the investor with an informed and objective opinion expressed by a professional rating agency after analyzing factors like business and financial prospects, management quality and corporate governance practices etc.

Investor Protection and Education Fund (IPEF) SEBI has set up the Investor Protection and Education Fund (IPEF) with the purpose of investor education and related activities. SEBI has contributed a sum of Rs.10 crore toward the initial corpus of the IPEF from the SEBI General Fund. In addition following amounts will also be credited to the IPEF namely: i) Grants and donations given to IPEF by the Central Government, State Governments or any institution approved by SEBI for the purpose of the IPEF; ii) Interest or other income received out of the investments made from the IPEF; and iii) Such other amount that SEBI may specify in the interests of the investors.

American Depository Receipt (ADR) & Global Depository Receipt (GDR) Government had set up an Expert Committee under the Chairmanship of Mr. Saumitra Choudhury, Member Economic Advisory Council to Prime Minister to review the extant ADR / GDR. The committee has recently submitted its report to the Government. The recommendations of the Committee are under consideration.

Strengthening of Credit Rating Agencies In order to have a greater enforceability of the regulatory framework relating to issue of capital by companies and to streamline the disclosures while also taking into account changes in market design, the erstwhile SEBI (Disclosure and Investor Protection) guidelines (DIP Guidelines) governing public offerings were replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR). There were certain changes made in the ICDR regulations vis-a-vis the provision contained in DIP Guidelines, on account of: (a) Removal of redundant provisions contained in DIP Guidelines, (b) Modifications on account of change in market design, and (c) Bringing more clarity in the existing provisions of the DIP Guidelines.

Capital Market Reforms in the angle of Products' Products always play an important role in any market. Indian capital market has seen a positive growth in the variety of financial products introduced successfully.

Stocks - Delivery Based Trading Delivery based stock trading is the primitive product in capital market segment. This base product is also in growth face in the last 10 years. The following table shows the movement of SENSEX in the last 5 years which is also a reason for the increase in delivery volume

Buy Today Sell Tomorrow (BTST) BTST is a facility provided by the stock broker with the permission of exchange. T+2 is the settlement cycle followed in India, i.e., if you buy a stock today then the stock will be credited to your Demat account after 2 day. For example; if you buy a stock on Monday then the stock will be credited to your account by Wednesday (provided Monday, Tuesday and Wednesday are not trading holidays). BTST provides the option to sell the stock before the stock is credited to the investors account. If any default happens in crediting the stock then the broker buys the stock through auction which makes the product riskier.

Mutual Funds : Mutual Funds are one of the oldest products traded in the market. Mutual Funds eliminate the basic two limitations of Indian investors, viz; lack of big money and lack of knowledge regarding the price movements. The following table shows the growth in Assets under Management (AUM) of a few major Asset Management Companies (AMCs) in India in the last few years.

3.4.6 INDIAN CAPITAL MARKET REGULATORY FRAMEWORK

SEBI: Securities and Exchange Board of India (SEBI) was set up as an administrative arrangement in 1988.In 1992, the SEBI Act was enacted, which gave statutory status to SEBI. It mandates SEBI to perform a dual function: investor protection through regulation of the securities market and fostering the development of this market. SEBI has been vested most of the functions and powers under the Securities Contract Regulation (SCR) Act, which brought stock exchanges, their members, as well as contracts in securities which could be traded under the regulations of the Ministry of Finance. It has also been delegated certain powers under the Companies Act. In addition to registering and regulating intermediaries, service providers, mutual funds, collective investment schemes, venture capital funds and takeovers, SEBI is also vested with the power to issue directives to any person(s) related to the securities market or to companies in areas of issue of capital, transfer of securities and disclosures. It also has powers to inspect books and records, suspend registered entities and cancel registration. RBI: Reserve Bank of India (RBI) has regulatory involvement in the capital market, but this has been limited to debt management through primary dealers, foreign exchange control and liquidity support to market participants. It is RBI and not SEBI that regulates primary dealers in the Government securities market. RBI instituted the primary dealership of Government securities in March 1998. Securities transactions that involve foreign exchange transactions need the permission of RBI.

Stock Exchanges: SEBI issued directives that require that half the members of the governing boards of the stock exchanges should be non broker public representatives and include a SEBI nominee. To avoid conflicts of interest, stock brokers are a minority in the committees of stock exchanges set up to handle matters of discipline, default and investor-broker disputes. The exchanges are required to appoint a professional, non member executive director who is accountable to SEBI for the implementation of its directives on the regulation of stock exchanges. SEBI has introduced a mechanism to redress investor grievances against brokers. Further, all issues are regulated through a series of disclosure norms as prescribed by SEBI and respective stock exchanges through their listing agreement. After a security is issued to the public and subsequently listed on a stock exchange, the issuing company is required under the listing agreement to continue to disclose in a timely manner to the exchange, to the holders of the listed securities and to the public any information necessary to enable the holders of the listed securities to appraise its position and to avoid the establishment of a false market in such listed securities. The powers and functions of regulatory authorities for the securities market seem to be diverse in nature. SEBI is the primary body responsible for regulation of the securities market, deriving its powers of registration and enforcement from the SEBI Act. There was an existing regulatory framework for the securities market provided by the Securities Contract Regulation (SCR) Act and the Companies Act, administered by the Ministry of Finance and the Department of Company Affairs (DCA) under the Ministry of Law, respectively. SEBI has been delegated most of the functions and powers under the SCR Act and shares the rest with the Ministry of Finance. It has also been delegated certain powers under the Companies Act. RBI also has regulatory involvement in the capital markets regarding foreign exchange control, liquidity support to market participants and debt management through primary dealers. It is RBI and not SEBI that regulates primary dealers in the Government securities market. However, securities transactions that involve a foreign exchange transaction need the permission of RBI. So far, fragmentation of the regulatory authorities has not been a major obstacle to effective regulation of the securities market. Rather, lack of enforcement capacity by SEBI has been a more significant cause of poor regulation. But since the Indian stock markets are rapidly being integrated, the authorities may follow the global trend of consolidation of regulatory authorities or better coordination among them.

3.5 FACTORS CONTRIBUTING TO THE GROWTH OF CAPITAL MARKET IN INDIA

The firm trend in the market is basically affected by two important factors: (i) operations of the institutional investors in the market; and (ii) the excellent results flowing in from the corporate sector.

Some important new financial intermediaries introduced in Indian capital market are:

Merchant Banking:

Merchant bankers are financial intermediaries between entrepreneurs and investors. Merchant banks may be subsidiaries of commercial banks or may have been set up by private financial service companies or may have been set up by firms and individuals engaged in financial up by firms and individuals engaged in financial advisory business. Merchant banks in India manage and underwrite new issues, undertake syndication of credit, advice corporate clients on fund raising and other financial aspects.Since 1993, merchant banking has been statutorily brought under the regulatory framework of the Securities Exchange Board of India (SEBI) to ensure greater transparency in the operation of merchant bankers and make them accountable. The RBI supervises those merchant banks which were subsidiaries, or are affiliates of commercial banks.

Leasing and Hire-Purchase Companies:

Leasing has proved a popular financing method for acquiring plant and machinery specially or small and medium sized enterprises. The growth of leasing companies has been due to advantages of speed, informality and flexibility to suit individual needs.

The Narasimhan Committee has recognised the importance of leasing and hire-purchase companies in financial intermediation process and has recommended that: (i) a minimum capital requirement should be stipulated; (ii) prudential norms and guidelines in respect of conduct of business should be laid down; and (iii) supervision should be based on periodic returns by a unified supervisory authority.

Mutual Funds:

It refers to the pooling of savings by a number of investors-small, medium and large. The corpus of fund thus collected becomes sizeable which is managed by a team of investment specialists backed by critical evaluation and supportive data.

A mutual fund makes up for the lack of investor's knowledge and awareness. It attempts to optimise high return, high safety and high liquidity trade off for maximum of investor's benefit. It thus aims at providing easy accessibility of media including stock market in country to one and all, especially small investors in rural and urban areas.

Mutual funds are most important among the newer capital market institutions. Several public sector banks and financial institutions set up mutual funds on a tax exempt basis virtually on same footing as the Unit Trust of India (UTI) and have been able to attract strong investor support and have shown significant progress.Government has now decided to throw open the field to private sector and joint sector mutual funds. At present Securities and Exchange Board of India (SEBI) has authority to lay down guidelines and to supervise and regulate working of mutual funds.

The guidelines issued by the SEBI in January 1991, are related in advertisements and disclosure and reporting requirements etc. The investors have to be informed about the status of their investments in equity, debentures, government securities etc.

The Narasimhan Committee has made the following recommendations regarding mutual funds: (i) creation of an appropriate regulatory framework to promote sound, orderly and competitive growth of mutual fund business: (ii) creation of proper legal framework to govern the establishments and operation of mutual funds (the UTI is governed by a special statute), and (iii) equality of treatment between various mutual funds including the UTI in the area of tax concessions.

Global Depository Receipts (GDR):

Since 1992, the Government of India has allowed foreign investment in the Indian securities through the issue of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). Initially the Euro-issue proceeds were to be utilised for approved end uses within a period of one year from the date of issue.

Since there was continued accumulation of foreign exchange reserves with RBI and there were long gestation periods of new investment the government required the issuing companies to retain the Euro-issue proceeds abroad and repatriate only as and when expenditure for the approved end uses were incurred.

Venture Capital Companies (VCC):

The aim of venture capital companies is to give financial support to new ideas and to introduction and adaptation of new technologies. They are of a great importance to technocrat entrepreneurs who have technical competence and expertise but lack venture capital. Financial institutions generally insist on greater contribution to the investment financing, in which technocrat entrepreneurs can depend on venture capital companies. Venture capital financing involves high risk. According to the Narasimhan Committee the guidelines for setting up of venture capital companies are too restrictive and unrealistic and have impeded their growth. The committee has recommended a review and amendment of guidelines.Knowing the high risk involved in venture capital financing, the committee has recommended a reduction in tax on capital gains made by these companies and equality of tax treatment between venture capital companies and mutual funds.

Other New Financial Intermediaries:

Besides the above given institutions, the government has established a number of new financial intermediaries to serve the increasing financial needs of commerce and industry is the area of venture Capital, credit rating and leasing etc.

(1) Technology Development and Information Company of India (TDICI) Ltd., a technology venture finance company, which sanctions project finance to new

technology venture since 1989.

(ii) Risk Capital and Technology Finance Corporation (RCTFC) Ltd., which provides risk capital to new entrepreneurs and offers technology finance to technology-oriented ventures since 1988.

(iii) Infrastructure Leasing and Financial Services (IL&FS) Ltd., set up in 1988 focuses on leasing of equipment for infrastructure development.

(iv) The credit rating agencies namely credit rating information services of India (CRISIS) Ltd., setup in 1988; Investment and Credit Rating Agency (ICRA) setup in 1991, and Credit Analysis and Research (CARE) Ltd., setup in 1993 provide credit rating services to the corporate sector.

Credit rating promotes investors interests by providing them information on assessed comparative risk of investment in the listed securities of different companies. It also helps companies to raise funds more easily and at relatively cheaper rate if their credit rating is high.

(v) Stock Holding Corporation of India (SHCIL) Ltd., setup in 1988, with the objective of introducing a book entry system for transfer of shares and other type of scrips thereby avoiding the voluminous paper work involved and thus reducing delays in transfers.

3.5.1FACTORS AFFECTING CAPITAL MARKET IN INDIA

Factors affecting capital market in India:-

The capital market is affected by a range of factors. Some of the factors which influence capital market are as follows:-

a) Performance of domestic companies: - The performance of the companies or rather corporate earnings is one of the factors which have direct impact or effect on capital market in a country. Weak corporate earnings indicate that the demand for goods and services in the economy is less due to slow growth in per capita income of people. Because of slow growth in demand there is slow growth in employment which means slow growth in demand in the near future. Thus weak corporate earnings indicate average or not so good prospects for the economy as a whole in the near term. In such a scenario the investors (both domestic as well as foreign) would be wary to invest in the capital market and thus there is bear market like situation. The opposite case of it would be robust corporate earnings and its positive impact on the capital market. The corporate earnings for the April - June quarter for the current fiscal has been good. The companies like TCS, Infosys, Maruti Suzuki, Bharti Airtel, ACC, ITC, Wipro, HDFC, Binani cement, IDEA, Marico Canara Bank, Piramal Health, India cements , Ultra Tech, L&T, Coca- Cola, Yes Bank, Dr. Reddy's Laboratories, Oriental Bank of Commerce, Ranbaxy, Fortis, Shree Cement ,etc have registered growth in net profit compared to the corresponding quarter a year ago. Thus we see companies from Infrastructure sector, Financial Services, Pharmaceutical sector, IT Sector, Automobile sector, etc. doing well. This across the sector growth indicates that the Indian economy is on the path of recovery which has been positively reflected in the stock market (rise in sensex & nifty) in the last two weeks. (July 13-July 24).

b) Environmental Factors: Environmental Factor in India's context primarily means- Monsoon. In India around 60 % of agricultural production is dependent on monsoon. Thus there is heavy dependence on monsoon. The major chunk of agricultural production comes from the states of Punjab, Haryana & Uttar Pradesh. Thus deficient or delayed monsoon in this part of the country would directly affect the agricultural output in the country. Apart from monsoon other natural calamities like Floods, tsunami, drought, earthquake, etc. also have an impact on the capital market of a country.

The Indian Met Department (IMD) on 24th June stated that India would receive only 93% rainfall of Long Period Average (LPA). This piece of news directly had an impact on Indian capital market with BSE Sensex falling by 0.5 % on the 25th June . The major losers were automakers and consumer goods firms since the below normal monsoon forecast triggered concerns that demand in the crucial rural heartland would take a hit. This is because a deficient monsoon could seriously squeeze rural incomes, reduce the demand for everything from motorbikes to soaps and worsen a slowing economy.

c) Macro Economic Numbers:-The macroeconomic numbers also influence the capital market. It includes Index of Industrial Production (IIP) which is released every month, annual Inflation number indicated by Wholesale Price Index (WPI) which is released every week, Export -Import numbers which are declared every month, Core Industries growth rate (It includes Six Core infrastructure industries - Coal, Crude oil, refining, power, cement and finished steel) which comes out every month, etc. This macro -economic indicators indicate the state of the economy and the direction in which the economy is headed and therefore impacts the capital market in India.A case in the point was declaration of core industries growth figure. The six Core Infrastructure Industries - Coal, Crude oil, refining, finished steel, power & cement - grew 6.5 % in June , the figure came on the 23 rd of July and had a positive impact on the capital market with the sensex and nifty rising by 388 points & 125 points respectively.

d) Global Cues :- In this world of globalisation various economies are interdependent and interconnected. An event in one part of the world is bound to affect other parts of the world, however the magnitude and intensity of impact would vary. Thus capital market in India is also affected by developments in other parts of the world i.e. U.S., Europe, Japan , etc. Global cues includes corporate earnings of MNC's, consumer confidence index in developed countries, jobless claims in developed countries, global growth outlook given by various agencies like IMF, economic growth of major economies, price of crude -oil, credit rating of various economies given by Moody's, S & P, etc. An obvious example at this point in time would be that of subprime crisis & recession. Recession started in U.S. and some parts of the Europe in early 2008 .Since then it has impacted all the countries of the world- developed, developing, less- developed and even emerging economies.

e) Political stability and government policies:- For any economy to achieve and sustain growth it has to have political stability and pro- growth government policies. This is because when there is political stability there is stability and consistency in government's attitude which is communicated through various government policies. The vice- versa is the case when there is no political stability .So capital market also reacts to the nature of government, attitude of government, and various policies of the government. The above statement can be substantiated by the fact the when the mandate came in UPA government's favour (Without the baggage of left party) on May 16 2009, the stock markets on Monday , 18th May had a bullish rally with sensex closing 800 point higher over the previous day's close. The reason was political stability. Also without the baggage of left party government can go ahead with reforms.

f) Growth prospectus of an economy:- When the national income of the country increases and per capita income of people increases it is said that the economy is growing . Higher income also means higher expenditure and higher savings. This augurs well for the economy as higher expenditure means higher demand and higher savings means higher investment. Thus when an economy is growing at a good pace capital market of the country attracts more money from investors, both from within and outside the country and vice -versa. So we can say that a growth prospect of an economy does have an impact on capital markets

g) Investor Sentiment and risk appetite: - Another factor which influences capital market is investor sentiment and their risk appetite .Even if the investors have the money to invest but if they are not confident about the returns from their investment, they may stay away from investment for some time. At the same time if the investors have low risk appetite, which they were having in global and Indian capital market some four to five months back due to global financial meltdown and recessionary situation in U.S. & some parts of Europe, they may stay away from investment and wait for the right time to come.

3.6 STOCK EXCHANGE- CONCEPT AND FUNCTIONS

The first organised stock exchange in India was started in 1875 at Bombay and it is stated to be the oldest in Asia. In 1894 the Ahmedabad Stock Exchange was started to facilitate dealings in the shares of textile mills there. The Calcutta stock exchange was started in 1908 to provide a market for shares of plantations and jute mills.

3.6.1 Stock Exchange - Meaning

Stock exchange or stock market is a market where old securities that have been already issued by the companies and other organizations to the public are bought and sold through authorized agents according to certain rules and regulations. It is a mechanism though which the holder of securities may find a buyer for his holdings at a fair price. Similarly buyer of securities may find an immediate seller who is willing to sell his holdings at a fair price. The securities are bought and sold continuously among the investors in these stock exchanges without the involvement of companies. Stock exchanges facilitate the free trade of only the securities that are listed. The Securities Contracts (Regulations) Act, 1956 defines stock exchange as under: "Stock Exchange is an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities".

3.6.2 Characteristics of Stock Exchange: The stock exchange is an organized market for the purchase and sale of listed securities. They facilitate, regulate and control the trade in securities. The following are the features of stock markets :

(1) Association: Stock market is an association of persons that may be incorporated or not.

(2) Mechanism: It provides a place or mechanism through which industrial and government securities may be bought and sold.

(3) Organized market: It is an organized market for securities. It allows trading in securities subject to certain regulations.

(4) Market for old securities: It provides the ready market for old securities that have been already issued by the companies to public. It does not deal in the fresh shares, debentures and bonds to be issued by the companies or government agencies to the public. In stock market transactions in old securities of companies are carried on without the involvement of companies.

(5) Deals with listed securities: It offers trading facilities only for those securities that are listed by the companies or issuing agencies with the exchange. It a company has not complied with the listing procedure of a stock market then its securities are not allowed to be traded on such stock market.

(6) Only the members allowed dealing: These stock markets allow only their members to transact the business in the market. Outsiders or non members cannot purchase or sale the securities on these stock exchanges. Membership of a stock exchange is limited. New people are not allowed to be a member unless there is a vacancy. Membership of a particular stock exchange (say Bombay stock Exchange or National stock Exchange or Bangalore Stock Exchange) is acquired by individuals and firms only on payment of the membership fees prescribed by that stock exchange. Such fee is normally very high. Members of a stock exchange are known as brokers. They purchase and sell securities for and on behalf of their clients, buyers and sellers, investors and speculators. For these services they charge fees known as brokerage.

(7) It also deals in government securities: An independent section of stock markets deals with government and semi- government securities. It is called gilt edged market and government securities are called gilt edged securities.

(8) Ensures free transferability of securities and securities evaluation: Stock exchange provides a mechanism for free transfer of industrial securities and also makes continuous evaluation of securities traded in the market.

3.6.3 Functions (Services) of Stock Exchange:

Stock exchanges play an important role in the economic development of a nation. They serve as an economic barometer of a country. They perform several economic functions and render invaluable services to the investors, companies and to the economy as a whole. These are as follows:

(1) Marketability of securities: Stock exchange provides a market for the purchase and sale of securities. As a result, any person holding securities can get back his money invested in the securities (share, debentures, government bonds etc.) by selling them through the brokers of a stock exchange at the market price. Similarly a person willing to make investment in securities or conduct speculation in securities can do so with the help of these stock markets.

(2) Liquidity to investment: People readily invest in the industrial securities as the money blocked in these securities can be released by selling them in stock exchange. In absence of these stock exchanges, the public would not have freely invested in the industrial and government securities. As a result, the industry and government would have starved for the capital. Thus stock exchanges provide liquidity for the industrial securities and help the industrial development of a country.

(3) Supply of long term funds: The securities traded in stock market are negotiable. They can be transferred with minimum formalities from one person to another. As a result of this facility people readily invest in the industrial securities and companies receive a good response for their public issue of shares and debentures whenever they need funds. Thus they are assured a long-term availability of funds due to the existence of stock markets.

(4) Evaluation of Securities: Stock exchange keeps a record and makes a public declaration of prices at which securities are traded . On the basis of these prices for the securities quoted in the markets the investors and speculators can evaluate the values of securities held by them.

(5) Motivation for the companies for improvement in performance: The performance of a company is reflected through the prices quoted for their securities in the stock markets. With the improvement in the performance of a company the prices of its shares in the market increase enhancing the goodwill of the company. Thus stock markets indirectly motivate the companies to improve their financial performance through continual increase in productivity and profitability.

(6) Assistance of capital formation: Stock market ensures liquidity of industrial securities; it also ensures the appreciation of funds invested in the securities with the improvement in the performance of companies and increase in the demand for their securities. Thus they motivate the public to invest their savings in the capital of companies. These savings are channelized in the productive activities of the companies resulting in the capital formation which is essential for the economic development of a nation.

(7) Protection of Investors: Stock markets conduct the trade in securities subject to certain rules and regulation. These rules prevent overtrading, illegitimate speculations and charging of excess commission on trading by the brokers in order to protect the interest of common investors. Thus stock exchanges safeguard the innocent investors from the malpractices of clever brokers dealing in securities. This strengthens the investors' confidence and promotes large investments.

(8) Encouragement of savings: Stock exchanges provide an attractive avenue for investors wherein they can invest their small savings in industrial securities and obtain a regular return on investment as well as capital appreciation. Thus they encourage savings habits among the public.

(9) Listing of securities: Stock exchanges do the listing of securities of various companies. Only listed securities are traded on stock exchanges. Listing of a security means permission to the security to quote officially on trading floor of the stock exchange. Shares or debentures of a particular company can be listed and traded at stock exchange only if the company fulfils certain standard norms fixed by the exchange.

(10) Maintaining business information: Companies whose securities are listed on stock exchange are required to furnish the financial statements and other reports and statements. The stock exchange maintains a detail record of the various companies whose securities are traded on its floor. Such information is regularly published and maintained on web site for public reference by the stock exchange.

3.6.4 Listing of Securities:

Listing of securities means admitting the securities' trading on a recognized stock exchange. Purchase and sale of a security cannot be conducted on a stock exchange unless it is officially listed in that stock exchange. Trading in a particular security takes place on a stock exchange only after the company issuing that security accomplishes the listing procedure. Listing is compulsory for the company that offers its shares and debentures to the public for subscription by issue of prospectus. Once the securities of a company are listed on recognized stock exchanges it has to follow the rules and regulations of the stock exchanges. It has to maintain necessary books; documents etc. and disclose any information which the stock exchanges call for.

3.6.5 Listing Procedure:

A company willing to list its securities in stock market should comply with the following formalities.

Important terms and concepts related to stock market:

(1) Group A or specified Shares: These are the actively traded shares of reputed companies having a broad investor base. Naturally these shares attract a lot of speculative forces. In case of these shares transactions take place in market lots of trading or multiples thereof.

2) Group B or Non-specified Shares: These are the shares of companies that have narrow investor base. Hence they are not actively traded in stock exchanges. Transactions of these shares cannot be carried forward. They are settled on settlement day. Group B also includes shares of companies listed on other stock exchanges.

(3) Group C Shares : These are shares of good companies in odd lots and also permitted shares. A number of shares that are less than market lot are known as odd lots. Market lot means the minimum number of shares of a particular security that must be transacted on a stock exchange. Odd lots have settlement once in a fortnight or on Saturdays. Permitted securities are those securities that are not listed on stock exchange but are listed on other stock exchange in India. So they are permitted to be traded on this stock exchange.

(4) Bull or Tejiwallas : Bulls are those speculators of stock exchange who expect a rise in prices of certain securities. Hence they go on buying shares in expectation of selling them at higher prices later. They are also called tejiwallas because they are optimistic about price rise in securities. In bullish market there will be excess of purchase over sale.

(5) Bears / Mandiwallas : Bears are those speculators who are pessimistic and they expect a fall in the prices of securities. They are known as Mandiwallas. With a view to take advantage of an expected fall in price they agree to sell for delivery on the settlement day the security which they may or may not possess. On the date of delivery of settlement they purchase the security at a lower price in market if their expectation proves correct and fulfil the promise of sale at higher price. In this way they make a profit. But if their expectation of fall in price does not come true and if actually the prices rise on the date of delivery or settlement they have to purchase the security at higher price and sell it at agreed lower price or pay for the difference in price and thus incur a loss. The sale of a security which the bear speculator does not possess is called short selling.

(6) Stags: Stags are those members who neither buy nor sell securities in the stock market. They simply apply for subscription to new issues expecting to sell them at a higher price later when such issues are quoted on the stock exchange. Generally, stags buy new issues and sell them on allotments or even before allotment for a profit. Since they act fast and are cautions they are called stags. Because stag is cautions by nature and runs fast.

(7) Gilt edged securities: These are the securities issued by government agencies that have a high liquidity and safety.

(8) Blue chips: Securities issued by the reputed companies that have ready market are called blue chips.

(9) Carry over or Badla System: The speculators like bulls and bears make money by anticipating the future trend of prices of securities. If their forecast comes true they make a money but if it fails they are likely to lose money on the settlement day. Forward trading is an arrangement that provides an opportunity for such speculators to avoid the loss by postponing of transactions to the next settlement day on payment of charge known as badla charge. Thus if a speculator carries forward his transactions from one settlement day to another, he has to pay Badla charge. If securities were purchased and are required to be carried forward to the next settlement day, their value on the settlement day is credited to the account of the speculator and brought forward to the next period on the debit side of account of the speculator. On the other hand, if the securities were sold and remain unsettled on the settlement day, the value of the securities on the settlement day is debited to the account of the speculator and brought forward to the next period on credit side of the speculator's account. The difference in the account of the speculator after the carry forward is settled in cash.

(10) Arbitrager: Arbitragers are those brokers who buy securities in one stock market and sell them in another stock market to the take advantage of the price differences prevailing in different markets for the same scrips.

(11) Short Selling: When bear speculators sell a large volume of securities without actually possessing them, they are said to be short selling.

3.6.6 Advantages of Listing:

Listing of securities result in the following advantages:

(1) Facilities marketing of securities: If a company does the listing of its shares on recognized stock exchanges its shareholders will be able to release their investment in the shares at market price whenever they want by selling these shares on stock exchanges. Similarly an investor who wants to purchase the shares of that company may buy those shares at market price in those stock exchanges. Thus constant marketing facilities are availed to the securities that are listed on stock exchange.

(2) Assures finance to the companies: Whenever a company offers its shares to the public it receives proper response from the investors only if such shares are listed on recognized stock exchanges. Because listing enables the investor to release his money the shares by selling those on stock exchange. Thus listing enables the companies to raise the necessary finance by the issue of its securities to the public.

(3) Ensures liquidity: The prices of listed securities are quoted daily in the share markets. Hence the listed securities can be readily converted into cash at the quoted price. Thus listing ensures liquidity of securities.

(4) Enables the investors to borrow the funds: Banks and other financial institutions accepted the listed securities as collateral securities against their loans and advances because these listed securities have a ready market. Thus the people holding the listed securities can raise loan against such securities without any difficulty.

(5) Protection to investors: The companies that have listed their securities on stock markets have to follow the rules and regulations of stock markets and Securities Exchange Board of India (SEBI). They have to maintain transparency in their working and have to disclose their financial information and policies. All these rules regulations and transparency aim at protection of interest of small investors who should not be deceived or put to loss.

(6) Offers wide publicity: Names of companies whose securities are listed on stock exchanges are mentioned regularly in stock market reports, T.V., News papers, Radios etc. Thus listed securities offer wide advertising and publicity to the companies concerned.

Procedure for dealing at Stock Exchange

The following procedure is followed for dealings at a stock exchange:

1. Selection of a Broker: Persons who want to buy and sell securities cannot act directly on a stock exchange because trading in securities in a stock exchange is allowed through brokers. Therefore, the first thing to be done is the selection of a broker through whom buying or selling of securities it to be done. A broker of repute should be selected so that fair dealings may be expected from him.

2. Placing an Order: After making a choice of the broker, the intending buyer or seller places an order for purchase or sale of securities. Brokers open account for each of their clients. Before opening of account of a client, a broker may seek bank guarantee from his client. Client places an order to his broker of his requirement of purchasing or selling securities. In his order, the client tells about the quantity and tentative price of purchase or sale. The broker will try to make purchases or sale of securities as far as possible to the nearest price offered by the client.

3. Making the Contract: After getting an order from the client, the broker or his authorized clerk makes efforts to materialize the order on the floor of exchange. A deal is struck when the other party also agrees and this becomes a contract of purchase of securities on the part of one party and a contract of sale on the part of the other party. When a deal is struck it is announced by another party mentioning the price, name and number of security and bargain is noted by both the parties in their note books. After this the seller of securities is sent a selling note and the purchaser of securities is sent a buying note mentioning the details of securities traded.

4. Settlement: Settlement of account depends upon the type of transaction whether it is cash or forward. Cash transaction is a spot transaction and payment is made on the delivery of securities. This type of transaction is also known as investment transaction because it is based on bona fide intention or purchase and sale of securities. On the other hand, a forward transaction is of a speculative nature and reveals forward delivery contract. It can be settled in any of the following three ways:

(i) Securities are delivered and payment is received on fixed settlement day after cancelling all intermediate purchases and sales. Such type of settlement is known as liquidation in full.

(ii) On fixed settlement days, securities are not delivered but only the different between ruling price and agreed price is settled. This type of settlement is known as liquidation by payment of differences.

(iii) When settlement is not made on fixed settlement date and it is desired that settlement should be carried forward to the next settlement period, is known as carry over to the next settlement. For giving the facility of carry over the broker makes a charge known as contango or backwardation. The account of the client is debited with contango charge (i.e. a payment made by way of interest) if it is the purchase which is being carried forward. If the sale is being carried forward (i.e. delivery of securities is due), the amount to be debited by way of compensation is known as backwardation. Contango charge is also known as badla charge and it should be calculated on the amount carried forward and for the period of next settlement date from this settlement date. Settlement day falls after 15 days or one month according to the byelaws of the stock exchange.

3.6.7 Major Stock Exchange in India

There are two leading stock exchanges in India which help us trade are:

1) National Stock Exchange: National Stock Exchange incorporated in the year 1992 provides trading in the equity as well as debt market. Maximum volumes take place on NSE and hence enjoy leadership position in the country today.

Introduction to NSE:

The National Stock Exchange (NSE) is India's leading stock exchange covering 364 cities and towns across the country. NSE was set up by leading institutions to provide a modern, fully automated screen-based trading system with national reach. The Exchange has brought about unparalleled transparency, speed & efficiency, safety and market integrity. It has set up facilities that serve as a model for the securities industry in terms of systems, practices and procedures. NSE has played a catalytic role in reforming the Indian securities market in terms of microstructure, market practices and trading volumes. The market today uses state-of-art information technology to provide an efficient and transparent trading, clearing and settlement mechanism, and has witnessed several innovations in products & services viz. demutualization of stock exchange governance, screen based trading, compression of settlement cycles, dematerialization and electronic transfer of securities, securities lending and borrowing, professionalization of trading members, fine-tuned risk management systems, emergence of clearing corporations to assume counterparty risks, market of debt and derivative instruments and intensive use of information technology. The National Stock Exchange of India Limited has genesis in the report of the High Powered Study Group on Establishment of New Stock Exchanges, which recommended promotion of a National Stock Exchange by financial institutions (FIs) to provide access to investors from all across the country on an equal footing. Based on the recommendations, NSE was promoted by leading Financial Institutions at the behest of the Government of India and was incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital Market (Equities) segment commenced operations in November 1994 and operations in Derivatives segment commenced in June 2000. NSE's mission is setting the agenda for change in the securities markets in India.

The NSE was set-up with the following objectives:

- establishing a nation-wide trading facility for equities, debt instruments and hybrids,
- ensuring equal access to investors all over the country through an appropriate communication network,
- providing a fair, efficient and transparent securities market to investors using electronic trading systems,
- enabling shorter settlement cycles and book entry settlements systems, and
- meeting the current international standards of securities markets

The standards set by NSE in terms of market practices and technologies have become industry benchmarks and are being emulated by other market participants. NSE is more than a mere market facilitator. It's that force which is guiding the industry towards new horizons and greater opportunities. Till the advent of NSE, an investor wanting to transact in a security not traded on the nearest exchange had to route orders through a series of correspondent brokers to the appropriate exchange. This resulted in a great deal of uncertainty and high transaction costs. One of the objectives of NSE was to provide a nationwide trading facility and to enable investors spread all over the country to have an equal access to NSE. NSE has made it possible for an investor to access the same market and order book, irrespective of location, at the same price and at the same cost. NSE uses sophisticated telecommunication technology through which members can trade remotely from their offices located in any part of the country. NSE trading terminals are present in 363 cities and towns all over India. NSE has been promoted by leading financial institutions, banks, insurance companies and other financial intermediaries NSE is one of the first demutualised stock exchanges in the country, where the ownership and management of the Exchange is completely divorced from the right to trade on it. Though the impetus for its establishment came from policy makers in the country, it has been set up as a public limited company, owned by the leading institutional investors in the country. From day one, NSE has adopted the form of a demutualised exchange - the ownership, management and trading is in the hands of three different sets of people. NSE is owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries and is managed by professionals, who do not directly or indirectly trade on the Exchange. This has completely eliminated any conflict of interest and helped NSE in aggressively pursuing policies and practices within a public interest framework. The NSE model however, does not preclude, but in fact accommodates involvement, support and contribution of trading members in a variety of ways. Its Board comprises of senior executives from promoter institutions, eminent professionals in the fields of law, economics, accountancy, finance, taxation, etc, public representatives, nominees of SEBI and one full time executive of the Exchange. While the Board deals with broad policy issues, decisions relating to market operations are delegated by the Board to various committees constituted by it. Such committees include representatives from trading members, professionals, the public and the management. The day-to-day management of the Exchange is delegated to the Managing Director who is supported by a team of professional staff.

2) Bombay Stock Exchange: BSE on the other hand was set up in the year

1875 and is the oldest stock exchange in Asia. It has evolved in to its present status as the premier stock exchange. At BSE you will find some scripts listed that are not available on NSE. Also BSE has the largest number of scripts which are listed.

Introduction to BSE: The stock exchange, Mumbai, popularly known as "BSE". BSE was established in 1875 as "The Native Share and Stock Brokers Association". It is the oldest one in Asia, even older than the Tokyo Stock Exchange, which was established in 1878. It is a voluntary non-profit making Association of Persons (AOP) and has converted itself into demutualised and corporate entity. It has evolved over the years into its present status as the Premier Stock Exchange in the country. It is the first Stock Exchange in the Country to have obtained permanent recognition in 1956 from the Govt. of India under the Securities Contracts (Regulation) Act, 1956. The Exchange, while providing an efficient and transparent market for trading in securities, debt and derivatives upholds the interests of the investors and ensures redressal of their grievances whether against the companies or its own member-brokers. It also strives to educate and enlighten the investors by conducting investor education programmers' and making available to them necessary informative inputs. A Governing Board having 20 directors is the apex body, which decides the policies and regulates the affairs of the Exchange. The Governing Board consists of 9 elected directors, who are from the broking community (one third of them retire every year by rotation), three SEBI nominees, six public representatives and an Executive Director & Chief Executive Officer and a Chief Operating Officer. The Executive Director as the Chief Executive Officer is responsible for the day-to-day administration of the Exchange and he is assisted by the Chief Operating Officer and other Heads of Department. The Exchange has inserted new Rule in its Rules, Bye-laws & Regulations pertaining to constitution of the Executive Committee of the Exchange. Accordingly, an Executive Committee, consisting of three elected directors, three SEBI nominees or public representatives, Executive Director & CEO and Chief Operating Officer has been constituted. The Committee considers judicial & quasi matters in which the Governing Board has powers as an Appellate Authority, matters regarding annulment of transactions, admission, continuance and suspension of member-brokers, declaration of a member-broker as defaulter, norms, procedures and other matters relating to arbitration, fees, deposits, margins and other monies payable by the member brokers to the Exchange, etc.

3.6.8 Role of Stock Exchange

Stock exchanges have multiple roles in the economy. This may include the following:

1) Raising capital for businesses: A stock exchange provides companies with the facility to raise capital for expansion through selling shares to the investing public.

2) Common forms of capital Raising: Besides the borrowing capacity provided to an individual or firm by the banking system, in the form of credit or a loan, there are four common forms of capital raising used by companies and entrepreneurs. Most of these available options might be achieved, directly or indirectly, through a stock exchange.

3) Going Public: Capital intensive companies, particularly high tech companies, always need to raise high volumes of capital in their early stages. For this reason, the public market provided by the stock exchanges has been one of the most important funding sources for many capital intensive startups. After the 1990s and early-2000s hi-tech listed companies' boom and bust in the world's major stock exchanges, it has been much more demanding for the high-tech entrepreneur to take his/her company public, unless either the company already has products in the market and is generating sales and earnings, or the company has completed advanced promising clinical trials, earned potentially profitable patents or conducted market research which demonstrated very positive outcomes. This is quite different from the situation of the 1990s to early-2000s period, when a number of companies (particularly Internet boom and biotechnology companies) went public in the most prominent stock exchanges around the world, in the total absence of sales, earnings and any well-documented promising outcome. Anyway, every year a number of companies, including unknown highly speculative and financially unpredictable hi-tech start ups, are listed for the first time in all the major stock exchanges - there are even specialized entry markets for these kind of companies or stock indexes tracking their performance (examples include the Alternext, CAC Small, SDAX, TecDAX, or most of the third market companies).

4) Limited Partnerships: A number of companies have also raised significant amounts of capital through R&D limited partnerships. Tax law changes that were enacted in 1987 in the United States changed the tax deductibility of investments in R&D limited partnerships. In order for a partnership to be of interest to investors today, the cash on cash return must be high enough to entice investors. As a result, R&D limited partnerships are not a viable means of raising money for most companies, specially hi-tech startups.

5) Venture Capital: A third usual source of capital for startup companies has been venture capital. This source remains largely available today, but the maximum statistical amount that the venture company firms in aggregate will invest in any one company is not limitless (it was approximately $15 million in 2001 for a biotechnology company). At those level, venture capital firms typically become tapped-out because the financial risk to any one partnership becomes too great.

6) Corporate Partners: A fourth alternative source of cash for a private company is a corporate partner, usually an established multinational company, which provides capital for the smaller company in return for marketing rights, patent rights, or equity. Corporate partnerships have been used successfully in a large number of cases.

7) Mobilizing savings for investment: When people draw their savings and invest in shares (through an IPO or the issuance of new company shares of an already listed company), it usually leads to rational allocation of resources because funds, which could have been consumed, or kept in idle deposits with banks, are mobilized and redirected to help companies' management boards finance their organizations. This may promote business activity with benefits for several economic sectors such as agriculture, commerce and industry, resulting in stronger economic growth and higher productivity levels of firms. Sometimes it is very difficult for the stock investor to determine whether or not the allocation of those funds is in good faith and will be able to generate long-term company growth, without examination of a company's internal auditing.

8) Facilitating Company Growth: Companies view acquisitions as Companies view acquisitions as an opportunity to expand product lines, increase distribution channels, hedge against volatility, increase their market share, or acquire other necessary business assets. A takeover bid or a merger agreement through the stock market is one of the simplest and most common ways for a company to grow by acquisition or fusion.

9) Profit Sharing: Both casual and professional stock investors, as large as institutional investors or as small as an ordinary middleclass family, through dividends and stock price increases that may result in capital gains, share in the wealth of profitable businesses. Unprofitable and troubled businesses may result in capital losses for shareholders.

10) Corporate Governance: By having a wide and varied scope of owners, companies generally tend to improve management standards and efficiency to satisfy the demands of these shareholders, and the more stringent rules for public corporations imposed by public stock exchanges and the government. Consequently, it is alleged that public companies tend to have better management records than privately held companies (those companies where shares are not publicly traded, often owned by the company founders and/or their families and heirs, or otherwise by a small group of investors). However, when poor financial, ethical or managerial records are known by the stock investors, the stock and the company tend to lose value. In the stock exchanges, shareholders of underperforming firms are often penalized by significant share price decline, and they tend as well to dismiss incompetent management teams.

11) Creating investment opportunities for small investors: As opposed to other businesses that require huge capital outlay, investing in shares is open to both the large and small stock because a person buys the number of shares they can afford. Therefore the Stock Exchange provides the opportunity for small investors to own shares of the same companies as large investors.

12) Government Capital-raising for Development Projects: Governments at various levels may decide to borrow money to finance infrastructure projects such as sewage and water treatment works or housing estates by selling another category of securities known as bonds. These bonds can be raised through the Stock Exchange whereby members of the public buy them, thus loaning money to the government. The issuance of such bonds can obviate the need, in the short term, to directly tax citizens to finance development-though by securing such bonds with the full faith and credit of the government instead of with collateral, the government must eventually tax citizens or otherwise raise additional funds to make any regular coupon payments and refund the principal when the bonds mature.

13) Barometer of the Economy: At the stock exchange, share prices rise and fall depending, largely, on economics forces. Share prices tend to rise or remain stable when companies and the economy in general show signs of stability and growth. An economic recession, depression, or financial crisis could eventually lead to a stock market crash. Therefore the movement of share prices and in general of the stock indexes can be an indicator of the general trend in the economy.

3.7 SEBI- OBJECTIVES AND FUNCTIONS

The Government has set up the Securities & Exchange Board of India (SEBI) in April, 1988. For more than three years, it has no statutory powers. Its interim functions during the period were (i) To collect information and advice the Government on matters relating to Stock and Capital Markets (ii) Licensing and regulation of merchant banks, mutual funds etc. (iii) To prepare the legal drafts for regulatory and development role of SEBI and (iv) To perform any other functions as may be entrusted to it by the Government. The need for setting up independent Govt. agency to regulate and develop the Stock and Capital Market in India as in many developed countries was recognised since the Sixty Five Year Plan was launched (1985) when some major industrial policy changes like opening up of the economy to outside world and greater role to the Private Sector were initiated. The rampant malpractices noticed in the

Stock and Capital Market stood in the way of infusing confidence of investors which is necessary for mobilisation of larger quantity of funds from the public and help the growth of the industry. The malpractices were noticed in the case of companies, merchants bankers and brokers who are all operating in the Capital Market. The need to curb these malpractices and to promote healthy Capital Market in India was felt. The security industry in India has to develop on the right lines for which a competent Govt. agency as in U.K. (SIB) or in U.S.A. (SEC) is needed.

As referred to earlier, malpractices have been reported in both the primary market and seondary market. A few examples of malpractices in the primary market are as follows:

a. Too many self style Investment Advisors and Consultants.

b. Grey Market or unofficial premiums on the new issues.

c. Manipulation of market prices before new issues are floated.

d. Delay in allotment letters or refund orders or in despatch of share certificates.

e. Delay in listing and commencement of trading in shares.

A few examples of malpractices in the secondary Market are as follows:

a. Lack of transparency in the trading operations and prices charged to clients.

b. Poor services due to delay in passing contract notes or not passing contract notes, at all.

c. Delay in making payments to clients or in giving delivery of shares.

d. Persistence of odd lots and refusal of companies to stop this practice of allotting shares in odd lots.

e. Insider trading by agents of companies or brokers rigging and manipulating prices.

f. Takeover bids to destabilise management.

3.7.1 Objectives

The SEBI has been entrusted with both the regulatory and developmental functions. The objectives of SEBI are as follows:

a. Investor protection, so that there is a steady flow of savings into the Capital Market.

b. Ensuring the fair practices by the issuers of securities, namely, companies so that they can raise resources at least cost.

c. Promotion of efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

Pending the legislative sanction to SEBI it carried out the functions of supervisory and advisory body of the Govt. It has initiated the basis for control and regulation of the market, arranged for the licensing of merchant banks, mutual funds etc. and performed the advisory functions to the Govt. The legislation giving powers to SEBI was passed on 4th April 1992 in the form of the Securities & Exchange Board of India Act to protect the interests of investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith or incidental there to.

3.7.2 Reasons for the Establishment of SEBI:

During 1980s, there was tremendous growth in the capital market due to increasing participation of public. This led to many malpractices like Rigging of prices, unofficial premium on new issues, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. by the brokers, merchant bankers, companies, investment consultants and others involved in the securities market.

This resulted in many investor grievances. Because of lack of proper penal provision and legislation, the government and the stock exchanges were not able to redress these grievances of the investors. This (necessitated a need for a separate regulatory body, and hence Securities and Exchange Board of India was established.

3.7.3 Purpose and Role of SEBI:

The main objective is to create such an environment which facilitates efficient mobilization and allocation of resources through the securities market. This environment consists of rules and regulations, policy framework, practices and infrastructures to meet the needs of three groups which mainly constitute the market i.e. issuers of securities (companies), the investors and the market intermediaries.

(i) To the Issuers:

SEBI aims to provide a market place to the issuers where they can confidently look forward to raise the required amount of funds in an easy and efficient manner.

(ii) To the Investors:

SEBI aims to protect the right and interest of the investors by providing adequate, accurate and authentic information on a regular basis.

(iii) To the Intermediaries:

In order to enable the intermediaries to provide better service to the investors and the issuers, SEBI provides a competitive, professionalised and expanding market to them having adequate and efficient infrastructure.

3.7.4 Functions of SEBI

The functions of SEBI can be divided into three parts viz:

(1) Regulatory function

(2) Development Function &

(3) Protective function.

1. Regulatory Functions:

Regulatory functions of SEBI are as follows:

(a) Registration of Brokers and Agents:

It registers brokers, sub-brokers, transfer agents, merchant banks etc.

(b) Notifications of Rules and Regulations:

It notifies rules and regulations for the smooth functioning of all intermediaries in the securities' market.

(c) Levying of Fees:

It levies fees, penalties and other charges for contravening its directions and orders.

(d) Regulator of Investment Schemes:

It registers and regulates collective investment schemes and mutual funds.

(e) Prohibits Unfair Trade Practices:

SEBI prohibits fraudulent and unfair trade practices.

(f) Inspection and Enquiries:

It undertakes inspection and conducts enquiries & audit of stock exchange

(g) Performing and Exercising Powers:

It performs & exercises such powers under Securities Contracts (Regulation) Act 1956, as have been delegated to it by the Government of India.

2. Development Functions:

Development functions of SEBI are as under:

(a) Training to intermediaries:

It promotes training of intermediaries of the securities.

(b) Promotion of fair trade:

It promotes fair trade practices by making underwriting optional.

c) Research:

It publishes information useful to all market participants for conducting research.

3. Protective Functions:

Protective Functions of SEBI are as under:

(a) Prevents Insider Trading:

It does so by prohibiting insiders such as directors, promoters etc. to make profit through trading of securities using confidential price sensitive information.

(b) Prohibits Fraudulent and Unfair Trade Practices:

It prohibits fraudulent and unfair trade practices in the security market, such as price rigging and sale or purchase of securities through misleading statements.

(c) Promotes Fair Practices:

It promotes fair practices and code of conduct in the securities market e.g. it looks after the interests of the debenture holders in terms of any mid-term revision of interest rates etc.

(d) Educates Investors:

It educates the investors through campaigns.

Other Functions:

1. Registering and regulating working of stock brokers, sub - brokers, share transfer agents, bankers to issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment adviser and such other intermediaries who may be associated with securities markets in any manner.

2. SEBI also perform the function of registering and regulating working of depositories, custodians of securities. Foreign Institutional Investors, credit rating agencies etc.

3. Registering and regulating working of Venture Capital Funds and collective investments schemes including mutual funds.

4. Promoting and regulating self - regulatory organizations.

5. Calling for information form, undertaking inspection, conducting inquiries and audits of stock exchange, mutual funds and intermediaries and self - regulatory organizations in the securities market.

6. Calling for information and record from any bank or any other authority or boars or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which are under investigation or inquiry by the Board.

7. Conduct research for any matter described if any.

8. Calling information from any agency, institution, banks etc.

3.8 SUMMARY

India's financial sector is diversified and expanding rapidly. It comprises commercial banks, insurance companies, non-banking financial companies, cooperatives, pensions funds, mutual funds and other smaller financial entities. Ours is a bank dominated financial sector and commercial banks account for over 60 per cent of the total assets of the financial system followed by the Insurance. Other bank intermediaries include regional rural banks and cooperative banks that target under serviced rural and urban populations. Many non banking finance companies (NBFC) operate in specialized segments (leasing, factoring, micro finance, infrastructure finance), though some can accept deposits. Pension provision covers 12 percent of the working population and consists of civil service arrangements, a compulsory scheme for formal private sector employees, and private scheme offered through insurance companies. The present landscape of financial law is less than satisfactory in certain respects. Today, India has over 60 Acts and multiple rules / regulations that govern the financial sector. Many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structure for it. The genesis of many of the Acts, rules, regulations that govern the financial sector in India can be traced back more than half a century in some cases. The RBI Act and the Insurance Act were enacted in 1934 and 1938 respectively and the Securities Contracts Regulation Act, which governs securities transactions, was legislated in 1956 when the financial landscape was very different from that seen today. For example, Let?s take the banking regulations, they were established before ATMs, credit cards, internet banking, investment advisory services, private banking, selling mutual funds and debt products, direct selling agents, vehicle loans, derivatives and a whole lot of other new products and services existed. These Acts have been amended time and again to keep pace with a changing reality but its legal foundations remained more or less static .The result is a frame work which is at times complex, ambiguous, inconsistent, and occasionally open to regulatory arbitrage. Financial sector reform affects everyone in the country and beyond given the growing interface of our economy with the rest of the world. We live in a globalizing world with strong and growing inter-connections between our financial systems. What happens anywhere in the world will have an impact everywhere, as indeed demonstrated by the experience of the last five years. As foreign banks come into our country, and our banks expand their global footprint, we cannot afford to be offline on global standards and international best practices. As the former Managing Director of the IMF has said "just because this crisis originated in advanced economies, emerging economies cannot assume that they have insulated themselves from all future crises. An efficient financial system has been regarded as a necessary pre condition for higher growth. Propelled by this ruling paradigm, several developing countries undertook programmes for reforming their financial system. The role of the financial system in India, until the early 1990s, was primarily restricted to the function of channelling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalization of large banks in 1969 and 1980, public ownership dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low profitability. Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India. Non-banking Financial Companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/ participants between the market segments. Apart from inhibiting the development of the markets, this also affected their efficiency. Against this backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well. Thus, the principal objective of financial sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of financial institutions and financial markets. The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of the banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential norms and the supervisory system. In the banking sector, the focus was on imparting operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring accountability and financial soundness. The restrictions on activities undertaken by the existing institutions were gradually relaxed and barriers to entry in the banking sector were removed. Reforms in financial markets focused on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions improvement in trading, clearing and settlement practices, more transparency, etc. Reforms encompassed regulatory and legal changes, building of institutional infrastructure, refinement of market microstructure and technological up gradation. In the various financial market segments, reforms aimed at creating liquidity and depth and an efficient price discovery process. Reforms in the commercial banking sector had two distinct phases. The first phase of reforms, introduced subsequent to the release of the Report of the Committee on Financial System, 1992 (Chairman: Shri M. Narasimham), focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham) placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices.

3.9 GLOSSARY

Financial Environment: It is a part of an economy with the major players being firms, investors, and markets.

Financial Instrument: It refers to the monetary contracts between parties.

Financial Market: It refers to a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand.

3.10 SELF ASSESSMENT QUESTIONS

1. What is Financial System? Give a brief description about the components of financial system?

2. Give a brief description about the financial markets? Elaborate on different types of financial markets?

3. Describe with examples Financial Instruments?

4. Explain Money market? Illustrate its types?

5. Elaborate Capital market?

3.11 LESSON END EXERCISES

1. Write a brief note on the Indian Financial System?

2. Write a detailed note on the reforms in Indian Capital Market?

3. What are the factors that affect capital market in India?

4, Describe SEBI?

5. Write note on

   a) Bombay Stock Exchange (BSE)

   b) National Stock Exchange (NSE)

3.12 SUGGESTED READINGS

1. Dr. Vasant Desai, The Indian Financial System And Development, Himalaya Publishing House.

2. Preeti Singh, Dynamics of Indian Financial System: Markets, Institutions & Services, 3rd ed. , ANE Books

3. M.K. Bhat, International Trade and Financial Environment, ANE Books.

3.13 REFERENCES

1. Introduction to Finance: Markets, Investments, and Financial Management,by Edgar A. Norton, Ronald W. Melicher

2. The Financial Environment by David Brighouse

GOVERNMENT POLICIES- RELATED ENVIRONMENT

Lesson Structure:

4.1 INTRODUCTION

A government policy is a deliberate system of principles to guide decisions and achieve rational outcomes. A policy is a statement of intent, and is implemented as a procedure or protocol. Policies are generally adopted by the Board of or senior governance body within an organization where as procedures or protocols would be developed and adopted by senior executive officers. Policies can assist in both subjective and objective decision making. Policies to assist in subjective decision making would usually assist senior management with decisions that must consider the relative merits of a number of factors before making decisions and as a result are often hard to objectively test e.g. work-life balance policy. In contrast policies to assist in objective decision making are usually operational in nature and can be objectively tested e.g. password policy.

The term may apply to government, private sector organizations and groups, as well as individuals. Presidential executive orders, corporate privacy policies, and parliamentary rules of order are all examples of policy. Policy differs from rules or law. While law can compel or prohibit behaviours (e.g. a law requiring the payment of taxes on income), policy merely guides actions toward those that are most likely to achieve a desired outcome.

Policy or policy study may also refer to the process of making important organizational decisions, including the identification of different alternatives such as programs or spending priorities, and choosing among them on the basis of the impact they will have. Policies can be understood as political, managerial, financial, and administrative mechanisms arranged to reach explicit goals. In public corporate finance, a critical accounting policy is a policy for a firm/company or an industry which is considered to have a notably high subjective element, and that has a material impact on the financial statements.

4.2 OBJECTIVES

By the end of this unit, students will be able to:

(a) understand the principal government objectives of economic growth, full employment, stable prices and balance of payments.

(b) understand methods available to measure economic performance, such as: inflation, economic growth, balance of payments, budget deficits and surpluses.

(c) understand conflicts can arise when attempting to achieve these objectives and the links to equity and equality.

(d) should consider how ethical issues affect the achievement of government objective

(e) should be aware of the benefits and drawbacks of the welfare state and the alternative of individuals providing for themselves

4.3 FISCAL POLICY-OBJECTIVES AND INSTRUMENTS

Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policy approaches used by economic managers to steer the broad aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. Fiscal policy is composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy. Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables. On a broad generalisation, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the "crowding out? of private investment. Sometimes a combination of these can occur. In any case, the impact of a large deficit on long run growth and economic well-being is negative. Therefore, there is broad agreement that it is not prudent for a government to run an unduly large deficit. However, in case of developing countries, where the need for infrastructure and social investments may be substantial, it sometimes argued that running surpluses at the cost of long-term growth might also not be wise (Fischer and Easterly, 1990). The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government?s finances in a way that the deficit or the accumulating debt burden is not too great. India?s fiscal policy with particular focus on historical trends, the development of fiscal discipline frameworks, the recent experience of fiscal response to the global financial crisis and subsequent return to a fiscal consolidation path. The initial years of India?s planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector driven industrialization process and also cover social welfare schemes. Indirect taxes were a larger source of revenue than direct taxes. However, growth was anaemic and the system was prone to inefficiencies. In the 1980s some attempts were made to reform particular sectors and make some changes in the tax system. But the public debt increased, as did the fiscal deficit. Triggered by higher oil prices and political uncertainties, the balance of payments crisis of 1991 led to economic liberalisation. The reform of the tax system commenced with direct taxes increasing their share in comparison to indirect taxes. The fiscal deficit was brought under control. When the deficit and debt situation again threatened to go out of control in the early 2000s, fiscal discipline legalisations were instituted at the central level and in most states. The deficit was brought under control and by 2007-08 a benign macro-fiscal situation with high growth and moderate inflation prevailed. The global financial crisis tested the fiscal policy framework and it responded with counter-cyclical measures including tax cuts and increases in expenditures. The post-crisis recovery of the Indian economy is witnessing a correction of the fiscal policy path towards a regime of prudence. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

4.3.1 BASIC CONCEPTS

At the outset, it is important to clarify certain basic concepts. The most elementary is perhaps the difference between revenue and capital flows, be they receipts or expenditures. While there are various complex legal and formal definitions for these ideas, presenting some simplified and stylised conceptual clarifications is deemed appropriate. A spending item is a capital expenditure if it relates to the creation of an asset that is likely to last for a considerable period of time and includes loan disbursements. Such expenditures are generally not routine in nature. By the same logic a capital receipt arises from the liquidation of an asset including the sale of government shares in public sector companies (disinvestments), the return of funds given on loan or the receipt of a loan. This again usually arises from a comparatively irregular event and is not routine. In contrast, revenue expenditures are fairly regular and generally intended to meet certain routine requirements like salaries, pensions, subsidies, interest payments, and the like. Revenue receipts represent regular 'earnings', for instance tax receipts and non-tax revenues including from sale of telecom spectrums. There are various ways to represent and interpret a government's deficit. The simplest is the revenue deficit which is just the difference between revenue receipts and revenue expenditures.

Revenue Deficit = Revenue Expenditure - Revenue Receipts (that is Tax + Non-tax Revenue)

A more comprehensive indicator of the government?s deficit is the fiscal deficit. This is the sum of revenue and capital expenditure less all revenue and capital receipts other than loans taken. This gives a more holistic view of the government?s funding situation since it gives the difference between all receipts and expenditures other than loans taken to

meet such expenditures. Fiscal Deficit = Total Expenditure (that is Revenue Expenditure + Capital Expenditure) - (Revenue Receipts + Recoveries of Loans + Other Capital Receipts (that is all Revenue and Capital Receipts other than loans taken)) "The gross fiscal deficit (GFD) of government is the excess of its total expenditure, current and capital, including loans net of recovery, over revenue receipts (including external grants) and non-debt capital receipts." The net fiscal deficit is the gross fiscal deficit reduced by net lending by government. The gross primary deficit is the GFD less interest payments while the primary revenue deficit is the revenue deficit less interest payments.

4.3.2 INDIA'S FISCAL POLICY ARCHITECTURE

The Indian Constitution provides the overarching framework for the country?s fiscal policy. India has a federal form of government with taxing powers and spending responsibilities being divided between the central and the state governments according to the Constitution. There is also a third tier of government at the local level. Since the taxing abilities of the states are not necessarily commensurate with their spending responsibilities, some of the centre?s revenues need to be assigned to the state governments. To provide the basis for this assignment and give medium term guidance on fiscal matters, the Constitution provides for the formation of a Finance Commission (FC) every five years. Based on the report of the FC the central taxes are devolved to the state governments. The Constitution also provides that for every financial year, the government shall place before the legislature a statement of its proposed taxing and spending provisions for legislative debate and approval. This is referred to as the Budget. The central and the state governments each have their own budgets. The central government is responsible for issues that usually concern the country as a whole like national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health. Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity. There is now increasing devolution of some powers to local governments at the city, town and village levels. The taxing powers of the central government encompass taxes on income (except agricultural income), excise on goods produced (other than alcohol), customs duties, and inter-state sale of goods. The state governments are vested with the power to tax agricultural income, land and buildings, sale of goods (other than inter-state), and excise on alcohol. Besides the annual budgetary process, since 1950, India has followed a system of five year plans for ensuring long-term economic objectives. This process is steered by the Planning Commission for which there is no specific provision in the Constitution. The main fiscal impact of the planning process is the division of expenditures into plan and non-plan components. The plan components relate to items dealing with long-term socioeconomic goals as determined by the ongoing plan process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes. Non-plan expenditures broadly relate to routine expenditures of the government for administration, salaries, and the like. While these institutional arrangements initially appeared adequate for driving the development agenda, the sharp deterioration of the fiscal situation in the 1980s resulted in the balance of payments crisis of 1991, which would be discussed later. Following economic liberalisation in 1991, when the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000, a new fiscal discipline framework was instituted. At the central level this framework was initiated in 2003 when the Parliament passed the Fiscal Responsibility and Budget Management Act (FRBMA). Taxes are the main source of government revenues. Direct taxes are so named since they are charged upon and collected directly from the person or organisation that ultimately pays the tax (in a legal sense). Taxes on personal and corporate incomes, personal wealth and professions are direct taxes. In India the main direct taxes at the central level are the personal and corporate income tax. Both are till date levied through the same piece of legislation, the Income Tax Act of 1961. Income taxes are levied on various head of income, namely, incomes from business and professions, salaries, house property, capital gains and other sources (like interest and dividends).3 Other direct taxes include the wealth tax and the securities transactions tax. Some other forms of direct taxation that existed in India from time to time but were removed as part of various reforms include the estate duty, gift tax, expenditure tax and fringe benefits tax. The estate duty was levied on the estate of a deceased person. The fringe benefits tax was charged on employers on the value of in-kind non-cash benefits or perquisites received by employees from their employers. Such perquisites are now largely taxed directly in the hands of employees and added to their personal income tax. Some states charge a tax on professions. Most local governments also charge property owners a tax on land and buildings. Indirect taxes are charged and collected from persons other than those who finally end up paying the tax (again in a legal sense). For instance, a tax on sale of goods is collected by the seller from the buyer. The legal responsibility of paying the tax to government lies with the seller, but the tax is paid by the buyer. The current central level indirect taxes are the central excise (a tax on manufactured goods), the service tax, the customs duty (a tax on imports) and the central sales tax on inter-state sale of goods. The main state level indirect tax is the post-manufacturing (that is wholesale and retail levels) sales tax (now largely a value added tax with intra-state tax credit). The complications and economic inefficiencies of this multiple cascading taxation across the economic value chain (necessitated by the constitutional assignment of taxing powers) are discussed later in the context of the proposed Goods and Services Tax (GST).

4.3.3 EVOLUTION OF INDIAN FISCAL POLICY TILL 1991

India commenced on the path of planned development with the setting up of the Planning Commission in 1950. That was also the year when the country adopted a federal Constitution with strong unitary features giving the central government primacy in terms of planning for economic development. The subsequent planning process laid emphasis on strengthening public sector enterprises as a means to achieve economic growth and industrial development. The resulting economic framework imposed administrative controls on various industries and a system of licensing and quotas for private industries. Consequently, the main role of fiscal policy was to transfer private savings to cater to the growing consumption and investment needs of the public sector. Other goals included the reduction of income and wealth inequalities through taxes and transfers, encouraging balanced regional development, fostering small scale industries and sometimes influencing the trends in economic activities towards desired goals. In terms of tax policy, this meant that both direct and indirect taxes were focussed on extracting revenues from the private sector to fund the public sector and achieve redistributive goals. The combined centre and state tax revenue to GDP ratio increased from 6.3 percent in 1950-51 to 16.1 percent in 1987-88.4 For the central government this ratio was 4.1 percent of GDP in 1950-51 with the larger share coming from indirect taxes at 2.3 percent of GDP and direct taxes at 1.8 percent of GDP. Given their low direct tax levers, the states had 0.6 percent of GDP as direct taxes and 1.7 percent of GDP as indirect taxes in 1950-51. The government authorised a comprehensive review of the tax system culminating in the Taxation Enquiry Commission Report of 1953. However, the government then invited the British economist Nicholas Kaldor to examine the possibility of reforming the tax system. Kaldor found the system inefficient and inequitable given the narrow tax base and inadequate reporting of property income and taxation. He also found the maximum marginal income tax rate at 92 percent to be too high and suggested it be reduced to 45 percent. In view of his recommendations, the government revived capital gains taxation, brought in a gift tax, a wealth tax and an expenditure tax (which was not continued due to administrative complexities).

4.4 NEW INDUSTRIAL POLICY OF 1991 AND ITS RATIONALE

The industrial policy of a country, sometimes denoted IP, is its official strategic effort to encourage the development and growth of part or all of the manufacturing sector as well as other sectors of the economy. The government takes measures "aimed at improving the competitiveness and capabilities of domestic firms and promoting structural transformation. A country's infrastructure (transportation, telecommunications and energy industry) is a major part of the manufacturing sector that often has a key role in IP. Industrial policies are sector-specific, unlike broader macroeconomic policies. Examples of the latter, which are horizontal, economy-wide policies, are tightening credit and taxing capital gains. Traditional examples of industrial policy that involves vertical, sector-specific policies, include protecting textiles from imports and subsidizing export industries. More contemporary industrial policies include measures such as support for linkages between firms and support for upstream technologies. Industrial policies are interventionist measures typical of mixed economy countries.

Many types of industrial policies contain common elements with other types of interventionist practices such as trade policy and fiscal policy. An example of a typical industrial policy is import-substitution-industrialization (ISI), where trade barriers are temporarily imposed on some key sectors, such as manufacturing. By selectively protecting certain industries, these industries are given time to learn (learning by doing) and upgrade. Once competitive enough, these restrictions are lifted to expose the selected industries to the international market. At the time of independence, India had an extremely underdeveloped and unbalanced industrial structure. Industries contributed less than one sixth part of national income. The country did have some industries like cotton textiles, jute and sugar, but there were virtually no basic, heavy and capital goods industries on which programmes of future industrialisation could be based. Whatever major industries were there, they were largely concentrated in a few areas such as Bombay. Surat, Ahmedabad. Jameshedpur, Calcutta, Delhi etc. While the rest of the country remained industrially neglected. Thus after independence, the government of India had to undertake effective measures to increase the tempo of industrialisation. Correct regional imbalances in industrial development and rectify the distorted industrial structure through rapid development of capital goods industries.

4.4.1 MEANING

Industrial policy is a statement which defines the role of government in industrial development. The place of the public and private sectors in industrialisation of the country and the relative role of large and small industries. The role of foreign capital etc. In brief, it is a statement of objectives to be achieved in the area of industrial development and the measures to be adopted towards achieving these objectives. The industrial policy thus formally indicates the spheres of activity of the public and the private sectors. It lays down rules and procedures that would govern the growth and pattern of industrial activity. The industrial policy is neither fixed nor inflexible. It is amended, modified and redrafted according to the changed situations, requirements and perspectives of developments. The industrial policy means the procedures, principles, policies rules and regulations which control the industrial undertaking of the country and pattern of industrialization. It explains the approach of Government in context to the development of industrial sector. In India the key objective of the economic policy is to achieve self-reliance in all sectors of the economy and to develop socialistic pattern of society. The industrial policy in the pre-reform period i.e. before1991 put greater emphasis on the state intervention in the field of industrial development. These policies no doubt have resulted into the creation of diversified industrial structure but caused a number of inefficiencies, distortions and rigidities in the system. Thus during late 70's and 80's, Government initiated liberalization measures in the industrial policy framework. The drastic liberalization measures were however, carried out in 1991.

4.4.2 INDUSTRIAL POLICIES PRIOR TO 1991

Industrial Policy Resolution, 1948

The first important industrial policy statement was made in the Industrial policy Resolution (IPR), 1948. The main thrust of IPR, 1948 was to lay down the foundation of mixed economy whereby the private and public sector was accepted as important components in the development of industrial economy of India. The policy divided the industries into four broad categories:

(i) Industries with Exclusive State Monopoly: It included industries engaged in the activity of atomic energy, railways and arms and ammunition.

(ii) Industries with Government Control: It included the industries of national importance and so needs to be registered. 18 such industries were put under this category eg. fertilizers, heavy chemical, heavy machinery etc.

(iii) Industries in the Mixed Sector: It included the industries where private and public sector were allowed to operate. Government was allowed to review the situation to acquire any existing private undertaking.

(iv) Industries under Private Sector: Industries not covered by above catego ries fell in this category.

IPR, 1948 gave public sector vast area to operate. Government took the role of catalytic agent of industrial development. The resolution assigned complementary role to small-scale and cottage industries. The foreign capital which was seen with suspect in the pre-independent era was recognized as an important tool to speedup up industrial development.

4.4.3 INDUSTRIES (DEVELOPMENT AND REGULATION) ACT (IDRA), 1951

IDRA, 1951 is the key legislation in the industrial regulatory framework. IDRA, 1951 gave powers to the government to regulate industry in a number of ways. The main instruments were the regulation of capacity (and hence output) and power to control prices. It specified a schedule of industries that were subject to licensing. Even the expansion of these industries required prior permission of the government which means the output capacity was highly regulated. The Government was also empowered to control the distribution and prices of output produced by industries listed in the schedule. The IDR Act gave very wide powers to the Government. This resulted in more or less complete control by the bureaucracy on the industrial development of the country.

4.4.4 THE MAIN PROVISIONS OF THE IDRA, 1951 WERE

a) All existing undertakings at the commencement of the Act, except those owned by the Central Government were compulsorily required to register with the designated authority.

b) No one except the central Government would be permitted to set up any new industrial undertaking "except under and in accordance with a licence issued in that behalf by the Central Government."

c) Such a license or permission prescribed a variety of conditions, such as, location, minimum standards in respect of size and techniques to be used, which the Central Government may approve.

d) Such licenses and clearances were also required in cases of 'substantial expansion' of an existing industrial undertaking.

4.4.5 Industrial Policy Resolution, 1956

IPR, 1956 is the next important policy statement. The important provisions are as follows:

(1) New classification of Industries: IPR, 1956 divided the industries into the following three categories:

(a) Schedule A industries: The industries that were the monopoly of state or Government. It included 17 industries. The private sector was allowed to operate in these industries if national interest so required.

(b) Schedule B industries: In this category of industries state was allowed to establish new units but the private sector was not denied to set up or expand existing units e.g. chemical industries, fertilizer, synthetic, rubber, aluminum etc.

(c) Schedule C industries: The industries not mentioned in the above category formed pat of Schedule C. Thus the IPR, 1956 emphasized the mutual existence of public and private sector industries.

(2) Encouragement to Small-scale and Cottage Industries: In order to strengthen the small-scale sector supportive measures were suggested in terms of cheap credit, subsidies, reservation etc.

(3) Emphasized on Reduction of Regional Disparities: Fiscal concessions were granted to open industries in backward regions. Public sector enterprises were given greater role to develop these areas.

The basic rationale of IPR, 1956 was that the state had to be given primary role for industrial development as capital was scarce and entrepreneurship was not strong. The public sector was enlarged dramatically so as to allow it to hold commanding heights of the economy.

Monopolies Commission

In April 1964, the Government of India appointed a Monopolies Inquiry

Commission "to inquire into the existence and effect of concentration of economic power in private hands." The Commission looked at concentration of economic power in the area of industry. On the basis of recommendation of the commission, Monopolistic and Restrictive Trade Practices Act (MRTP Act), 1969 was enacted. The act sought to control the establishment and expansion of all industrial units that have asset size over a particular limit.

Industrial Policy Statement, 1973

The Policy Statement of 1973 drew up a list of industries to be started by large business houses so that the competitive effort of small industries was not affected. The entry of competent small and medium entrepreneurs was encouraged in all industries. Large industries were permitted to start operations in rural and backward areas with a view to developing those areas and enabling the growth of small industries around.

Industrial Policy Statement, 1977: The main elements of the new policy were:

1. Development of Small-Scale Sector: The main thrust of the new industrial policy was an effective promotion of cottage and small industries. Government initiated wide-spread promotional and supportive measures to encourage small sector. The small sector was classified into 3 categories viz. Cottage and household industries which provide self-employment; tiny sector and small-scale industries. The purpose of the classification was to specifically design policy measures for each category. The policy statement considerably expanded the list of reserved items for exclusive manufacture in the small-scale sector.

2. Restrictive Approach towards Large Business Houses: The large scale sector was allowed in basic, capital goods and high-tech industries. The policy emphasized that the funds from financial institutions should be made available largely for the development of small sector. The large sector should generate internal finance for financing new projects or expansion of existing business.

3. Expanding Role of Public sector: The industrial policy stated that the public sector would be used not only in the strategic areas but also as a stabilizing force for maintaining essential supplier for the consumer.

Further, the policy statement reiterated restrictive policy towards foreign capital whereby the majority interest in ownership and effective control should rest in Indian hands.

Industrial Policy, 1980

The industrial policy 1980 emphasized that the public sector is the pillar of economic infrastructure for reasons of its greater reliability, for the large investments required and the longer gestation periods of the projects crucial for economic development. The IPR1956 forms the basis of this statement. The important features of the policy were:

1. Effective Management of Public Sector:

The policy emphasized the revival of efficiency of public sector undertaking.

2. Liberalization of Industrial licensing:

The policy statement provided liberalized measures in the licensing in terms of automatic approval to increase capacity of existing units under MRTP and FERA. The asset limit under MRTP was increased. The relaxation from licensing was provided for large number of industries. The broad-banding concept was introduced so that flexibility is granted to the industries to decide the product mix without applying for a new license.

3. Redefining Small-Scale Industries:

The investment limit to define SSI was increased to boost the development of this sector. In case of tiny sector the investment limit was raised to Rs.1 lakh; for small scale unit the investment limit was raised from Rs.10 lakh to Rs.20 lakh and for ancillaries from Rs.15 lakh to Rs. 25 lakh.

Industrial policy, 1980 focused attention on the need for promoting competition in the domestic market, technological up gradation and modernization. The policy laid the foundation for an increasingly competitive export based industries and for encouraging foreign investment in high-technology areas.

4.4.6 ERA OF LIBERALIZATION AFTER 80'S:

After 1980, an era of liberalization started, and the trend was gradually to dilute the strict licensing system and allow more freedom to the entrepreneurs. The steps that were taken in accordance with the policy included:

(i) Re-endorsement of licenses: The capacity indicated in the licenses could be re-endorsed, provided it was 25 percent more than the licensed capacity (1984).

(ii) Liberalization of 1990: The measures were as follows:

a) Exemption from licensing for specific new units.

b) Investment of foreign equity up to 40 percent was freely allowed.

c) Location restrictions were removed.

4.4.7 MAJOR FEATURES OF PRE-1991 INDUSTRIAL POLICY:

1. Protection to Indian Industries: Local industries were given shelter from international competition by introducing partial physical ban on the imports of products and high imports tariffs. Protection from imports encouraged Indian industry to undertake the manufacture of a variety of products. There was a ready market for all these products.

2. Import-Substitution Policy: Government used its import policy for the healthy development of local industries. Barring the first few years after Independence, the country was facing a shortage of foreign exchange, and so save scarce foreign exchange imports-substitution policy was initiated i.e. Government encouraged the production of imported goods indigenously.

3. Financial Infrastructure: In order to provide the financial infrastructure necessary for industry, the Government set up a number of development banks. The principal function of a development bank is to provide medium and long-term investments. They have to also play a major role in promoting the growth of enterprise. With this objective, Government established the Industrial Finance Corporation of India (IFCI) (1948), Industrial Credit and Investment Corporation of India (ICICI) (1955), Industrial Development Bank of India (IDBI) (1964), Industrial Reconstruction Corporation of India (1971), Unit Trust of India (UTI) (1963), and the Life Insurance Corporation of India (LIC).

4. Control over Indian Industries: Indian industries were highly regulated through legislations such as Industrial licensing, MRTP Act, 1969 etc. These legislations restricted the production, expansion and pricing of output of almost all kinds of industries in the country.

5. Regulations on Foreign Capital under the Foreign Exchange and Regulation Act (FERA): FERA restricted foreign investment in a company to 40percent. This ensured that the control in companies with foreign collaboration remained in the hands of Indians. The restrictions were also imposed on technical collaborations and repatriations of foreign exchange by foreign investors.

6. Encouragement to Small Industries: Government encouraged small-scale industries (SSIs) by providing a number of support measures for its growth. Policy measures addressed the basic requirements of the SSI like credit, marketing, technology, entrepreneurship development, and fiscal, financial and infrastructural support.

7. Emphasis on Public Sector: The Government made huge investments in providing infrastructure and basic facilities to industries. This was achieved by establishing public sector enterprises in the key sectors such as power generation, capital goods, heavy machineries, banking, tele- communication, etc.

4.4.8 REVIEW OF PRE-1991 INDUSTRIAL POLICY

The pre1991 industrial policies created a climate for rapid industrial growth in the country. It has helped to create a broad-base infrastructure and basic industries. A diverse industrial structure with self-reliance on a large number of items had been achieved. At the time of independence the consumer goods industry accounted for almost half of the industrial production. In 1991 such industries accounted for only about 20 percent. In contrast capital goods production was less than 4 percent of the total industrial production. In 1991 it had gone up to 24 percent. Industrial investment took place in a large variety of new industries. Modern management techniques were introduced. An entirely new class of entrepreneurs has come up with the support system from the Government, and a large number of new industrial centers have developed in almost all parts of the country. Over the years, the Government has built the infrastructure required by the industry and made massive investments to provide the much-needed facilities of power, communications, roads etc. A good number of institutions were promoted to help entrepreneurship development, provide finance for industry and to facilitate development of a variety of skills required by the industry.

However, the implementation of industrial policy suffered from shortcomings. It is argued that the industrial licensing system has promoted inefficiency and resulted in the high-cost economy. Licensing was supposed to ensure creation of capacities according to plan priorities and targets. However, due to considerable discretionary powers vested in the licensing authorities the system tended to promote corruption and rent-seeking. It resulted into pre-emption of entry of new enterprises and adversely affected the competition. The system opposite to its rationale favored large enterprises and discriminate against backward regions. Government announced a number of liberalization measures in the industrial policy of 1970, 1973 and 1980. However, the dramatic liberalization efforts were made in the industrial policy, 1991.

4.4.9 NEW INDUSTRIAL POLICY, 1991

India's New Industrial Policy announced in July 1991 (hereafter NIP) was radical compared to its earlier industrial policies in terms of objectives and major features. It emphasized on the need to promote further industrial development based on consolidating the gains already made and correct the distortion or weaknesses that might have crept in, and attain international competitiveness. (Ministry of Industry, 1991). The liberalized Industrial Policy aims at rapid and substantial economic growth and integration with the global economy in a harmonized manner. The Industrial Policy reforms have reduced the industrial licensing requirements, removed restrictions on investment and expansion, and facilitated easy access to foreign technology and foreign direct investment.

1. Distinctive Objectives of New Industrial Policy (NIP), 1991: NIP had two distinctive objectives compared to the earlier industrial policies:

i) Redefinition of Concept of Self-Reliance: NIP redefined the concept of economic self-reliance. Since 1956 till 1991, India had always emphasized on Import Substitution Industrialization (ISI) strategy to achieve economic-self reliance. Economic self-reliance meant indigenous development of production capabilities and producing indigenously all industrial goods, which the country would demand rather than importing from outside. The goal of economic self-reliance necessitated the promotion of ISI strategy. It helped to built up the vast base of capital goods, intermediate goods and basic goods industries over a period of time. NIP redefined economic self-reliance to mean the ability to pay for imports through foreign exchange earnings through exports and not necessarily depending upon the domestic industries.

ii) International Competitiveness: NIP emphasized the need to develop indigenous capabilities in technology and manufacturing to world standards. None of the earlier industrial policies, either explicitly or implicitly, had made reference to international technology and manufacturing capabilities in the context of domestic industrial development (Ministry of Commerce and Industry, 2001). For the first time, NIP explicitly underlined the need for domestic industry to achieve international competitiveness.

To achieve these objectives, among others, NIP initiated changes in India's industrial policy environment, which gained momentum gradually over the decade. The **important elements of NIP** can be classified as follows:

1. Public sector de-reservation and privatization of public sector through dis-investment;

2. Industrial Delicensing;

3. Amendments of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969;

4. Liberalised Foreign Investment Policy;

5. Foreign Technology Agreements (FTA);

6. Dilution of protection to SSI and emphasis on competitiveness enhancement.

1. Public Sector De-Reservation and Privatization through Dis-Investment:

Till 1991, Public Sector was assigned a pre-eminent position in Indian Industry to enable it to achieve "commanding heights of the economy" under the Industrial Policy Resolution (IPR), 1956. Accordingly, areas of strategic importance and core sectors were exclusively reserved for public sector enterprises. Public enterprises were accorded preference even in areas where private investments were possible.

Since 1991, **the public sector policy** consists of:

(i) Reduction in the number of industries reserved for public sector: Now only two industries (atomic energy and railway transport) are reserved for the Public Sector. They are known as "Annexure I" industries (Ministry of Commerce and Industry, 2001). The essence of government's Public Sector Undertakings (PSUs) policy since 1991 has been that government should not operate any commercial enterprises. The policy emphasized to bring down government equity in all non-strategic PSUs to 26 percent or lower, restructure or revive potentially viable PSUs, close down PSUs, which cannot be revived and fully protect the interests of workers. Government's withdrawal from non-core sectors is indicated on considerations of long-term efficient use of capital, growing financial un-viability and the compulsions for these PSUs to operate in an increasingly competitive and market oriented environment (Disinvestment Commission, 1997).

(ii) Implementation of Memorandum of Understanding (MOU): As a part of the measures to improve the performance of public enterprises, more and more of public sector units have been brought under the purview of Memorandum of

Understanding (MoU) system. A memorandum of understanding is a performance contract, a freely negotiated document between the Government and a specific public enterprise.

(iii) Referral to BIFR: Many sick public sector units have been referred to the Board for Industrial and Financial Reconstruction (BIFR) for rehabilitation or, where necessary, for winding up.

(iv) Manpower Rationalization: In order to make manpower rationalization Voluntary Retirement Scheme (VRS) has been introduced in a number of PSUs to shed the surplus manpower.

(v) Private Equity Participation: PSUs have been allowed to raise equity finance from the capital market. This has provided market pressure on PSUs to improve their performance.

(vi) Disinvestment and Privatization: Disinvestment and privatization of existing PSUs has been adopted to improve corporate efficiency, financial performance and competition amongst PSUs. It involves transfer of Government holding in PSUs to the private shareholders.

2. Industrial Delicensing:

The removal of licensing requirements for industries, domestic as well as foreign, commonly known as "de-licensing of industries" is another important feature of NIP. Till the 1990s, licensing was compulsory for almost every industry, which was not reserved for the public sector. This licensing system was applicable to all industrial enterprises having investment in fixed assets (which include land, buildings, plant & machinery) above a certain limit. With progressive liberalization and deregulation of the economy, industrial license is required in very few cases. Industrial licenses are regulated under the Industries (Development and Regulation) Act 1951. At present, industrial license is required only for the following:

(i) Industries retained under compulsory licensing (five industries are reserved under this category).

(ii) Manufacture of items reserved for small scale sector by larger units: An industrial undertaking is defined as small scale unit if the capital investment does not exceed Rs. 10 million (approximately $ 222,222). The Government has reserved certain items for exclusive manufacture in the small-scale sector. Non small-scale units can manufacture items reserved for the small-scale sector if they undertake an obligation to export 50 percent of the production after obtaining an industrial license.

(iii) When the proposed location attracts locational restriction: Industrial undertakings to be located within 25 kms of the standard urban area limit of 23 cities having a population of 1 million as per 1991 census require an industrial license.

Thus, excluding these, investors are free to set up a new industrial enterprise, expand an industrial enterprise substantially, change the location of an existing industrial enterprise and manufacture a new product through an already established industrial enterprise. The objective of industrial delicencing would be to enable business enterprises to respond to the fast changing external conditions. Entrepreneurs will be free to make investment decisions on the basis of their own commercial judgment. This will facilitate the technological dynamism and international competitiveness. Further industries will have freedom to take advantage of 'economies of scale' as well as 'economies of scope' in the current industrial policy environment.

3. Amendment of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969: An important objective of India's earlier industrial policies was to prevent emergence of private monopolies and concentration of economic power in a few individuals. Accordingly, Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 was enacted and MRTP Commission was set up as a permanent body to periodically review industrial ownership, advice the government to prevent concentration of economic power, investigate monopolistic trade practices and inquire into restrictive trade practices, which are prejudicial to public interest. An MRTP firm was mainly defined in terms of asset size. An MRTP company had to obtain prior approval of the government for setting up a new enterprise as well as for expansion. However, MRTP Act was applicable only to private sector companies.

Since 1991 MRTP Act has been restructured and pre-entry restrictions have been removed with regard to prior approval of the government for the establishment of a new undertaking, expansion, amalgamation, merger, take over, and appointment of directors of companies. The asset restriction and market share for defining an MRTP firm has been done away with. MRTP Act is now applicable to both private and public sector enterprises and financial institutions. Today only restrictive trade practices of companies are monitored and controlled. The MRTP act has been replaced by the Competition Act, 2002. This law aims at upholding competition in the Indian market. The competition commission has been established in 2003 which mainly control the practice that have an adverse impact on competition.

4. Liberalized Foreign Investment Policy:

India's earlier industrial policies welcomed FDI but emphasized that ownership and control of all enterprises involving foreign equity should be in Indian hands. The Balance of Payments (BoP) difficulties in the mid 1960s forced the country to adopt a more restrictive approach towards FDI through the setting up of a Foreign Investment Board, which classified industries into two groups: banned and favored for foreign technical collaboration and FDI. The number of industries for foreign investment was steadily narrowed down and by 1973 there were only 19 industries where FDI was permitted (Kucchal, 1983).The enactment of FERA, 1973 marked the beginning of the most restrictive phase of India's foreign investment policy. The NIP radically reformed foreign investment policy to attract foreign investment. The important foreign investment policy measures are as follows:

i) Repeal of FERA, 1973: FERA, 1973 has been repealed and Foreign Exchange Management Act (FEMA) has come into force with effect from June 2000 (RBI, 2003). Investment and returns can be freely repatriated except where the approval is subject to specific conditions such as lock-in period on original investment, dividend cap, foreign exchange neutrality, etc. as specified in the sector specific policies. The condition of 'dividend balancing' was withdrawn for dividends declared. A foreign investor can freely enter, invest and operate industrial enterprises in India,

ii) Dilution of Restrictions on Foreign Direct Investment (FDI): FDI is allowed in all sectors including the services sector except atomic energy and railway transport. FDI in small scale industries is allowed up to 24 percent equity. Use of brand names/trade marks is allowed. Further, FDI up to 100 percent is allowed under the automatic route in all activities/sectors

5. Foreign Technology Agreement

The automatic approvals for technology agreement are allowed to industries within specified parameters. Indian companies are free to negotiate the terms of technology transfer with their foreign counterparts according to their own commercial judgment.

6. Dilution of Protection to Small Scale Industries (SSI) and Emphasis on Competitiveness: SSIs enjoyed a unique status in Indian economy due to its diversified presence across the country and thereby utilizing resources and skills, which would have otherwise remained unutilized. Due to their potential to generate large-scale employment, produce consumer goods of mass consumption, alleviate regional disparities, etc., industrial policies protected the sector for its growth. The principal protective measures for SSI comprised:

(i) Demarcating SSI from the rest of industry through a definition under the IDR Act, 1951

(ii) Concessional credit from the banking system

(iii)Fiscal concessions

(iv) Exemption from industrial licensing and labor legislations

(v) Preferential access to scarce raw materials, both domestic and imported

(vi) Market support from the government through reservation of products for government purchase and price preferences

(vii) Reservation of products for exclusive manufacturing in SSIs and restrictions on the growth of output and capacity in the large-scale sector for products reserved for SSI manufacturing. These policy measures protected SSIs from both internal and external competition.

However, since 1991 the protective emphasis of SSI policy has undergone dilution. In August 1991, government of India brought out an exclusive policy for SSI. The policy marked: (i) the beginning of an end to protective measures to small industry and (ii) promotion of competitiveness by addressing the basic concerns of the sector namely technology, finance and marketing. Subsequently, the number of items reserved exclusively for small industry manufacturing has been gradually brought down. This policy has lost its relevance to a large extent because though these products could not be manufactured by large enterprises domestically, they can be imported from abroad due to the removal quantitative and non-quantitative restrictions on most imports by April 1, 2001 (Ministry of Finance, 2002). Concession element in lending rates for small industry has been largely withdrawn during the 1990s (RBI, 2003). The number of products reserved exclusively for purchase from small industry by the government has been reduced to 358 items from 409 items. Measures have been adopted to improve technology and export capabilities of SSIs. Thus the overall promotion orientation of SSI has shifted from protection towards competitiveness.

4.4.10 IMPACT OF INDUSTRIAL POLICY, 1991

The all-round changes introduced in the industrial policy framework have given a new direction to the future industrialization of the country. There are encouraging trends on diverse fronts. Industrial growth was 1.7 per cent in 1991-92 that has increased to 9.2 percent in 2007-08.The industrial structure is much more balanced. The impact of industrial reforms is reflected in multiple increases in investment envisaged, both domestic and foreign. This is due to encouraging response from the private sector. There has been dramatic increase in FDI since 1991. The foreign investment as a percentage of total GDP has increased from 0.5 percent in 1990-91 to 5.7 percent in 2006.Investments in infrastructure sector such as power generation have surged from players of various sizes in different states. The capital goods have grown at an accelerated pace, over a high base attained in the previous years, which augurs well for the required industrial capacity addition.

Features

The New Industrial Policy of 1991 comes at the center of economic reforms that launched during the early 1990s. All the later reform measures were derived out of the new industrial policy. The Policy has brought comprehensive changes in economic regulation in the country. As the name suggests, these reform measures were made in different areas related to the industrial sector.

As part of the policy, the role of public sector has been redefined. A dedicated reform policy for the public sector including the disinvestment programme were launched under the NIP 1991. Private sector has given welcome in major industries that were previously reserved for the public sector.

Similarly, foreign investment has given welcome under the policy. But the most important reform measure of the new industrial policy was that it ended the practice of industrial licensing in India. Industrial licensing represented red tapism.

Because of the large scale changes, the Industrial Policy of 1991 or the new industrial policy represents a major change from the early policy of 1956.

The new policy contained policy directions for reforms and thus for LPG (Liberalisation, Privatisation and Globalisation). It enlarged the scope of private sector participation to almost all industrial sectors except three (modified). Simultaneously, the policy has given welcome to foreign investment and foreign technology. Since 1991, the country's policy on foreign investment is gradually evolving through the introduction of liberalization measures in a phase wise manner.

Perhaps, the most welcome change under the new industrial policy was the abolition of the practice of industrial licensing. The1991 policy has limited industrial licensing to less than fifteen sectors. It means that to start an industry, one has to go for license and waiting only in the case of these few selected industries. This has ended the era of license raj or red tapism in the country. The 1991 industrial policy contained the root of the liberalization, privatization and globalization drive made in the country in the later period. The policy has brought changes in the following aspects of industrial regulation:

1. Industrial delicensing

2. Deregulation of the industrial sector

3. Public sector policy (dereservation and reform of PSEs)

4. Abolition of MRTP Act

5. Foreign investment policy and foreign technology policy.

1. Industrial delicensing policy or the end of red tapism: the most important part of the new industrial policy of 1991 was the end of the industrial licensing or the license raj or red tapism. Under the industrial licensing policies, private sector firms have to secure licenses to start an industry. This has created long delays in the start up of industries. The industrial policy of 1991 has almost abandoned the industrial licensing system. It has reduced industrial licensing to fifteen sectors. Now only 13 sector need license for starting an industrial operation.

2. Deregulation of the industrial sector- Previously, the public sector has given reservation especially in the capital goods and key industries. Under industrial deregulation, most of the industrial sectors was opened to the private sector as well. Previously, most of the industrial sectors were reserved to the public sector. Under the new industrial policy, only three sectors- atomic energy, mining and railways will continue as reserved for public sector. All other sectors have been opened for private sector participation.

3. Reforms related to the Public sector enterprises: reforms in the public sector were aimed at enhancing efficiency and competitiveness of the sector. The government identified strategic and priority areas for the public sector to concentrate. Similarly, loss making PSUs were sold to the private sector. The government has adopted disinvestment policy for the restructuring of the public sector in the country. at the same time autonomy has been given to PSU boards for efficient functioning.

4. Foreign investment policy: another major feature of the economic reform measure was it has given welcome to foreign investment and foreign technology. This measure has enhanced the industrial competition and improved business environment in the country. Foreign investment including FDI and FPI were allowed. Similarly, loan capital has also introduced in the country to attract foreign capital.

5. Abolition of MRTP Act: The New Industrial Policy of 1991 has abolished the Monopoly and Restricted Trade Practice Act. In 2010, the Competition Commission has emerged as the watchdog in monitoring competitive practices in the economy.

The industrial policy of 1991 is the big reform introduced in Indian economy since independence. The policy caused big changes including emergence of a strong and competitive private sector and a sizable number of foreign companies in India

The Government policies and procedures in the pre-1991 period aimed at industrial development of the country, but the enactment of the IDR Act, procedures laid down for obtaining industrial licensing and various rules acted as a great deterrent to the growth of industries in the country. The bureaucracy acquired unprecedented powers and authority over all kinds of industrial activities. The NIP announced in July 1991, unshackle the industries from the cobweb of bureaucratic control to allow it to achieve international competitiveness. NIP encouraged foreign investment in the economy and opened it to greater domestic and international competition.

4.4.11 GLOBALIZATION

Broadly speaking, the term 'globalization' means integration of economies and societies through cross country flows of information, ideas, technologies, goods, services, capital, finance and people. Cross border integration can have several dimensions - cultural, social, political and economic. The Policies and developments in many countries including India are influenced by the globalization. Globalization is not only a movement of ideas, information, capitals, people, technologies, goods and services, and labour across the nation-states but has serious implications on socio-economic and political sphere of life. Limiting ourselves to economic integration only, one can see the three channels of globalization (a) trade in goods and services, (b) movement of capital and (c) flow of finance and (d) movement of people. The globalization through economic integration has been presented as the best, natural and universal path towards development of mankind

Process of Globalization

(a) The integration of the national economy with that of the global economy.

(b) The conversation of a national market into an international one, which facilitates the international mobility of factors like production or commodities.

(c) An economic as well as a political, social, and cultural integration with rest of the world, though it varies greatly from country to country, which in turn depends on the development of means and modes of communication in a particular country. In current economic literature, the term 'globalization' is used to mean liberal "outward oriented" policy, which includes eliminating anti export biases, lowering of a very high import tariffs, placing lesser reliance on quantitative restrictions on imports. This is the aim of the liberalization policy adopted by India. However, the "outward-looking" policy does not mean that government would completely abandon all forms of control and place the entire economy to remove certain imbalances and restrictions, which hamper free flow of trade. Globalization also aims at making greater number of goods and services available to the people, at relatively cheaper prices. Thus, it is believed, globalization would generally improve the economic performance of the nation.

Main Features of Economic Globalization

From about the end of 19th century, key technological developments in transportation and communication as well as of trade have contributed to the increasing economic integration of the world. Some fundamental aspects of globalization include:

1. Post Industrialism: According to David Harvey, there has been a transition (shift) from 'fixed' industrial system to regime of 'flexible accumulation' characterized by flexibility in labour processes, products and patterns of consumption; and increasing mobility of capital and labour. This 'post industrial' system is marked by increasing centralization of capital in the hands of big corporations at one end, and flourishing of

small business at the other, with the former dominating the latter. Capitalism is becoming more tightly organized. Since there is more centralized control over trade enabled by growth of information technology and reorganization of global financial system.

2. World Trade: World trade links geographically dispersed produces and consumers. While USA became the largest trading nation in 20th century, GATT established in 1947, aimed at freer trade through agreed reduced tariffs, led to the growth of world trades and reduction in relative share of major industrial powers in world trade. Major push is towards globalization of markets.

3. Multinational Corporations: Integration of global economy has given raise to MNC's which are powerful not only economically but politically also. Overall, 51 of the largest economies in the world are corporations. According to the UN Development Programme, 500 corporations now control 70% of the world's trade and 80% of its foreign investment.

4. New International Division of Labour: Internalization of capital since the 1970's had led to economic restructuring reflected in deindustrialization of developed countries and a shift to tertiary (service) sector activities such as banking, finance, specialized administrative services, etc. while manufacturing and assembly operations are exported to less developed countries where labour is cheap and laws are lax. But it was noticed that with technological innovations such as automation, computerization, the question of cheap labour does not arise; labour productivity can be enhanced with lesser number of workers. Hence major shift in industrial organization is to new systems of flexible specialization, just-in-time delivery TQM, etc. Rather than direct investment by first world MNC's in third world through local subsidiaries, there is now a wide variety of negotiated agreements: joint ventures, marketing agreements, secondary sourcing, subcontracting various kinds of limited alliances. MNCs look at less developed countries mainly not as a source of cheap labour and raw materials but as expanding local markets and potential industrial partners.

5. Financial Markets: IMF has started controlling the finance aspect. As a result of debt crisis, countries turn to IMF, which then imposes devaluation of currency, structural adjustment programme and other conditions. Global financial institutions

exert enormous control over the domestic policies of member countries and in 1980's, they started advocating liberalization, privatization and globalization. MNC's have started demanding free capital movement and opening of capital and other markets.

4.4.12 LIBERALIZATION

Liberalization is understood to be the situation of the political economy where the means of production will be in the hands of the market and the economic efficiency is measured in terms of market-defined objectives. Major economic activities are opened for private participation keeping only key issues of welfare and other regulatory mechanism with the state. This opening up of various sectors for private participation and allowing them to manage the businesses for maximizing the profits will clearly underline the freedom available for the market to have their own labour participation practices and deployment of human resources. Liberalisation thus aims minimizing the labour participation and downsizing the workforce in the industry in the name of removing the dead wood to maximize efficiency.

In the Indian context, economic liberalization includes the following:

1. Dismantling of industrial licensing system
2. Reduction in physical restrictions on imports and import duties
3. Reduction in controls on foreign exchange, both current and capital account
4. Reform of financial system
5. Reduction in levels of personal and corporate taxation
6. Reduction in restrictions on foreign direct and portfolio investments
7. Opening up public sector domains like power, transport, banking etc
8. Partial privatization of public sector units
9. Change in approach towards industrial sickness

10. Softening of MRTP regulations

Effects of Liberalization

The economic reforms of the 1990s swept away the oppressive licensing controls on industry and foreign trade, allowed the market to determine the exchange rate, drastically reduced protective customs tariffs, opened up to foreign investment, modernised the stock markets, freed interest rates, strengthened the banking system and began privatisation of public enterprises. Airline, telecom, TV broadcast and insurance were opened for private players. The consequences have been far-reaching.

First, the opening up of foreign trade and investment (and a competitive exchange rate) boosted exports, services and inward remittances enormously; today they account for 20 per cent of the GDP compared to 10 per cent in 1990. Flourishing external commerce and rising foreign investment dethroned the baleful deity of "foreign exchange scarcity", which had justified four decades of dreadful economic policy and draconian, corruption-spawning controls. Today's open economy is more productive and more resilient to shocks like high oil prices. With over $140 billion of forex reserves, strong exports and low external debt, the recent surge in global oil prices has not derailed the economy's forward momentum. Second, the mix of industrial decontrol, greater foreign competition and a modernised capital market fostered the rise of strong Indian firms, built by unshackled entrepreneurs able to compete globally. Today's household brands like Infosys, Jet, Airtel and Videocon hardly existed a decade ago. Established companies like Tata, Reliance and HLL reinvented themselves to meet competition. This led to larger advertising budgets, which sustained the media explosion (print and TV) of the past decade that has helped to mould a new mindset. Third, the post-crisis reforms of the early 1990s restored (then improved) the growth momentum of the 1980s and ensured a quarter century of nearly 6 per cent economic growth. With average living standards rising at almost 4 per cent a year, the poverty ratio dropped below a quarter of the population and the catch phrase of "a rising middle class" gained substance. Today, over a 100 million Indians live in households with incomes between Rs.2 lakh and Rs.10 lakh a year. Fourth, the strong improvement in the country's external finances and sustained growth over 25 years also raised India's economic and political profile in the world. In a real sense, the 1990s' economic liberalisation freed India's foreign and defence policies from economic weakness and dependence on foreign aid. A more assertive strategic policy became possible. 1.Liberalization was reinforced by the conclusion of the Uruguay round of multi-lateral trade negotiation in 1994 and the establishment of WTO.

2. The expansion of regional integration efforts also stimulates the trend towards liberalization.

3. Liberalization policies have significantly widened the effective economic space available to producers and investors.

4. Producers and investors behave as if the world economy consisted of a single market and production platforms with regional or national sub-sections rather than as a set of national economies linked by trade and investment flows.

5. However, liberalization is also endangered by the rise of national protectionism and the use of economic sanctions by the leading economic powers.

4.4.13 PRIVATIZATION

Privatization is a process that reduces the involvement of the state or the public sector in the economic activities. Privatization implies many on the government sectors are sold or given to private individual hands to run them. Privatization is frequently associated with industrial or service-oriented enterprises, such as mining, manufacturing or power generation, but it can also apply to any asset, such as land, roads, or even rights to water. In recent years, government services such as health, sanitation, and education have been particularly targeted for privatization in many countries." In recent years, privatization has been suggested as a measure to cure problems related to the public sector such as mounting losses, low profitability, and underutilization of capacity, etc. There has been rising interest in privatization process in the developing countries in the recent past. In fact, Bimal Jalan (former RBI Governor) has argued that it is the low return of investment in the public sector enterprises that is to a large extent, responsible for the fiscal crisis of the Central Government. Serious problems are observed in the form of:

1. Insufficient growth in productivity

2. Poor project management

3. Lack of continuous technological up-gradation

4. Inadequate attention to research and development and human resources development

In addition, public enterprises have shown a very low rate of return on the capital investment. This had hindered their ability to regenerate themselves in terms of new investments as well as in technology development. The outcome is that many of the public enterprises have become a burden rather than being an asset to the government. Privatization is an essentially effective tool for restructuring and reforming the public sector enterprises running without significant aim and mission as private sector is perceived to be fundamentally more self motivated, prolific and reliable for superior quality of products and services. Privatization can be of three prominent types:

1. Delegation: Government keeps hold of responsibility and private enterprise handles fully or partly the delivery of product and services.

2. Divestment: Government surrenders the responsibility.

3. Displacement: The private enterprise expands and gradually displaces the government entity.

Impact of Privatization on Indian Economy

1. It frees the resources for a more productive utilisation.

2. Private concerns tend to be profit oriented and transparent in their functioning as private owners are always oriented towards making profits and get rid of sacred cows and hitches in conventional bureaucratic management.

3. Since the system becomes more transparent all underlying corruption are minimized and owners have a free reign and incentive for profit maximisation so they tend to get rid of all free loaders and vices that are inherent in government functions.

4. Gets rid of employment inconsistencies like free loaders or over employed departments reducing the strain on resources.

5. Reduce the government's financial and administrative burden.

6. Effectively minimises corruption and optimises output and functions.

7. Private firms are less tolerant towards capitulation and appendages in government departments and hence tend to right size the human resource potential befitting the organisations needs and may cause resistance and disgruntled employees who are accustomed to the benefits as government functionaries.

8. Permit the private sector to contribute to economic development.

9. Development of the general budget resources and diversifying sources of income

4.5 MONETARY POLICY- OBJECTIVES AND INSTRUMENTS OF CREDIT CONTROL

Traditionally macroeconomics and development are treated as separate. It follows, inclusion

typically discussed in the latter category, is regarded as separate from monetary policy. It is in development economics the large informal sector is analyzed. But after independence, monetary policy was subordinated to planned development and therefore implicitly directed at inclusion. Even so the sphere acted on and reacted to was a limited one, since large areas of the economy were still not monetized, and the modern sector was small. So inclusion was about expanding the sphere of the modern economy. But the results were disappointing as development occurred only at a snail's pace. As reforms successfully pushed up growth rates, the ease of transition from the informal to the formal sector has risen implying a higher elasticity of aggregate supply. A whole new range of jobs are available; inclusion is potentially easier. Once a populous emerging market (EM) crosses a critical threshold and high catch-up growth is established, higher labour mobility blurs the distinction between formal and informal sectors. A macroeconomics of the aggregate economy becomes both necessary and feasible. Since monetary policy affects a larger part of the economy, it can directly affect inclusion by affecting the pace of job creation. There are problems that tend to raise costs thus pushing up the price at which any level of output is available. If these are addressed, monetary policy can better support inclusive growth. This requires a change in the type and efficacy of government policies designed for inclusion. Such improvements have become politically and technologically feasible. Although inclusion is a term of relatively recent coinage, monetary policy in independent India always had a commitment to development. The ideas of the time favoured planning, and it early became a national goal. The fervor that followed independence also made it natural to give precedence to development. To support planned development, with the commanding heights for capital-intensive public sector projects, the emphasis was on generating resources for public investment, allocating resources to priority sectors, and expanding the reach of the formal financial system1. Institutions such as the big development banks were set up. The early push towards inclusive financial deepening included the expansion of bank branches after nationalization, with emphasis on rural branches and on credit to agriculture. The RBI also worked towards larger sized financially viable rural cooperatives that could have eliminated the middleman. But the government chose to emphasize village level cooperatives. In setting up the RBI, checks and balances were put in to give a degree of freedom from political influence. These were regarded as essential for the control of inflation. Under the constitution

and the division of responsibilities, if the RBI did not follow the policy direction given by the finance minister, the government would have to go to Parliament, which could assert some

discipline. But since monetary policy had to support resource mobilization for the Plan precedents and procedures became established that vitiated the autonomy of the RBI. It came to be regarded as a department of the government-monetary policy became one more another instrument to achieve national goals. The Bank's primary responsibility became to find resources for Government expenditure. Small steps taken to accommodate government borrowing requirements led, over time, to the destruction of autonomy. And the RBI found it had adopted and internalized what had earlier been the opposite government view.

4.5.1 Monetary policy

It is the process by which the monetary authority of a country, like the central bank or currency board, controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency. Further goals of a monetary policy are usually to contribute to economic growth and stability, to lower unemployment, and to maintain predictable exchange rates with other currencies. Monetary economics provides insight into how to craft an optimal monetary policy. Since the 1970s, monetary policy has generally been formed separately from fiscal policy, which refers to taxation, government spending, and associated borrowing. Monetary policy is referred to as either being expansionary or contractionary. Expansionary policy is when a monetary authority uses its tools to stimulate the economy. An expansionary policy increases the total supply of money in the economy more rapidly than usual. It is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Also, this increases the aggregate demand (the overall demand for all goods and services in an economy), which boosts growth as measured by gross domestic product (GDP). Expansionary monetary policy usually diminishes the value of the currency, thereby decreasing the exchange rate. The opposite of expansionary monetary policy is contractionary monetary policy, which slows the rate of growth in the money supply or even shrinks it. This slows economic growth to prevent inflation. Contradictory monetary policy can lead to increased unemployment and depressed borrowing and spending by consumers and businesses, which can eventually result in an economic recession; it should hence be well managed and conducted with care. Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity. In India, monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth. The RBI implements the monetary policy through open market operations, bank rate policy, reserve system, credit control policy, moral persuasion and through many other instruments. Using any of these instruments will lead to changes in the interest rate, or the money supply in the economy. Monetary policy can be expansionary and contradictory in nature. Increasing money supply and reducing interest rates indicate an expansionary policy. The reverse of this is a contradictory monetary policy. For instance, liquidity is important for an economy to spur growth. To maintain liquidity, the RBI is dependent on the monetary policy. By purchasing bonds through open market operations, the RBI introduces money in the system and reduces the interest rate. Monetary Policy of India is formulated and executed by Reserve Bank of India to achieve specific objectives. It refers to that policy by which central bank of the country controls(i) the supply of money, and (ii) cost of money or the rate of interest, with a view to achieve particular objectives.

In the words of D.C. Rowan, "The monetary policy is defined as discretionary act undertaken by the authorities designed to influence (a) the supply of money, (b) cost of money or rate of interest, and (c) the availability of money for achieving specific objective." Thus, monetary policy of India refers to that policy which is concerned with the measures taken to regulate the volume of credit created by the banks. The main objectives of monetary policy are to achieve price stability, financial stability and adequate availability of credit for growth.

4.5.2 ELEMENTS OF THE MONETARY POLICY OF INDIA

i. It regulates the stocks and the growth rate of money supply.

ii. It regulates the entire banking system of the economy.

iii. It determines the allocation of loans among different sectors.

iv. It provides incentives to promote savings and to raise the savings-income ratio.

v. It ensures adequate availability of credit for growth and tries to achieve price stability.

4.5.3 OBJECTIVES OF MONETARY POLICY:

According to RBI Governor Dr. D. Subba Rao, "The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability."

Following are the main objectives of monetary policy:

i. To Regulate Money Supply in the Economy:

Money supply includes both money in circulation and credit creation by banks. Monetary policy is farmed to regulate the money supply in the economy by credit expansion or credit contraction. By credit expansion (giving more loans), the money supply can be expanded. By credit contraction (giving less loans) money supply can be decreased.

The main aim of the monetary policy of the Reserve Bank was to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

ii. To Attain Price Stability:

Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

iii. To promote Economic Growth:

An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

iv. To Promote saving and Investment:

By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

v. To Control Business Cycles:

Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

vi. To Promote Exports and Substitute Imports:

By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

vii. To Manage Aggregate Demand:

Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

viii. To Ensure more Credit for Priority Sector:

Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

ix. To Promote Employment:

By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.

x. To Develop Infrastructure:

Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.

xi. To Regulate and Expand Banking:

RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks. All this has expanded banking in all parts of the country.

4.5.4 Instruments of Monetary Policy:

The instruments of monetary policy are of two types: first, quantitative, general or indirect; and second, qualitative, selective or direct. They affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit. We discuss them as under:

Bank Rate Policy:

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the central bank becomes costly and commercial banks borrow less from it.

The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate.

It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

Open Market Operations:

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise and fall in price is checked.

Changes in Reserve Ratios:

This weapon was suggested by Keynes in his Treatise on Money and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

Selective Credit Controls:

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them.

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 60% means that the pledger of securities of the value of Rs 10,000 will be given 40% of their value, i.e. Rs 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

4.5.5 REFORMS IN THE INDIAN MONETARY POLICY

The Monetary Policy of RBI has major changes during the economic reforms. Monetary Policy is separated from Fiscal Policy after 1991.

The major changes in the Indian Monetary Policy are as follows:-

1. Reduced CRR And SLR

The Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio(SLR) are gradually reduced during the economic reforms period in India. It is reduced from the earlier high level of 15% plus incremental CRR of 10.5% to current 6% level .The SLR is also reduced from early 30.5% to current minimum of 24% level. This has left more loan able funds with commercial banks.

2. Increased Micro Finance

The RBI has focused more on the SHG (self help group) to strengthen the Rural Finance. Micro Finance Institutions (MFIs) are kept under priority sector lending e.g- Urban Co-operative banks. It comprises small and marginal farmers, Agriculture and Non- Agriculture

Labor, Artisans and Rural sections of the society. Now, still only 30% of the target population has been benefited.

3. Fixing Prudential Norms

In order to induce professionalism in its operations, the RBI fixed prudential norms for commercial banks. It includes recognition of income sources, classification of assets, provisions for bad-debts, maintaining international standards in accounting practices etc. It helped banks in reducing and re-structuring non-performing assets (NPAS).

4. Introduction of CRAR

Capital to risk weighted assets ratio (CRAR) was started in 1992. Almost all the banks in India has reached the capital adequacy ratio (CAR) above the statutory level of 9%.

5. Diversification of Banking

The Indian Banking sector was well-diversified during the economic reforms period. Many of the banks have started new services and new products. Some bank have established subsidiaries in Merchant Banking, mutual funds, insurance, venture capital etc.

6. New Generation Banks

During the reforms many new generations banks have successfully emerged on the financial horizon. Bank such as ICICI Bank, UTI Bank have given a big challenge to the Public Sector Banks leading to a greater degree of competition.

7. Operational Autonomy

During the reforms period commercial banks enjoyed the operational freedom. If a bank satisfies the CAR then it gets freedom in opening new branches.

8. Improved Profitability and Efficiency

During the reform period, the productivity and efficiency of many commercial banks has improved. It has happened due to reduced, non-performing loans, use of technology, use of computers and some other relevant measures adopted by the govt.

9. Changes in Accordance to the External Reforms

During the 1990, the external sector has undergone major changes. It comprises various controls on imports, reduce tariffs, etc. The Monetary Policy has shown the impact of liberal inflow of the foreign capital and its implication on domestic money supply.

4.5.6 IMPLICATIONS OF MONETARY POLICY FOR INCLUSIVE GROWTH

Although inclusion is a term of relatively recent coinage, monetary policy in independent India always had a commitment to development. The ideas of the time favoured planning, and it early became a national goal. The fervor that followed independence also made it natural to give precedence to development. To support planned development, with the commanding heights for capital-intensive public sector projects, the emphasis was on generating resources for public investment, allocating resources to priority sectors, and expanding the reach of the formal financial system. Institutions such as the big development banks were set up. The early push towards inclusive financial deepening included the expansion of bank branches after nationalization, with emphasis on rural branches and on credit to agriculture. The RBI also worked towards larger sized financially viable rural cooperatives that could have eliminated the middleman. But the government chose to emphasize village level cooperatives. In setting up the RBI, checks and balances were put in to give a degree of freedom from political influence. These were regarded as essential for the control of inflation. Under the constitution and the division of responsibilities, if the RBI did not follow the policy direction given by the finance minister, the government would have to go to Parliament, which could assert some discipline. But since monetary policy had to support resource mobilization for the Plan precedents and procedures became established that vitiated the autonomy of the RBI. It came to be regarded as a department of the government-monetary policy became one more another instrument to achieve national goals. The Bank's primary responsibility became to find resources for Government expenditure. Small steps taken to accommodate government borrowing requirements led, over time, to the destruction of autonomy. And the RBI found it had adopted and internalized what had earlier been the opposite government view. For example, the use of ad hoc treasury bills took off during the second plan after the RBI agreed in 1955 to the Government's proposal to create them to maintain Government cash balances at 50 crores or above. This effectively made unlimited soft credit available for the government; the latter also reduced safeguards that restricted currency expansion. Ambitious projects in the second 5-year plan, and a paucity of resources, made the government soon turn to deficit financing. Deficits were continuously used from the second five year Plan, and from the late seventies revenue deficits became positive as the government borrowed even to finance consumption. Although development was important, stability of the monetary and financial systems also remained a major objective. Since, given the support to the plans, it was not possible to control aggregate credit, the RBI turned towards controlling sectoral credit and secondary liquidity creation to achieve its twin goals of development and stability. Since it could not prevent expansion of high-powered or reserve money through steady monetization of deficits, the RBI fought for and got additional powers that gave it control over banks' cash reserves-it could vary the cash reserve requirement (CRR) between 3 and 15 percent of scheduled bank's demand and time liabilities. Liquidity provisions in the Banking Companies Act were also strengthened and became the Statutory Liquidity Ratio (SLR). Now bank resources could be diverted for government financing, while restricting growth of broad money, yet setting up many schemes to direct credit towards development priorities. According to the ideas of the time, in effect planning was extended to the monetary and financial system also. Given the steady monetization of deficits, and the loss of autonomy of the central bank (CB), it is a puzzle that the country avoided episodes of sustained high inflation. The answer is, in a democracy with a large number of poor, and hardly any indexation of wages, high inflation was not politically acceptable. This explains the tight control that was kept on aggregate money supply, while selective credit controls directed credit in line with Plan priorities. A democracy is said to be subject to 'inflation bias'. Since the government has to face election, it pressures the CB, who is responsible for monetary and financial stability, to try to raise output and employment. If the CB creates surprise inflation, after workers have made their work decisions based on expected wages, this lowers real wages. Unemployment falls since firms are then want to employ larger numbers. Workers are tricked into working for lower wages. But over time the process becomes anticipated and higher nominal wages adjustments are built in. So there is only excess inflation, with no decrease in unemployment. A large literature on the inflation bias explores the structure of institutions, such as independence of a CB or appointment of a conservative central banker that can allow the CB to resist potential pressure. Bureaucrats are expected to be able to take a longer view compared to politicians since their prime motivation

is their reputation, not winning elections. But in a poor populous democracy without full indexation of wages and prices, inflation hurts the poor who have the most votes. Therefore, democratic accountability also acts to force the CB to keep inflation low unlike as in mature economies. It is the fiscal authority that may be tempted into excess expenditures, forcing the CB to accommodate fiscal needs, while using distorting administrative measures, including credit controls, to keep inflation low. This was the Indian experience. There is a continuing debate on whether democracy helps or harms growth, but the majority view is it reduces inequality. While pulls and pressures may restrain growth its quality tends to be higher with less volatility and inequality, as local voice gets reflected in a wide variety of robust and efficient institutions. Thick participatory institutions are known as horizontal democracy- participation is more than just at election time. Democracy may reduce growth by reducing physical capital and raising government consumption, but stimulates growth by improving

human capital and reducing inequality (Tavares and Wacziarg, 2001). The second puzzle then is why poverty and inequality remained high in India despite all the initiatives for development pushed by a vibrant democracy.

Politics

The answer includes the closed-economy government-led model that created much inefficiency. Poor growth and bursts of inflation translated into political fragmentation, after the first twenty years of independence when the Congress party provided a stable government. As intense multi party competition set in, populist schemes multiplied. The losses from large public investment projects also encouraged a shift to transfers. A majoritarian democratic regime, such as India's, has a bias towards targeted transfers at the expense of public goods, compared to a regime based on proportional voting. With multiple competing parties, swing votes become critical for winning in a first-past-the-post system. And winning parties target transfers to the well identified groups that vote them in. The first reaction of new caste-based regional parties to the acquisition of power was consumption transfers to their support groups. Once in power they needed to accumulate resources to buy votes and legislators in the future. Institutions of governance were undermined. In the South where the caste-based movement was older, progressive reform, emphasizing education and capacity building, was achieved. By the 1980s, Central Sponsored Schemes (CSS) became a way for the central government to directly reach the masses. New schemes were announced every year, although targeting was poor and waste and corruption proliferated. These may have helped manage but did not eliminate poverty. Since state elections were separated from those at the Centre in 1971, frequent elections kept up pressure continually and harmed longer-term development. This period also coincided with major oil shocks. In order to keep prices of direct government services low, user charges were kept fixed although costs were rising. Low price caps for many public goods created systematic incentives to lower quality and investment. Subsidies, transfers and distortions increased while current and future provision of public goods suffered. Falling efficiency and rising costs compounded the problem of low user charges, and prevented a fall in prices from improvements in technology and organization. But where the government had monopoly power and was servicing the rich, prices were raised much above costs of production, or indirect charges, not obvious to voters, such as the prices of intermediate goods, were raised. The Indian railways illustrate this process. Prices of mass travel were rarely raised, but freight charges rose continuously. As a result the railways lost freight to subsidized diesel trucks. Yet the latter have much higher social costs since railways are the cheapest and least environmentally polluting mode of transport for bulk goods. The voter may be paying less for train travel but more for every good she consumes, and in addition bears the costs of pollution. As the rich turned to private providers, revenue losses contributed to the inability to service the poor adequately. The cross-subsidization was not sufficient to cover costs. The choices made amounted to protecting the poor through current transfers, rather than building their assets and human capital, when it was the latter that was the sustainable option. This was a rational social outcome because the rich could often escape imposts in the long-term, and the poor had high discount rates and pessimistic growth projections.

Outcomes

After a good initial start with the 1st and 2nd five-year plans, the system was unable to raise growth rates or moderate the supply-side shocks the economy was subject to. Growth fell to a paltry 3 percent per annum in the seventies and although it recovered to 5.6 percent in the 1980s. It remained much below what its peers in Asia, including China were achieving as they moved to more open systems. Both higher growth, lower inflation, and government action were essential for further inclusion. The economy had always been vulnerable to the monsoon-agriculture was a regular source of supply shocks. During an agricultural shock monetary policy would initially support increased drought relief then tighten just as the lagged demand effects of an agricultural slowdown were hitting industry. Macro policy was thus pro-cyclical, but pervasive controls limited volatility. Since the early seventies, oil shocks became a new source of such shocks. Administered oil and food prices were normally raised with a lag after monetary tightening brought inflation rates down. Indian commodity prices were less volatile than international, but over time their cumulative rise was more. They raised less but never fell, imparting an upward bias to the price level, and turning a temporary price shock into a persistent shock. Since high inflation was not politically acceptable, the use of CRR and SLR enabled a squeeze on money and credit in response to supply shocks, which intensified the demand recession that followed. This discouraged growth and the productivity increases that would have lowered inflation from the cost side. India did not have high inflation, but it had repressed and chronic inflation. Since the tax base and tax-GDP ratio was low, some inflation provided useful seignorage revenue. The push towards inclusive financial deepening, especially the expansion of bank branches after nationalization, probably contributed to the sharp rise in the savings (GDS) GDP ratio in the 70s. Another large jump came in the post-reform high growth period, and the growth rate of GDS overtook that of capital formation (GDCF) and consumption (PFCE), although it fell with growth. India has a healthy combination of savings to finance investment and consumption to create demand. But the savings are poorly intermediated through the financial sector, and after large government borrowings little is left for the private sector. Even in 2010 less than half the population had a bank account-financial exclusion remained severe, and despite its high savings rate, drove the country towards excessive reliance on foreign inflows. Since the seventies, dominant development ideas changed to favour openness. This was the way the rest of the world was going. In India also the ill effects of pervasive market distortions were becoming obvious. Some liberalization started in the mid-eighties, but a major thrust for external openness came from the mid 1991 balance of payment crisis when foreign exchange reserves were down to 11 days of imports. The stagnation in the economy contributed to the crisis which helped bring home the lesson that excessive interest controls and credit rationing hurt growth and stability. It made possible the implementation of the series of pending committee reports that favoured moves to let markets determine key asset prices and credit allocation. But more openness required more credible institutions. Poor fiscal finances had precipitated many outflows and currency crises in emerging markets. Therefore liberalizing reforms in the nineties strengthened the autonomy of the CB compared to the Government. Ad hoc treasury bills and automatic monetization of the deficits was stopped in the 90s. The Ways and Means Advance (WMA) system was started in 1997. Primary issues of government securities no longer devolved on the RBI. From April 1, 2006, the RBI could not participate in the primary auction of government securities. The basic objectives of monetary policy remained price stability and development, but the operating procedures shifted from credit controls towards flexible monetary targeting with 'feedback' from the mid 1980s till 1997-98. But deregulation and liberalization of the financial markets combined with the increasing openness of the economy in 1990s made money demand more unstable, and broad money more endogenous. The informal nominal money supply targeting proved inadequate under these changes; interest rates were volatile in the 1990s. After the adverse impact of the nineties peak in interest rates, the RBI moved towards using the interest rate as an instrument, basing its actions on a number of indicators of monetary conditions. This became more feasible as the money market developed, and a liquidity adjustment facility was put in place to fine tune short-term liquidity (Figure 4). The RBI would lend and absorb short-term liquidity within a band so as to keep short-term market rates within the band, which defined the policy rates3. The RBI formally adopted a 'multiple indicator approach' in April 1998, following informal changes in practice from the mid-nineties. There was no formal inflation targeting, but policy statements gave both inflation control and acilitating growth as key objectives. A specific value of 5 percent was given as the desirable rate of inflation, with the aim to bring it even lower in the long-term. But monetary tightening was excessive not only because of an initial inability to smooth interest rates. There were episodes of excessive tightening in 2008 and in 2011 that sharply reduced growth rates. More autonomy to the CB can, without changes in the rules of the game through fiscal reform, lead to higher interest rates that increase the burden of public debt and impose a large output sacrifice, as the CB seeks to compensate for government overspending. A democratically accountable Central Banker in a developing democracy would anyway keep inflation low, so if rules restrain fiscal populism, and change the composition of government expenditure towards capacity creation that reduces inflation, the CB can focus less on inflation and more on supporting growth.

4.5.7 IMPLICATIONS OF ACTIVE INCLUSION FOR MONETARY POLICY

In an open economy, good government finances and low inflation are a prerequisite for the confidence of markets. And when growth creates opportunities, the masses want good public

services that make it easier to harness opportunities. If the disappointment with large scale investment projects, led the government to shift to subsidies and transfers, today there is scope to turn to a different kind of capacity creation. After the global financial crisis (GFC) the extreme shift in ideology from Government must do it to markets know best has also moderated, encouraging government action suited to meeting real needs and to filling the gaps that market do not address. As improvements in government expenditure composition and governance lower costs, monetary policy can also support an inclusive growth. After developing the idea of active inclusion, we draw out its implications for monetary policy, and the institutional changes that can make improvements in governance credible.

Active Inclusion

"Inclusive growth" has become the government's objective, but debates have refined the meaning of the term, as creating conditions for the masses to contribute to and participate in growth (UNDP 2011). This requires pro-poor growth, access to quality public services and jobs. It is active inclusion (Goyal 2012), which differs from redistribution from a productive section to others. A more active rather than a passive sharing is also now more feasible politically. As growth creates more opportunities, the cost of activity falls and its rewards rise. For example, although the output of Indian education is heterogeneous, and leaves much to be desired, it does make transition from illiteracy to semi and neo-literacy possible. Jobs are available for the wide range of skills produced. That the largest rise in enrolment in English schools shows the ordinary Indian is responding to new opportunities But creating conditions for active inclusion still requires government initiative, since spill overs that are not internalized mean private provision of human capital will always be below the social optimal. Negative externalities from failures in social infrastructure also raise the cost of private provision. The really backward will continue to need special help. Examples of government initiatives that can contribute to active inclusion are improving infrastructure, health, education, technology the poor use, and public service delivery. The rewards to hard work then increase. Successes with conditional cash transfers, made in technology-enabled leak-proof ways in Brazil, show subsidizing activities that improve human capital incentivizes even the really disadvantaged. They compensate for market failures that exclude the very poor. For government schemes to effectively add to capacity, the composition of Government expenditures must change more towards investment that expands capacity defined broadly to include human capacity. Second, those expenditures have to be effective, achieving targets at minimum cost. New technologies of delivery are making this possible. Essential social protection expenditures can switch to more economical and effective modes. Active inclusion shifts the focus from growth alone to growth with higher productivity jobs that allow wages to rise. Wages rising without a rise in productivity only lead to inflation. Given the still large share of food in the average consumption basket a rise in agricultural productivity is critical for a non-inflationary rise in wages. To the extent active inclusion is occurring, it implies an elastic supply.

4.6 SUMMARY

Indian monetary policy supported government investment after independence, but is finding it difficult to support government consumption and transfers, consistent with keeping inflation low. If government changes the composition of its expenditure towards supporting human capacity, monetary policy will be able to support this active inclusion. The earlier set of policies was not successful in achieving inclusive growth. This lack of success, and the change in development ideas, led to greater reliance on markets. The share of investment in government expenditure decreased. But the limitations of markets have also become obvious, and there is a better understanding of the kind of interventions that are required and that do work. There are policies for active inclusion that expand human capacity in effective ways. Since this makes more productive labour available, reducing wasteful distortions that raise costs and prices, the complementarities between social spending and macroeconomic policy are enhanced. The prospects for monetary support of growth that delivers inclusive growth improve, despite increasing autonomy of monetary authorities, since their fears about unsustainable government deficits reduce. More autonomy is part of greater macroeconomic stability essential in a more open economy. These pressures, together with stronger democratic institutions that impose greater continuous accountability on the government will make the change in government expenditure from consumption to a different kind of investment incentive compatible.

4.6.1 EVALUATION OF MONETARY POLICY IN INDIA

During the reforms though monetary policy has achieved higher success. It is not free from limitation or demerits. It needs to be evaluated on a proper scale.

Monetary Policy fails to tackle Budgetary Deficit-

1. The higher level of budget deficit has made Monetary Policy ineffective. The automatic monetization of deficit has let to high monetary expansion.

2. The coverage area of Monetary Policy is limited- Monetary Policy covers only commercial banking sector. Other non- banking institutions remain untouched. It limits the effectiveness of the Monetary Policy in India.

3. Money market is not organized- There is a huge size of money market in our country. It does not come under the control of the RBI. Thus any tool of the monetary policy does not affect the unorganized money market making Monetary Policy less affective.

4. Predominance of cash transaction- In India still there is huge dominance of the cash in total money supply. It is one of the main obstacles in the effective implementation of the Monetary Policy. Because monetary policy operates on the bank credit rather on cash.

5. Increase volatility -As the Monetary has adopted changes in accordance to the changes in the external sector in India, It could lead to high amount of the volatility.

4.7 GLOSSARY

Fiscal Policy: It involves the government changing tax rates and levels of government spending to influence aggregate demand in the economy.

Monetary Policy: It involves changing the interest rate and influencing the money supply.

4.8 SELF ASSESSMENT QUESTIONS

1. What is fiscal policy? Give its basic description?

2. Elaborate objectives and components of fiscal policy?

3. Explain India's Fiscal policy architecture?

4. Explain New Industrial Policy of 1991 and its rationale?

5. Describe the impact of Industrial Policy, 1991?

6. Explain India's monetary policy with its objectives and components?

4.9 LESSON END EXERCISES

1. Write a brief note on fiscal policy of India?

2. Give a detailed discussion on New Industrial policy of India?

3. Describe the elements of the monetary policy of India?

4. Explain the implications of monetary policy for inclusive growth of India?

5. Elaborate reforms in the Indian Monetary Policy of India?

4.10 SUGGESTED READINGS

1. P. Banerjee, Fiscal Policy in India, Gyan Publishing House, India

2. Peter Heller, Sustainable Fiscal Policy For India: An International Perspective, OUP, India

4.11 REFERENCES

1. India: Monetary Policy, Financial Stability and Other Essays by C. Rangarajan

2. Monetary History of India by Rituparna Das.