CHAPTER

15

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*No country in today's globalised world can be fully insulated from what happens in the global economy and India is no exception to the rule. As the country is increasingly integrated into the world, it cannot remain impervious to developments abroad. The unfolding of the Euro zone crisis and uncertainty surrounding the global economy have impacted the Indian economy causing drop in growth, higher current account deficit and declining capital inflows.**

* *As writes the MoF, **Economic Survey 2012–13**, GoI, N. Delhi, p. 131.*

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DEFINITION

All economic activities of an economy which take place in foreign currency fall in sectors such as export, import, foreign investment, external debt, current account, capital account, balance of payment, etc., to name a few (***definition***).[1]

FOREX RESERVES

The total foreign currencies (of different countries) an economy possesses at a point of time is its 'foreign currency assets/reserves'.[2] The Forex Reserves (short for '**for**eign **ex**change reserves') of an economy is its 'foreign currency assets' added with its *gold reserves, SDRs* (Special Drawing Rights) and *Reserve Tranche* in the IMF.[3] In a sense, the Forex reserves is the upper limit upto which an economy can manage foreign currency in normal times if need be.

As per a RBI release on April 3, 2015, India's forex reserves was at US$ 341.37 (composed of Gold Reserves of US$ 19,83 buillion; SDR of US$ 4 billion and Reserve Tranche Position with the IMF at US$ 1.29 billion). As per the *Annual Report* of the IMF (released on March 11, 2015), India's forex reserves stood at 148 per cent of IMF's reserve adequacy.

OPTIMUM FOREX – THE RIDDLE

In recent times, there has been a debate over India's optimum level of the forex reserves. The RBI is aware of the downside risks to the exchange rate, as is reflected by its action of buying the US dollar. Officially, the RBI *targets neither* a particular exchange rate nor foreign exchange reserves, and maintains such interventions by it to just *reduce volatility* in the forex market. But in the process of supporting weakening rupee, RBI needs to buy dollar, ultimately, leading to higher forex buid-ups. The Chief Economic Advisor of the Finance ministry, however, clearly stated the kind of reserve accretion the government is looking at. Citing the example of China, the *Economic Survey 2014–15* said India could target foreign exchange reserves of US$750 billion to $1 trillion.

Today, China has *de facto* become one of the lenders of last resort to governments experiencing financial troubles. China, in its own heterodox and multiple ways, is assuming the roles of both an IMF and World Bank as a result of its reserves. The question for India, as a rising economic and political power, is whether it, too, should consider a substantial addition to its reserves.

While forex reserves act as insurance when the rupee tends to be volatile against the dollar, there are costs attached to it. When RBI purchases dollars in the spot, it leads to infusion of rupee into the system which leaves *inflationary* effect on the economy. Since the RBI does not want such actions to create inflationary pressure, so, it converts spot purchases into forwards. This way, it is a direct cost because of the forward premiums. If RBI opts for open market operations (OMOs) to mop up excess liquidity, that also involves costs.

RBI invests these dollars in instruments such as US treasuries, which offer *negligible* returns, owing to lower yields. But experts say these are unavoidable costs. The returns from rupee assets are much lower compared to returns from dollar assets. But RBI is not into investment management, it is there to maintain stability in the system.

In August 2014, RBI chief Raghuram Rajan agreed foreign exchange reserves came at a cost. India earns next to nothing for the foreign reserves it holds—actually, this way India finances another

1. Based on Stiglitz and Walsh, ***Economics***, op. cit., pp. 757–58.
2. Based on Samuelson and Nordhaus, ***Economics,*** op. cit., p. 604.
3. Ibid., pp. 605–07.

country when it has a significant financing needs. It is very difficult to state the level of reserves considered adequate by RBI. Though there are costs involved, the costs to benefit cannot be quantified by any model. Globally, there has been no study on the adequacy of reserves. In such an environment, RBI will have to go by experiences.

EXTERNAL DEBT

After the BoP crisis of 1991, India's prudent external debt policies and management with a focus on sustainability, solvency, and liquidity have helped contain the increase in size of external debt to a moderate level and it is compositionally better with a longer term maturity profile. India's total external debt stock stood at US$ **455.9** billion by September 2014 (3 per cent higher over March 2014), as per the latest data *(Economic Survey 2014–15)*. The rise in total external debt during the period was due to long-term debt, particularly NRI deposits.

The ***maturity profile*** of India's external debt indicates the dominance of long-term borrowings (by September 2014):

- Long-term debt accounted for 81.1 per cent of the total external debt.
- Short-term debt in total external debt was 18.9 per cent. at end-September 2014.
- Government debt share was 19.4 per cent while the non-government debt share was 80.6 per cent.
- Currency composition: US dollar-denominated debt in external debt stock continued to be the highest at 60.1 per cent, followed by Indian rupee (24.2 per cent), the SDR (6.5 per cent), Japanese yen (4.5 per cent), and euro (3.0 per cent) denominated.

The currency composition of government (sovereign) debt indicates predominance of SDR- denominated debt (33.5 per cent), which is attributable to borrowing from the International Development Association (IDA), i.e. the soft loan window of the World Bank under the multilateral agencies, and SDR allocations by the International Monetary Fund (IMF).

Over the years, India's external debt stock has witnessed ***structural change*** in terms of composition (by September 2014):

- The proportion of concessional debt declined from 42.9 per cent during the period 1991–2000 to 28.1 per cent in 2001–10 and further to 9.8 per cent at end-September 2014.
- The dominance of non-government debt in total external debt is evident from the fact that such debt accounted for 65.6 per cent of total debt during the 2000s decade, against 45.3 per cent in the 1990s. Non-government debt accounted for over 70 per cent of total debt in the last five years and stood at 80.6 per cent at end-September 2014.
- India's foreign exchange reserves provided a cover of 68.8 per cent at end-March 2014.
- India's external debt has remained within manageable limits as indicated by the external debt to GDP ratio of **23.5** per cent and debt service ratio of **5.9** per cent in 2013–14.

The prudent external debt management policy of the GoI has helped in containing rise in external debt and maintaining a comfortable external debt position. The policy continues to focus on—

(i) Monitoring long- and short-term debt.

(ii) Raising sovereign loans on concessional terms with longer maturities.

(iii) Regulating external commercial borrowings through enduse, all-in-cost, and maturity restrictions.

(iv) Rationalizing interest rates on NRI deposits.

Cross-country comparison of external debt based on the *World Bank's International Debt Statistics 2015,* which contains the external debt data for the year 2013, indicates that India continues to be among the less vulnerable countries. India's key debt indicators compare well with other indebted developing countries. The ratio of India's external debt stock to gross national income at 23.0 per cent was the sixth lowest. In terms of the cover provided by foreign exchange reserves to external debt, India's position was sixth highest at 64.7 per cent

FIXED CURRENCY REGIME[4]

A method of regulating exchange rates of world currencies brought by the IMF. In this system exchange rate of a particular currency was fixed by the IMF keeping the currency in front of a basket of important world currencies (they were UK£, US $, Japanese ¥, German Mark DM and the French Franc FFr). Different economies were supposed to maintain that particular exchange rate in future. Exchange rates of currencies were modified by the IMF from time to time.

FLOATING CURRENCY REGIME[5]

A method of regulating exchange rates of world currencies based on the market mechanism (i.e., demand and supply). In the follow up to the fixed currency system of exchange rate determination, it was the UK which blamed the system for its payment crisis of late 1960s. Looking at the major loopholes in this system, the UK government decided to switch over to the floating currency regime in 1973—the same year the IMF allowed an option to its member countries to go for either of the currency systems.

In the floating exchange rate system, a domestic currency is left free to float against a number of foreign currencies in its foreign exchange market and determine its own value. Such exchange rates, are also called as *market driven* or *based* exchange rates, which are regulated by factors such as the demand and supply of the domestic and the foreign currencies in the concerned economy.

MANAGED EXCHANGE RATES

A managed-exchange-rate system is a hybrid or mixture of the fixed and flexible exchange rate systems in which the government of the economy attempts to affect the exchange rate ***directly*** by buying or selling foreign currencies or ***indirectly***, through monetary policy[6] (i.e., by lowering or raising interest rates on foreign currency bank accounts, affecting foreign investment, etc.).

Today, most of the economies have shifted to this system of exchange rate determination. Almost all countries tend to intervene when the markets become ***disorderly*** or the ***fundamentals*** of economics are challenged by the exchange rate of the time. Some of the major examples of the managed exchange-rate system have been given below:[7]

(i) Some countries allow to ***free float*** their currencies and allow the market forces to determine their exchange rate with rare government intervention. This is the idea

4. Ibid., pp. 610–11.
5. Ibid., pp. 611–15.
6. Ibid., p. 615.
7. The discussion is based primarily on Samuelson and Nordhaus, ***Economics,*** op. cit., pp. 613–15 and D. Salvatore, ***International Economics,*** John Wiley & Sons, New Jersey, USA, 2004, pp. 717–22.

from which the ***floating currency regime*** basically emerged. The USA and the EU are the major examples in this category.

(ii) Some economies have ***managed but flexible*** exchange rates, under which the governments buy or sell its currency to reduce day-to-day volatility of currency fluctuations and sometimes go for systematic intervention for desired objectives. Canada and Japan fall in this category, besides many developing countries. India too falls under this category which follows the ***dual currency regime*** since 1992–93 financial year.[8]

(iii) Some economies, particularly small ones, peg their currencies to a major currency or to a ***basket*** of currency in a fixed exchange rate—known as the ***pegging of currencies.*** At times, the peg is allowed to glide smoothly upward or downward—a system which is known as ***gliding*** or ***crawling peg.*** Some economies have a ***hard fix*** of a ***currency board.*** A ***currency board*** is working well in Hong Kong while the same failed in Argentina in 2002.

FOREIGN EXCHANGE MARKET

The market where different currencies can be bought and sold is called the foreign exchange market.[9] Out of the trades in different currencies, the exchange rate of the currency is determined by the economy.[10] This is an institutional framework for the exchange of one national currency for another.[11] This is particularly correct either in the case of a free float exchange (i.e., floating currency) regime or is a managed or hybrid exchange rate system. It is altogether not allowed either in a ***fixed currency system*** or a ***hard fix*** (in a hard fix this happens once the currency to which the hard fix has been done itself starts fluctuating).

EXCHANGE RATE IN INDIA

Indian currency, the 'rupee', was historically linked with the British Pound Sterling till 1948 which was fixed as far back as 1928. Once the IMF came up, India shifted to the fixed currency system committed to maintain rupee's external value (i.e., exchange rate) in terms of gold or the US ($ Dollar). In 1948, Rs. 3.30 was fixed equivalent to US $ 1.

In September 1975, India delinked rupee from the British Pound and the RBI started determining rupee's exchange rate with respect to the exchange rate movements of the basket of world currencies (£, $, ¥, DM, Fr.). This was an arrangement between the fixed and the floating currency regimes.

In 1992–93 financial year, India moved to the floating currency regime with its own method which is known as the 'dual exchange rate'.[12] There are two exchange rates for rupee, one is the 'official rate' and the other is the 'market rate'. Here the point should be noted that it is the everyday's changing market-based exchange rate of rupee which affects the official exchange rate and not the other way round. But the RBI may intervene in the forex market via the demand and supply of rupee or the foreign currencies. Another point which should be kept in mind is that none of the economies have till date followed an ideal free-floating exchange rate. They require some

8. ***LERMS, Union Budget 1992–93,*** MoF, GoI, N. Delhi.
9. Stiglitz and Walsh, op. cit., p. 757.
10. Samuelson and Nordhaus, op. cit., p. 604
11. D. Salvatore, 2004, op. cit., p.7.
12. ***LERMS,*** op. cit.

mechanism to intervene in the foreign exchange market because this is a highly speculative market.

TRADE BALANCE

The monetary difference of the total export and import of an economy in one financial year is called trade balance. It might be positive or negative, known to be either favourable or unfavourable, respectively to the economy.

TRADE POLICY

Broadly speaking, the economic policy which regulates the export-import activities of any economy is known as the trade policy. It is also called the foreign trade policy or the Exim Policy. This policy needs regular modifications depending upon the economic policies of the economies of the world or the trading partners.[13]

DEPRECIATION

This term is used to mean two different things. In foreign exchange market, it is a situation when domestic currency loses its value in front of a foreign currency if it is market-driven. It means depreciation in a currency can only take place if the economy follows the floating exchange rate system.

In domestic economy, depreciation means an asset losing its value due to either its use, wear and tear or due to other economic reasons. Depreciation here means *wear and tear*. This is also known as ***capital consumption.*** Every economy has an official annual rates for different assets at which fixed assets are considered depreciating.

DEVALUATION

In the foreign exchange market when exchange rate of a domestic currency is cut down by its government against any foreign currency, it is called devaluation. It means official depreciation is devaluation.

REVALUATION

A term used in foreign exchange market which means a government increasing the exchange rate of its currency against any foreign currency. It is official appreciation.

APPRECIATION

In foreign exchange market, if a free floating domestic currency increases its value against the value of a foreign currency, it is appreciation. In domestic economy, if a fixed asset has seen increase in its value it is also known as appreciation. Appreciation rates for different assets are not fixed by any government as they depend upon many factors which are unseen.

CURRENT ACCOUNT

It has two meanings—one is related to the banking sector and the other to the external sector:

(i) In the banking industry, a business firms bank account is known as current account. The account is in the name of a firm run by authorised person or persons in which no interest is paid by the bank on the deposits. Every withdrawal from the account takes place by cheques with limitations on the number of deposits and withdrawals in a single day. The *overdraft* facility or the *cash-cum-credit* (c/c Account) facility to business firms is offered by the banks on this account only.

(ii) In the external sector, it refers to the account maintained by every government of the world in which every kind of

13. D. Salvatore, 2004, op.cit., pp. 235–36.

current transactions is shown—basically this account is maintained by the central banking body of the economy on behalf of the government. Current transactions of an economy in foreign currency all over the world are—export, import, interest payments, private remittances and transfers.

All transactions are shown as either inflow or outflow (credit or debit). At the end of the year, the current account might be positive or negative. The positive one is known as a surplus current account, and the negative one is known as a deficit current account. India had surplus current accounts for three consecutive years (2000–03)—the only such period in Indian economic history.

Current account deficit is shown either numerically by showing the total monetary amount of the deficit, or in percentage of the GDP of the economy for the concerned year. Both the data are used in analysis as per the specific requirement. As per a RBI release of April 2014, presently the sustainable level of current account deficit for India is 2.5 per cent of the GDP.

CAPITAL ACCOUNT

Every government of the world maintains a capital account, which shows the capital kind of transactions of the economy with outside economies. Every transaction in foreign currency (inflow or outflow) considered as capital is shown in this account—external lending and borrowing, foreign currency deposits of banks, external bonds issued by the Government of India, FDI, PIS and security market investment of the QFIs (Rupee is fully convertible in this case).

There is no deficit or surplus in this account like the current account .

BALANCE OF PAYMENT (BoP)

The outcome of the total transactions of an economy with the outside world in one year is known as the balance of payment (BoP) of the economy.[14] Basically, it is the net outcome of the current and capital accounts of an economy. It might be favourable or unfavourable for the economy. However, negativity of the BoP does not mean it is unfavourable. A negative BoP is unfavourable for an economy if only the economy lacks the means to fill the gap of negativity.

The BoP of an economy is calculated on the principles of accountancy (***double-entry book-keeping***)[15] and looks like the balance sheet of a company—every entry shown either as credit (inflow) or debit (outflow). If there is a positive outcome at the end of the year, the money is automatically transferred to the foreign exchange reserves of the economy. And if there is any negative outcome, the same foreign exchange is drawn from the country's forex reserves. If the forex reserves are not capable of fulfilling the negativity created by the BoP, it is known as a BoP crisis and the economy tries different means to solve the crisis in which going for forex help from the IMF is the last resort.

CONVERTIBILITY

An economy might allow its currency full or partial convertibility in the current and the capital accounts. If domestic currency is allowed to convert into foreign currency for all current account purposes, it is a case of full current account convertibility. Similarly, in cases of capital outflow, if the domestic currency is allowed to

14. Samuelson and Nordhaus, op. cit., p. 601.
15. It means that each external transaction is recorded/entered twice—once as a credit and once as a debit of an equal amount. This is because every transaction has two sides—we sell something and we receive payment for it, similarly we buy something and we have to pay for it (See ***Salvatore,*** op. cit., p. 432).

convert into foreign currency, it is a case of full capital account convertibility. If the situation is of partial convertibility, then the portion allowed by the government can be converted into foreign currency for current and capital purposes. It should always be kept in mind that the issue of currency convertibility is concerned with foreign currency *outflow* only.

CONVERTIBILITY IN INDIA

India's foreign exchange earning capacity was always poor and hence it had all possible provisions to check the foreign exchange outflow, be it for current purposes or capital purposes (remember the draconian FERA). But the process of economic reforms has changed the situation to unidentifiable levels.

CURRENT ACCOUNT

Current account is today fully convertible (operationalised on August 19, 1994). It means that the full amount of the foreign exchange required by someone for current purposes will be made available to him at official exchange rate and there could be an unprohibited outflow of foreign exchange (earlier it was partially convertible). India was obliged to do so as per Article VIII of the IMF which prohibits any exchange restrictions on current international transactions (keep in mind that India was under pre-conditions of the IMF since 1991).

CAPITAL ACCOUNT

After the recomendations of the S.S. Tarapore Committee (1997) on Capital Account Convertibility, India has been moving in the direction of allowing full convertibility in this account, but with required precautions. India is still a country of partial convertibility (40:60) in the capital account, but inside this overall policy, enough reforms have been made and to certain levels of foreign exchange requirements, it is an economy allowing full capital account convertibility—

(i) Indian corporate are allowed full convertibility in the automatic route upto $ 500 million overseas ventures (investment by Ltd. companies in foreign countries allowed).

(ii) Indian corporate are allowed to prepay their external commercial borrowings (ECBs) via automatic route if the loan is above $ 500 million.

(iii) Individuals are allowed to invest in foreign assets, shares, etc., upto the level of $ 2,50,000 per annum.

(iv) Unlimited amount of gold is allowed to be imported (this is equal to allowing full convertibility in capital account via current account route, but not feasible for everybody) which is not allowed now.

The Second Committee on the Capital Account Convertibility (CAC)—again chaired by S.S. Tarapore—handed over its report in September 2006 on which the RBI/the government is having consultations.

LERMS

India announced the Liberalised Exchange Rate Mechanism System (LERMS) in the Union Budget 1992–93 and in March 1993 it was operationalised. India delinked its currency from the fixed currency system and moved into the era of floating exchange-rate system under it.

Indian form of exchange rate is known as the 'dual exchange rate', one exchange rate of rupee is official and the other is market-driven.[16] The market-driven exchange rate shows the actual tendencies of the foreign currency demand and

16. **LERMS**, op. cit.

supply in the economy vis-a-vis the domestic currency. It is the market-driven exchange rate which affects the official rate and not the other way round.

NEER

The Nominal Effective Exchange Rate (NEER) of the rupee is a weighted average of exchange rates before the currencies of India's major trading partners.

REER

When the weight of inflation is adjusted with the NEER, we get the Real Effective Exchange Rate (REER) of the rupee. Since inflation has been on the higher side in recent months, the REER of the rupee has been more against it than the NEER.

EFF

The Extended fund Facility (EFF) is a service provided by the IMF to its member countries which authorises them to raise any amount of foreign exchange from it to fulfil their BoP crisis, but on the conditions of structural reforms in the economy put by the body. It is the first agreement of its kind. India had signed this agreement with the IMF in the financial year 1981–82.

IMF CONDITIONS ON INDIA

The BoP crisis of the early 1990s made India borrow from the IMF which came on some conditions. The medium term loan to India was given for the restructuring of the economy on the following conditions:

(i) Devaluation of rupee by 22 per cent (done in two consecutive fortnights—rupee fell from '21 to '27 against every US Dollar).

(ii) Drastic custom cut to a peak duty of 30 per cent from the erstwhile level of 130 per cent for all goods.

(iii) Excise duty to be increased by 20 per cent to neutralise the loss of revenue due to custom cut.

(iv) Government expenditure to be cut by 10 per cent per annum (the burden of salaries, pensions, subsidies, etc.).

The above-given conditions to which India was obliged were vehemently opposed by the Indian corporate sector, opposition in the Parliament and majority of Indians. But by the end of 1999–2000, when India saw every logic in strengthening its BoP position there was no ideological opposition to the idea. It should always be kept in mind that the nature of structural reforms India went through were guided and decided by these pre-conditions of the IMF.

This is how the direction of structural reforms of an economy are regulated by the IMF in the process of strengthening the BoP position of the crisis-driven economy. The purpose has been served in the Indian case. India has not only fulfilled these conditions but it has also moved ahead.

HARD CURRENCY

It is the international currency in which the highest faith is shown and is needed by every economy. The strongest currency of the world is one which has a high level of liquidity. Basically, the economy with the highest as well as highly diversified exports that are compulsive imports for other countries (as of high-level technology, defence products, life saving medicines and petroleum products) will also create high demand for its currency in the world and become the hard currency. It is always scarce.

Upto the second world war, the best hard currency was the Pound Sterling (£) of the UK, but soon it was replaced by the US Dollar—at present some experts believe that the Euroland's currency (€) might replace it, too. Some of the best hard currencies of the world today are the US Dollar, the Euro(€), Japanese Yen (¥) and the UK Sterling Pound (£).

SOFT CURRENCY

A term used in the foreign exchange market which denotes the currency that is easily available in any economy in its forex market. For example, rupee is a soft currency in the Indian forex market. It is basically the opposite term for the hard currency.

HOT CURRENCY

Hot currency is a term of the forex market and is a temporary name for any hard currency. Due to certain reasons, if a hard currency is exiting an economy at a fast pace for the time, the *hard* currency is known to be *hot*. As in the case of the SE Asian crisis, the US dollar had become hot.

HEATED CURRENCY

A term used in the forex market to denote the domestic currency which is under enough pressure (heat) of depreciation due to a hard currency's high tendency of exiting the economy (since it has become hot). It is also known as *currency under heat* or *under hammering*.

CHEAP CURRENCY

A term first used by the economist J. M. Keynes (1930s). If a government starts re-purchasing its bonds before their maturities (at full-maturity prices) the money which flows into the economy is known as the cheap currency, also called cheap money.

In the banking industry, it means a period of comparatively lower/softer interest rates regime.

DEAR CURRENCY

This term was popularised by economists in early 1930s to show the opposite of the cheap currency. when a goverment issues bonds, the money which flows from the public to the government or the money in the economy in general is called dear currency, also called as *dear money*.

In the banking industry, it means a period of comparatively higher/costlier interest rates regime.

SPECIAL ECONOMIC ZONE[17]

How does a country of over a billion people take on the challenge of providing a better life to its citizens? The question would naturally elicit a million different responses having their roots in several social, economic and political measures. No one today, however, doubts the efficacy of faster and broad-based economic development as a primary tool for providing the average Indian a better deal. The country needs massive investments in manufacturing, infrastructure development and in its productive capacities. We also need to aggressively promote exports of goods and services in an ever so highly competitive global market place. This alone would lead to a strong edifice for sustained growth and creation of productive employment. These were the very aims for which the Government of India mooted the Special Economic Zone (SEZ) Policy in April 2000 which was further concretised through the SEZ Act 2005 and the SEZ Rules 2006 policy.

The concept of SEZ is not a new one and it is an improvement to the concept of Export Processing Zones. India was *one of the first* in Asia to recognise the effectiveness of the Export Processing Zone (EPZ) model in promoting exports, with ***Asia's first*** EPZ set up in Kandla in 1965—seven more

17. Based on the updated informations available with the **Ministry of Commerce & Industry,** GoI, N. Delhi, May 11 , 2012.

EPZs were set up thereafter. However, the EPZs were not able to emerge as effective instruments for export promotion on account of multiplicity of controls and clearances, absence of world-class infrastructure, and an unstable fiscal regime. In order to overcome these shortcomings and attract larger foreign investments in India, the SEZ Policy was announced in April 2000. This policy was intended to make *SEZs an engine for economic growth* supported by quality infrastructure complemented by an attractive fiscal package, both at the Centre and the state levels, with the minimum possible regulations.

What is SEZ?

SEZ, or Special Economic Zone, is essentially an industrial cluster meant largely for exports. An SEZ is governed by a special set of rules aimed at attracting direct investment for export-oriented production. SEZs, earlier known as Export Processing Zones or Free Trade Zones, are *duty free enclaves* which are treated as *foreign territory* only for trade operations, duties, tariffs and typically marked by the best infrastructure and least red tape. Other salient features of SEZs are:

(i) manufacturing or service activities are allowed;

(ii) full freedom for sub-contracting;

(iii) no routine examination by customs authorities of export/import cargo;

(iv) units in SEZs have to become net foreign exchange earners within three years; and

(v) domestic sales from them are subject to full customs duty and the import policy in force.

The SEZ concept recognises the issues related to economic development and provides for developing self-sustaining industrial townships so that the increased economic activity does not create pressure on the existing infrastructure. This issue is addressed in the SEZ policy by specifying a non-processing area for creation of support infrastructure. Every SEZ is divided into a processing area where alone the SEZ units would come up and the non-processing area where the supporting infrastructure is to be created. The SEZ developer would be responsible for all civic amenities and infrastructure including roads, sewerage, open spaces, green spaces, education facilities, power, water supply and housing etc.

Land Acquisition Issue & SEZ

While the benefits of SEZs are visible and evident, one major issue that has often been raised pertains to the acquisition of agricultural land for setting up SEZs. Acquisition of land is a matter that comes under the purview of the state governments since land/land usage is a state subject. While there is a *Central Land Acquisition Act* of 1894 extensively amended in 1971, the states have made modifications to the same and have their own compensation and relief & rehabilitation measures depending upon their requirements and necessities.

The need of the hour is to formulate a working land reforms and land acquisition law which could address the emerging new realities (like agitations by farmers after the land has already been acquired and compensation paid to them) related to the issue of land acquisition. The second thing is an active and willing co-operation/participation coming from the state governments. Involving the PRIs will provide a more durable and effective way out to this issue.

Meanwhile, on the proposed and revised **Land Acquisition Bill, 2013**, a political concensus has been reached *(on April 18, 2013)*—which paved the way for the Bill to get introduced in the current Session of the Parliament—it will replace India's existing *Land Acquisition Act, 1894*. The Bill is more careful, realistic and futuristic about the contemporary and emerging challenges of land acquisition in the country. The major highlights of the Bill are as follows:

(i) For the first time, resettlement and rehabilitation both have been emphasised on the same footing;
(ii) Scrutiny of all private purchase of land between 2011 and 2013 (there has been a concern among many that the land mafias have grabbed cheap land from the farmers before the proposed Bill has been passed by the government);
(iii) A provision to enable state legislation on leasing in place of acquisition of land;
(iv) Instead of acquisition, land to be leased to developers, so that the ownership remains with farmers and provides them a regular income. The government to amend the *Land Acquisition, Rehabilitation and Resettlement Bill, 2011*, to provide for an enabling provision to states for enacting laws in this regard (leasing of land is a state subject under the Constitution).

The new government at the centre has, meanswhile, proposed a new *Land Acquisition Bill, 2015*. The bill is faced with stiff opposition from the political parties in opposition farmers alike and is still to be passed by the parliament.

GAAR

The GAAR (General Anti-Avoidance Rules), originally proposed in the *Direct Taxes Code 2010*, are targeted at arrangements or transactions made specifically to avoid taxes. The government had decided to advance the introduction of GAAR and implement it from the financial year 2013–14 itself. More than 30 countries have introduced GAAR provisions in their respective tax codes to check such tax evasion.

The ***objective*** of the GAAR provisions is to codify the doctrine of *'substance over form'* where the real intention of the parties and purpose of an arrangement is taken into account for determining the tax consequences, irrespective of the legal structure of the concerned transaction or arrangement. It essentially comes into effect where an arrangement is entered into with the main purpose or one of the main purposes of obtaining a *tax benefit* and which also satisfies at least one of the following *four tests*:

(i) The arrangement creates rights and obligations that are not at arm's length,
(ii) it results in misuse or abuse of provisions of tax laws,
(iii) lacks commercial substance or is deemed to lack commercial substance, or
(iv) it is not carried out in a bona fide manner.

Thus, if the tax officer believes that the main purpose or one of the main purposes of an arrangement is to obtain a tax benefit and even if one of the above *four tests* are satisfied, the tax officer has powers to declare it as an impermissible avoidance arrangement and re-characterise the entire transaction in a manner that is more conducive to maximising tax revenues. There are many troubling aspects of this provision that will make doing business in India even more ***challenging***, than what it already is from a tax perspective—

(i) It is presumed that obtaining tax benefit is the main purpose of the arrangement unless otherwise proved by the taxpayer. This is an onerous burden that under a fair rule of law should be discharged by the revenue collector and not the taxpayer. In fact, the *Parliamentary Standing Committee on DTC* has specifically recommended that the onus of proving the existence of a tax-avoidance motive and a transaction lacking commercial substance, should rest with the revenue invoking GAAR and not shifted to the taxpayer. This is essentially to ensure that the revenue authorities exercise proper discretion, proper application of mind and gather enough credible data and evidence before attempting to invoke far-reaching provisions such as GAAR.

(ii) An arrangement will be deemed to lack commercial substance under GAAR if it involves the location of an asset or of a transaction or of the place of residence of any party that would not have been so located for any substantial commercial purpose other than obtaining tax benefit. This again is an amazingly wide provision that provides a great weapon in the armoury of the tax authorities to challenge almost every inbound or outbound transaction with respect to India, made through any of the favourable tax treaties that India has entered into. The governments intention becomes clear visibly by one of the finance ministry replies to the *Standing Committee on DTC*, where it has made it clear that the GAAR provisions will check *treaty shopping* by the taxpayer for avoidance of payment of tax in India.

(iii) GAAR allows tax authorities to call a business arrangement or a transaction 'impermissible avoidance arrangement' if they feel it has been primarily entered into to avoid taxes. Once an arrangement is ruled 'impermissible' then the tax authorities can deny tax benefits. Most aggressive tax avoidance arrangements would be under the risk of being termed impermissible. It has a provision according to which the onus to prove that an arrangement is 'impermissible' will lie with the tax department. The GAAR panel, the final body that will decide on the applicability of the law, will include an independent member. The rule can apply on domestic as well as overseas transactions.

(iv) GAAR is a very broadbased provision and can easily be applied to most tax-saving arrangements. Many experts feel that the provision would give unbridled powers to tax officers, allowing them to question any taxsaving deal. Foreign institutional investors are worried that their investments routed through Mauritius could be denied tax benefits enjoyed by them under the Indo-Mauritius Tax Treaty. The proposal *(announced on May 8, 2012)* had spooked stock market as FII inflows dropped on concerns, and the rupee hit a low of Rs. 53.47 to the Dollar.

Meanwhile, the government has postponed GAAR to the next financial year (i.e., 2016–17). This will give a breather to tax payers and also allow the government time to frame clear rules after consultations with stakeholders.

RISKS IN FOREIGN CURRENCY BORROWINGS

Corporate borrowers in India and other emerging economies are keen to borrow in foreign currency to benefit from lower interest and longer terms of credit. Such borrowings however, are not always helpful, especially in times of high currency volatility. During good times, domestic borrowers could enjoy triple benefits of

(i) lower interest rates,
(ii) longer maturity, and
(iii) capital gains

due to domestic currency appreciation. This would happen when the local currency is appreciating due to surge in capital flows and the debt service liability is falling in domestic currency terms. The opposite would happen when the domestic currency is depreciating due to reversal of capital flows during crisis situations, *as happened during the 2008 global crisis.*

A sharp depreciation in local currency would mean corresponding *increase in debt service liability*, as more domestic currency would be required to buy the same amount of foreign exchange for debt service payments. This would lead to ***erosion in profit*** margin and have 'mark-to-market' implications for the corporate. There would also be 'debt overhang' problem, as the volume of debt would rise in local currency terms. Together, these factors could create corporate distress, especially because the rupee tends to depreciate precisely when the Indian economy is also under stress, and corporate revenues and margins are under pressure.

In this context, it is felt that one of the factors contributing to faster recovery of the Indian economy after the 2008 global crisis was the low level of corporate external debt. As a result, the significant decline in the value of rupee did not have a major fallout for the corporate balance-sheets. Foreign currency borrowings, therefore, have to be contracted carefully, especially when no 'natural hedge' is available. Such natural hedge would happen when a foreign currency borrower also has an export market for its products. As a result, export receivables would offset, at least to some extent, the currency risk inherent in debt service payments. This happens because fall in the value of the rupee that leads to higher debt service payments is partly compensated by the increase in the value of rupee receivables through exports.

When export receivables and the currency of borrowings is different, the *prudent approach* is for corporations to enter *currency swaps* to re-denominate asset and liability in the same currency to create natural hedge. Unfortunately, too many Indian corporations with little foreign currency earnings leave foreign currency borrowings unhedged, so as to profit from low international interest rates. This is a dangerous gamble for reasons described above and should be avoided.

RECENT RTAs BY INDIA

Since India became one of the founding members of the WTO, its attention has grown towards the regional trade groupings. These groupings give regional competitveness to the economy and strengthens it to compete at the global level in a more organised way. Recent developments with regard to India's regional trade agreements (RTAs) have been given below: [18]

SAFTA

The SAFTA (South Asia Free Trade Area) Agreement came into force on January 1, 2006. Under it, India has granted *zero basic custom* duty to all LDCs, viz., Afghanistan, Bangladesh, Bhutan, and Maldives, on all items except 25 items relating to alcohol and tobacco. Under the SAFTA Agreement, India has reduced the SAFTA Sensitive List for non-LDCs from 878 to 614 by reduction of 264 tariff lines from September 6, 2012. As per the schedule of Tariff Liberalisation Programme (TLP) under SAFTA, India has brought down its peak tariff rates to ***5 the per cent from January 1, 2013***.

EHS

India-Thailand FTA, *Early Harvest Scheme* (EHS) under the Framework Agreement for establishing India-Thailand FTA was signed on October 9, 2003, which includes trade in goods trade in services, investment, and other areas of economic cooperation, to be concluded as a single undertaking. Under EHS, tariff has gradually been eliminated on a list of 82 common items

18. Department of Commerce, Ministry of Commerce and Industry, GoI, N Delhi, April 24, 2013.

simultaneously by both sides between September 1, 2004 and August 31, 2006. Under the India-Thailand FTA, it is proposed to provide ASEAN plus tariff concessions. So far 26 rounds of the India-Thailand Trade Negotiation Committee (ITTNC) meetings have been held. The last round was held on November 26–27, 2012 in New Delhi.

CECA

India-ASEAN Comprehensive Economic Cooperation Agreement (CECA) Services and Investment Agreements was signed on August 13, 2009 under the broader framework of the CECA between India and ASEAN which has already come into force. Conclusions of negotiations for the Services Agreement and Investment Agreement have been announced during the ASEAN-India Commemorative Summit held on *December 20, 2012* in New Delhi—legal scrubbing for these agreements were finalised in February 2013. The agreement will be signed during ASEAN Economic Ministers (AEM)-India Consultations in *August 2013*.

RCEP

During the 20th ASEAN Summit held in Cambodia in April 2012, ASEAN States agreed to move towards establishing an RCEP (Regional Comprehensive Economic Partnership) Agreement among *ASEAN + 6* (Australia, China, India, Japan, Korea, and New Zealand involving ASEAN and its FTA partners. The *objective* of launching RCEP negotiations is to achieve a modern, comprehensive, high-quality, and mutually beneficial economic partnership agreement among the ASEAN member States and ASEAN's FTA partners. The RCEP will *cover* trade in goods and services, investment, economic and technical cooperation, intellectual property, competition, dispute settlement, and other issues.

BITA

Fifteen rounds of negotiations and a number of inter-sessional and Chief Negotiator level meetings of BITA (India - EU Broad Based Trade and Investment Agreement) have been held till date. The 15th round was held in December 4–7, 2012 in New Delhi. Chief negotiator level meeting was held on *January 29–30, 2013* in New Delhi.

GSTP

The agreement establishing the GSTP (Global System of Trade Preferences) among developing countries was signed on April 13, 1988 at Belgrade following the conclusion of the First Round of Negotiations. Forty-three countries have ratified the agreement and become participants. India has offered tariff concessions on 70.08 per cent of dutiable tariff lines with an across-the-board *margin of preference* (MoP) of 20 per cent on the applied tariffs prevailing on the date of import. India has also unilaterally offered special concessions to LDC participants by granting an MoP of 25 per cent on 77 per cent of all its dutiable tariff lines. The Cabinet Committee on Economic Affairs (CCEA), in its meeting on August 23, 2012, has granted approval for implementing India's schedule of concessions. The tariff concessions are to be implemented in 30 days after a minimum of four participants ratify their schedules of concessions. So far India and Malaysia have ratified their schedules.

CRUDE OIL PRICE MOVEMENTS

Any major change in global commodity prices, particularly crude oil prices, has implication for the external sector as India is increasingly integrated with the rest of the world. India's rising two-way external-sector transactions have more than doubled as a proportion of GDP over the last ten years. Trade openness provides opportunities for higher growth through higher exports and makes available better quality products domestically at globally competitive prices.

India's large oil import dependence and the sharp rise in global crude oil prices, the widening of the CAD in 2011–12 and 2012–13 may be an atypical outcome. Changes in crude oil prices have direct bearing on India's CAD.

Historically, crude oil imports accounted for a substantial portion of the country's total imports. Petroleum, oil, and lubricants (POL) imports accounted for more than ***one-third*** of India's total imports in recent years. In 2013–14, POL imports accounted for 36.6 per cent of total imports and was estimated to be over 33 per cent in 2014–15. The changes in trade deficit and by implication CAD in recent years are largely explained by the changes in crude oil prices.

COMPOSITION OF TRADE

The commodity composition of India's trade has undergone many changes since liberalization and has been driven by trade policy, movements in international prices, and the changing pattern of domestic demand. Main features of India's composition of trade, as per the *Economic Survey 2014–15,* are as given below:

EXPORT COMPOSITION

- *Manufactured goods* constitute the bulk of exports—over 63 per cent in recent years, followed by crude and petroleum products (including coal) with a 20 per cent share, and agriculture and allied products with a share of 13.7 per cent share.
- The *top seven* product groups accounting for nearly 80.9 per cent of India's total exports in were shared as: petroleum products (19.4 per cent); gems and jewellery (13.0 per cent); agriculture and allied products (12.0 per cent); textiles and allied products (11.6 per cent); chemicals and related products (10.1 per cent); transport equipment (8.5 per cent) and machinery (6.3 per cent).

IMPORT COMPOSITION

- One of the major items in India's import basket is the POL group, which accounted for 36.6 per cent of India's total imports. POL imports surged with a growth of 46.2 per cent in 2011–12, mainly on account of significant increase in global crude oil prices.
- Capital goods imports are another major group which declined continuously from 2011–12 onwards. Within capital goods, imports of machinery registered positive growth in 2014–15.
- Gold and silver imports accounted for 11.4 per cent of India's total imports in 2012–13 and 7.4 per cent in 2013–14.

DIRECTION OF TRADE

There has been significant *market diversification* in India's trade in recent years—a process that has helped in coping with the sluggish global demand, which owes to a great extent to the weakness in the euro zone. Main features of India's direction of trade, as per the *Economic Survey 2014–15,* is given below:

INDIA'S EXPORTS

- Region-wise, India's export shares to Europe and America have declined over the years—from 23.6 per cent and 20.1 per cent, respectively in 2004–05 to 18.6 per cent and 17.2 per cent, respectively.
- India's exports to Asia and Africa have increased from 47.9 per cent and 6.7 per cent, respectively in 2004–05 to 49.4

per cent and 9.9 per cent respectively in 2013–14.

- The change in direction immediately prior to the global financial crisis and since 2010–11 indicates the process of diversification underway.
- Countrywise, India's exports to the USA and UAE—major destinations with a share in India's total exports of 12.5 per cent and 9.7 per cent, respectively. However, India's exports to China (4.7 per cent share) and Belgium (2.0 per cent share) declined by 14.7 per cent and 10.7 per cent during the same period.

India's Imports

- The share of Europe in India's imports also declined from 23.0 per cent in 2004-05 to 15.8 per cent while the shares of Asia and Africa increased substantially from 35.6 per cent and 3.6 per cent in 2004–05 to 60.7 per cent and 8.1 per cent, respectively.
- The share of America in India's imports has also increased from 8.8 per cent to 12.8 per cent.
- China is the major source of India's imports, accounting for 11.3 per cent of India's total imports, followed by Saudi Arabia (8.1 per cent share), the UAE (6.5 per cent share), and the USA (5.0 per cent share).

RECENT STEPS TO PROMOTE TRADE

The government has taken sveral new initiatives to promote trade conditions of India in recent times. Major ones, as per the *Economic Survey 2014–15*, are as given below:

(i) To promote domestic manufacturing capabilities, scrips issued under different schemes, namely FPS (Focus Product Scheme), FMS (Focus Market Scheme), VKGUY (Vishesh Krishi & Gram Udyog Yojana), SFIS (Served From India Scheme), AIIS (Agri Infrastructure Incentive Scheme), for import of goods can be utilized for payment of *excise duty* for domestic procurement. This is an important measure for ***import substitution*** and will help save foreign exchange as well as create additional employment.

(ii) Scrips issued under the FPS, FMS, VKGUY can be utilized for payment of service tax.

(iii) To support export of products from the North Eastern Region (NER), exporters are entitled to additional incentives of 1 per cent of FOB[19] value of exports in addition to other benefits under the FTP if exports are made from land customs station located in the NER.

(iv) To diversify India's exports, *7 new markets* (Algeria, Aruba, Austria, Cambodia, Myanmar, Netherlands Antilles, and Ukraine) have been added to the FMS, 7 new markets (Belize, Chile, EI Salvador, Guatemala, Honduras, Morocco, and Uruguay) to the Special FMS.

(v) To boost export of *services,* the government has organised two editions of a 'Services Conclave' in identified service sectors which are crucial to India.

19. **FOB** (Free On Board) is a transportation term related to the shipping of goods. Normally, the term FOB along with some point represents the sellers responsibility to the mentioned point, henceforth all freight, carriage and insurance costs to be borne by the buyer. The term is used by a seller 'FOB Chennai' means that the seller will pay all the expenses upto the port of Chennai (which includes cost of loading, Customs clearance, origin documentation charges, and other charges). Beyond this point, it will be the responsibility of the buyer to pay all the charges.

In the Conclave, barriers, if any, in the specific service sectors are identified and issues relating to the reforms needed, India's potential for enhancing exports in those sectors, and new markets for exporting services are discussed.

Global Services Exhibition was organized in April 2015 in New Delhi—as a platform for enhancing strategic cooperation and developing synergies between competitive players of the services sector and their global counterparts.

(vi) *Indian Trade Portal* was launched in December 2014. This portal provides vital information to Indian industry on forty-two export markets and also a mechanism to take advantage of the increased market access provided through various regional and bilateral free trade agreements (FTA) and comprehensive economic cooperation/partnership agreements (CECA/CEPA).

The information is provided in a user-friendly manner in four easy steps for exporters and importers to access the portal, which will contribute to ease of doing usiness for trade and industry. This portal makes available important data like:

(a) Most favoured nation (MFN) tariff,

(b) Preferential tariff,

(c) Rules of Origin (RoO), and

(d) Non-tariff measures.

(vii) In order to mainstream the *states* so that they focus expressly on boosting exports, the key steps required to be initiated by them have been distilled and listed. A *fifteen-point matrix* has been developed and sent to all states/union territories (UTs) to incorporate the following:

(a) Development of export strategy by the state government,

(b) Appointment of an Export Commissioner for coordination of all export-related activities by the state government, and

(c) Instituting export awards to motivate the leading exporters from the state and encourage them to bring in greater export revenues.

NEW FOREIGN TRADE POLICY

The GoI announced the new Foreign Trade Policy 2015–20 on April 1, 2015. The new five year Foreign Trade Policy, 2015–20 provides a framework for increasing exports of goods and services as well as generation of employment and increasing value addition in the country, in keeping with the Make in India. The focus of the new policy is to support both the manufacturing and services sectors, with a special emphasis on improving the 'ease of doing business'. The special features of the FTP 2015–20 are as follows:

1. Two new schemes have been intorduced, namely—

(i) Merchandise Exports from India Scheme (MEIS) for export of specified goods to
specified markets.

(ii) Services Exports from India Scheme (SEIS) for increasing exports of notified services, in place of a plethora of schemes earlier, with different conditions for eligibility and usage.

There would be no conditionality attached to any scrips issued under these schemes. Duty credit scrips issued under MEIS and SEIS and the goods imported against these scrips are fully transferable. For grant of rewards under MEIS, the countries have been categorized into 3 Groups, whereas the rates of rewards under MEIS range from 2 per cent to 5 per cent. Under SEIS the selected Services would be rewarded at the rates of 3 per cent and 5 per cent.

2. Measures have been adopted to nudge procurement of capital goods from indigenous manufacturers under the EPCG scheme by reducing specific export obligation to 75 per cent of the normal export obligation. This will promote the domestic capital goods manufacturing industry. Such flexibilities will help exporters to develop their productive capacities for both local and global consumption.
3. Measures have been taken to give a boost to exports of defense and hi-tech items. At the same time *e-Commerce* exports of handloom products, books/periodicals, leather footwear, toys and customized fashion garments through courier or foreign post office would also be able to get benefit of MEIS (for values upto INR 25,000). These measures would not only capitalize on India's strength in these areas and increase exports but also provide employment.
4. In order to give a boost to exports from SEZs, government has now decided to extend benefits of both the reward schemes (MEIS and SEIS) to units located in SEZs. It is hoped that this measure will give a new impetus to development and growth of SEZs in the country.
5. Trade facilitation and enhancing the *ease of doing business* are the other major focus areas—
   (a) One of the major objective of new FTP is to move towards paperless working in 24×7 environment.
   (b) The government has reduced the number of mandatory documents required for exports and imports to three, which is comparable with international benchmarks.
   (c) A facility has been created to upload documents in exporter/importer profile and the exporters will not be required to submit documents repeatedly.
   (d) Attention has also been paid to simplify various *Aayat Niryat Forms*, bringing in clarity in different provisions, removing ambiguities and enhancing electronic governance.
   (e) Approved Exporter System (AES) has been launched to enable manufacturers to self-certify their manufactured goods originating from India with a view to qualifying for preferential treatment under various forms of bilateral and regional trade agreements. This will help these manufacturer exporters considerably in getting fast access to international markets.
6. A number of steps have been taken for encouraging manufacturing and exports under 100 per cent schemes. The steps include a fast track clearance facility for these units, permitting them to share infrastructure facilities, permitting inter unit transfer of goods and services, permitting them to set up warehouses near the port of export and to use duty free equipment for training purposes.
7. Considering the strategic significance of *small and medium scale enterprise* in the manufacturing sector and in employment generation, *MSME Clusters-108* have been identified for focused interventions

to boost exports. Outreach activities will be organized in a structured way at these clusters with the help of EPCs and other willing *Industry Partners* and *Knowledge Partners*.

8. *Niryat Bandhu Scheme* has been galvanized and repositioned to achieve the objectives of Skill India.

The FTP Statement describes the market and product strategy and measures required for trade promotion, infrastructure development and overall enhancement of the trade ecosystem. It seeks to enable India to respond to the challenges of the external environment, keeping in step with a rapidly evolving international trading architecture and make trade a major contributor to the country's economic growth and development. The GoI promised to have regular interactions with all stakeholders, including State Governments to achieve the national objectives.